CFA INSTITUTE | Centre for Financial Market Integrity

5 September 2008

Mr. Gavin Francis
Director of Capital Markets,
International Accounting Standards Board
30 Cannon Street
EC4M 6XH
United Kingdom

Re: Comment Letter on the IASB Discussion Paper on *Financial Instruments with Characteristics of Equity*

Dear Mr. Francis,

The CFA Institute Centre for Financial Market Integrity (CFA Institute Centre),[1] in consultation with its Corporate Disclosure Policy Council (CDPC)[2], appreciates the opportunity to comment on the IASB Discussion Paper on *Financial Instruments with Characteristics of Equity (the "DP".)*

The CFA Institute Centre represents the views of its members, including portfolio managers, investment analysts, and advisors, worldwide. Central tenets of the CFA Institute Centre mission are to promote fair and transparent global capital markets, and to advocate for investor protections. Our goal is to help ensure that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality. The CFA Institute Centre also develops, promulgates, and maintains guidelines encouraging the highest ethical standards for the global investment community through standards such as the *CFA Institute Code of Ethics and Standards of Professional Conduct.*

1. INTRODUCTION

We welcome the efforts undertaken by the FASB and IASB to revisit the conceptual foundations that underlie the reporting of liabilities and equity and to seek a much more robust approach to the reporting of

[1] The CFA Institute Centre for Financial Market Integrity is part of CFA Institute. With headquarters in Charlottesville, VA, and regional offices in New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 96,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 134 countries, of whom nearly 82,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 135 member societies in 56 countries and territories.

[2] The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The Council is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the Council provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

560 Ray C. Hunt Drive
PO Box 3668
Charlottesville, VA
22903-0668 USA
434 951 5499 tel
434 951 5262 fax
info@cfainstitute.org
www.cfainstitute.org

claims against companies' assets. The development of appropriate standards for recognition, measurement and presentation of claims against the assets of companies is an increasingly vexing and challenging problem for standard setters. This problem has been exacerbated in recent decades as the pace of innovation in the development of financial instruments and various structured finance products has accelerated.

These innovations have also affected the nature of claims against the assets, i.e., liabilities and equity, as these changes have led to new products and services, new ways of shaping the distributions of risk and cash flows, and, unfortunately, new ways of circumventing extant accounting principles for claims. However, these innovations not only have challenged traditional liability and equity concepts, but have led to increasing efforts[3] to obscure the nature of the claims against the assets, and the risks and return distributions inherent in those claims.

Shortcomings of current literature

Under US Generally Accepted Accounting Principles (GAAP), the definition of liabilities for financial instruments is captured through multiple standards[4]. Under International Financial Reporting Standards (IFRS), the definition of liabilities is contained in IAS 32, *Financial Instruments: Presentation and Disclosure*. Both standards define liability instruments and treat equity instruments as residuals. Relative to US GAAP, IAS 32 is more restrictive in its definition of equity instruments. For example, puttable shares and instruments with contingent settlement provisions are reported as liabilities under IAS 32, but may be accounted for as equity under US GAAP.

Nevertheless, the principles in IAS 32 are more akin to a bolt-on set of principles focused on an outcome, rather than being a conceptually coherent set of principles. In addition, they can result in inconsistencies in the accounting for instruments with similar economic characteristics. Under IFRS, the form of settlement can dictate the classification criteria. For example, indirect ownership interests in an ESOP that are settled in cash are classified as liabilities, but ownership interests that are settled in shares are classified as equity. While the distinction between cash-settled, share-settled, or cash-or-share-settled instruments is an important one, we believe these classifications could be dealt with on a more

---

[3] This latter problem was not only recognized but was the main focus of the 15 June 2008 report of the SEC, *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* ("the Report"). The Report concluded that the following objectives should drive and inform standard setting and financial reporting for liabilities and other claims:

- discourage transactions and transaction structures motivated primarily and largely by accounting and reporting considerations, rather than economics;
- expand the use of objectives-oriented standards;
- improve the consistency and relevance of disclosures; and
- focus financial reporting on communication with investors, rather than just compliance with rules.

[4] 1) FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity* 2) FASB Statement No.133, *Accounting for Derivative Instruments and Hedging Activities* 3) Emerging Issues Task Force (EITF) Issue no: 00-19, *Accounting for Derivative Financial Instruments Indexed to, and potentially settled in, a company's own stock*

conceptually-robust basis if those distinctions were made by presenting them with clearly labeled separate line items in the financial statements

Due to conceptual inconsistencies of the principles contained in IAS 32, current accounting practice will struggle to keep pace with the innovation and proliferation of instruments. For example, as noted in the discussion paper, IAS 32 emphasizes the substance of instruments, but does not formally incorporate the linkage principle. That is likely to result in the necessity for perpetual interpretative guidance. Therefore, the efforts of the IASB to find a conceptually consistent and less complex approach are highly welcome. Moreover, such an approach would resonate with regulatory bodies and investors because it would help to reduce the complexity of reporting for financial instruments.

Importance of Defining Equity

The issue of whether to classify a financial instrument as either a liability or as equity is critical to the financial information reported to investors. For example, the determination will affect whether and how an instrument is re-measured, the reporting of gains and losses associated with re-measurement, and the characterization of the costs associated with the instrument, for example dividends vs. interest expense. Moreover, the classification may affect the determination of certain covenants included in credit agreements or bond indentures.

Based on the fundamental accounting equation on the relationship between assets, liabilities and equity, there are three possible approaches to defining either liabilities or equity, namely

- Define liabilities and treat equity as a residual. Both US GAAP and IAS 32 have adopted the approach of defining liabilities. However, this approach has created complexity for users because of the numerous interpretative challenges of classifying hybrid financial instruments with characteristics of both liabilities and equity.
- Define equity and treat liabilities as a residual. We believe this approach is the most sound and beneficial for investors. By narrowly defining equity, the boards can help eliminate the need for interpretative guidance on how to classify financial instruments and make financial reporting more transparent. The three approaches discussed in the DP fall along this trajectory.
- The third approach is to define both equity and liabilities and possibly have a mezzanine category for financial instruments that meets neither definition. However such an approach has the shortcoming of purposefully introducing a gray area and can only add to interpretative complexity.

2. BASIC OWNERSHIP APPROACH: OUR PREFERRED APPROACH

The discussion paper has presented three possible approaches for classifying financial instruments as equity: basic ownership, ownership settlement and reassessed expected outcomes. Under the basic ownership approach, an instrument would be classified as equity if it (1) is the most subordinated interest in an entity and (2) entitles the holder to a share of the entity's net assets after all higher priority claims have been satisfied. The holders of equity instruments are viewed as the owners of the entity. All other instruments, for example, all forward contracts, options, and convertible debt, would be classified as liabilities or assets. Instruments classified as liabilities or assets that have varying or uncertain settlement amounts would be measured at fair value with changes in fair value reported in income. The underlying principle of the basic ownership approach is that claims against the entity's assets are liabilities (or assets) if they reduce (or enhance) the net assets available to the owners of the entity.

From an investor perspective, we concur with the prioritization of the objectives of simplicity, conceptual consistency and economic relevance articulated by the FASB in its support of the basic ownership approach. We believe that the Basic Ownership Approach, if properly considered and developed, has the potential to provide the robust foundation for the reporting of claims of capital providers that is needed for 21^{st} century operations of companies. The reasons for our support include a) it being based on the perspective of residual claimants b) it's alignment with the proprietorship principle c) reduced accounting arbitrage opportunities and d) simplicity and conceptual consistency.

Residual Claimant Perspective

This approach, briefly summarized, recognizes that although individual claims can vary widely in their terms, e.g. maturity, amounts, seniority, collateral, contingencies, and the like, all must be ultimately satisfied from the assets held by the company. Thus, the claims of the *last residual claimants*, typically the common shareowners, whose claims will be satisfied from the net assets of the company, i.e., assets less liabilities and all other claims, are dependent upon the full satisfaction of all of the claims senior to those of the residual interest. Thus, if sufficient information is provided to fulfill the information needs of the residual claimants, then most or all of the information needs of the more senior claimants will be met as well, a principle already explicitly recognized in the extant conceptual frameworks of both the FASB and the IASB.

Thus, from the point of view of the residual claimants, what is important in assessing the value of their investments is a clear understanding of the risk and return distributions associated with each of the senior claims. Classes of equity with different voting rights or dividends are still equity. However, senior securities that have an equity kicker are not equity as they mainly participate in the upside.

Reduced accounting arbitrage opportunities

The basic ownership approach is likely to be sufficiently flexible to deal with financial innovations designed to try to circumvent clear, complete and transparent reporting of claims against assets. Relative to IAS 32 and current US GAAP, in addition to the narrow definition of equity, the linkage principle will be more expansively applied under the basic ownership approach and this will reduce gaming opportunities. We would encourage the IASB to adopt an anticipatory approach that narrows the definition of equity instruments and the potential for accounting arbitrage. Accounting policy is meant to be neutral and to reflect economic reality and the prevalence of accounting arbitrage is symptomatic of sub-optimal policy.

Alignment with Proprietary Principle

The basic ownership approach is conceptually consistent with reporting that is conducted from a residual claimant perspective and it formally recognizes the objective of financial reporting discussed in the conceptual frameworks of both the FASB and the IASB.

Simplicity and conceptual consistency

The basic ownership approach has the potential to greatly *enhance the transparency and usefulness* of the reporting of liabilities and equity by facilitating both simplicity and ease of implementation:

- Simplicity: Capital market participants typically make adjustments to the accounting numbers in their calculation of leverage ratios. The basic ownership approach provides a simple starting point when making those kinds of adjustments.
- Ease of implementation: In comparison to the ownership settlement and reassessed expected outcomes, the basic ownership approach has greater conceptual coherence and is easier to implement and, thus, is likely to result in higher levels of consistency. For example, it does not bear the conceptual inconsistencies of the ownership settlement where the form of settlement dictates classification. Nor does it have the implementation difficulties that are likely to arise from the very complex reassessed expected outcomes approach. Under the basic ownership approach there is less necessity to apply the separation principle and assess substance over form across a multitude of instruments. This lowers both compliance hurdles and interpretive complexity

3. COMMENT ON THE THREE PROPOSED APPROACHES AND RELATED MATTERS

The three approaches presented by both Boards present conceptually robust approaches on how to tackle the challenge of classifying financial instruments as either liabilities or equity. The approaches delineate and analyse various key principles that ought to inform the definition of the equity boundary. These principles include ownership, subordination and residual interest, maturity, settlement requirements (i.e. settlement form and date) and the directional consistency of fair value changes.

Given the proliferation and diversity of financial instruments, we appreciate the inherent difficulty in formulating any single conceptual model that can be totally exempt from gray areas arising in the accounting treatment of some of these instruments. We acknowledge that the basic ownership model as has been currently presented could leave areas of classification ambiguity if an instrument neither meets the definition of liabilities as understood under the current literature nor fulfills the basic ownership requirements. Nevertheless, compared to other models, the basic ownership approach provides a superior starting point for capital market participants to calculate economic leverage. This is due to its conceptual consistency and relative simplicity. The ownership settlement approach has similar shortcomings to IAS 32, as it comprises a set of conceptually inconsistent principles. This is evident in the proposed accounting treatment of preference and indirect ownership instruments. The reassessed expected outcomes approach will be very difficult to implement because of its conceptual difficulty.

Interaction with Conceptual Framework Project

We also recognize that these proposals, which aim to simplify the accounting for financial instruments, are preceding the finalization of the conceptual framework. The conceptual framework will address several important questions including the definition of equity and liabilities and the determination of the reporting entity. We emphasize the need for the board to ensure conceptual consistency across all key projects and across all layers of financial reporting, but we urge the two boards not to treat the outstanding conceptual framework deliberations as a 'show stopper' to the resolution of a pernicious problem. The board's decision on this matter can help inform the deliberations on the conceptual framework at a future date.

Re-measurement of preference shares, hybrids and mandatorily redeemable shares

We are concerned that the boards have not clarified the re-measurement and presentation treatments of preference shares and mandatorily redeemable shares. In the Comprehensive Business Reporting Model (CBRM), we advocate that all claims other than the basic ownership instruments ought to be accounted for on a fair value basis. In a prior comment letters[5] we stated our view that the information most useful to the residual claimant in assessing senior claims is the *current amount required to transfer or otherwise settle the claim in the market*. At the same time, we recognize and agree that information regarding the historical contractual terms associated with various instruments is also of interest for some purposes, e.g., assessing claims in bankruptcy, or long-term forecasting under the assumption of a healthy going concern, among others. However, we believe such information should be provided in the notes to the financial statements.

We support the fair value re-measurement of hybrid instruments. Such instruments are simply a means of financing in which the holder is given the opportunity to benefit from higher equity value, yet do not bear the residual risk. For example the holder of a convertible bond will convert only if the common stock rises but does not bear the downside residual risk of a common shareholder. In practice the convertible holder will simply sell unless it must convert to achieve the best price. Such instruments should be marked to market as liabilities.

For the same reasons, we support the fair value re-measurement of perpetual preference shares and mandatorily redeemable shares. For preference shares, their preference means that they recover their investment except in the case where the common equity is totally extinguished. Accounting standards are intended for going concerns, not bankrupt firms. Mandatorily redeemable preferred shares have the same economic characteristics as subordinated bonds because their holders lose only in bankruptcy.

Preferred shares and mandatorily redeemable shares represent a decision by managements to build a complex capital structure. In understanding their impact on the enterprise value of the entity, fair value is the most relevant measure of these shares. From an equity holder's perspective, the fair value of these items would represent an approximation of the amount the company would need to pay to settle these

[5] 1) Comment letter on FASB stance on Fair value accounting-dated 31st October 2006 2) Comment letter on FASB Fair value option dated 8th May 2006

shares and return the company to a simple capital structure. From a common equity holder perspective, any change in fair value in those priority shares has an impact on the value of the common shares. Any other measures are less relevant.

In parallel to resolving the liability and equity classification and thereafter re-measurement, we would urge the board to address the related financial statement presentation issues.

Conceptual approaches

Separation principle: In a previous comment letter[6], we expressed our agreement that compound financial instruments should be separated into liability and equity components. However, the bifurcation of instruments into equity and liability components imposes compliance and interpretive complexity. This is another reason we find the basic ownership approach to be superior because it minimizes the instances in which the separation principle has to be applied

Linkage and substance principles: We support the application of the linkage and substance principles. These principles will enable a better reflection of economic substance over form. As noted in the discussion paper, the basic ownership model will entail the application of the linkage principle to a greater extent than is the case under IAS 32. That will better inform users about economic realities.

Alternative approaches

Even though the three proposed approaches capture the key elements for classifying financial instruments as equity, for conceptual completeness we would encourage the IASB to further deliberate on the loss absorption and claims approach and to share the basis for its conclusions on these two. The other approaches include conceptual principles such as loss absorption and there is likely to be greater support for any one approach if the board has analyzed all plausible options.

---

[6] Comment letter dated May 1 2001 on FASB Proposed Statement on *Accounting for Financial Instruments with Characteristics of Liabilities, Equity or Both*

4. CLOSING REMARKS

If you, other board members or your staff have questions or seek further elaboration of our views, please contact either: Vincent T. Papa, CFA, by phone at +44.207.531.0763, or Patrick Finnegan, CFA, by phone at +1.212.754.8350. Alternatively, you may reach us at Vincent.Papa@cfainstitute.org or Patrick.Finnegan@cfainstitute.org.

Sincerely,

/s/Kurt N. Schacht	*/s/ Gerald I. White*
Kurt N. Schacht, CFA Managing Director	Gerald I. White, CFA Chair, Corporate Disclosure Policy Council

cc: Corporate Disclosure Policy Council