May 18, 2001

Director Research and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: File Reference No. 213-B and 213-C

Dear Sir:

The Committee on Corporate Reporting (CCR) of Financial Executives International is writing to provide its views on the Proposed Statement of Financial Accounting Standards, *Accounting for Financial Instruments with Characteristics of Liabilities, Equity or Both,* and the Proposed Amendment to FASB Concept Statement No. 6 (the "EDs").

After careful review, the Committee was unable to find any aspect of financial reporting that would be improved by adoption of either of these proposals. Given the difficulties encountered by companies in applying FAS 133, we believe that expanded application of bifurcation will not improve the quality of financial reporting. Moreover, the FASB has failed to provide compelling reasons why the issues these EDs purport to solve have not already been satisfactorily addressed by existing GAAP. We therefore respectfully request that both of these projects be dropped from the Board's agenda.

Financial Instruments with Characteristics of Both Liabilities and Equity

We strongly disagree with the Board's proposal to bifurcate financial instruments that include both liability and equity components. Under the proposed rules, many commonly understood compound financial instruments, such as convertible debt, will be split into two instruments and included in both the liability and equity sections of the balance sheet.

Some securities valuation professionals have raised doubts about the wisdom of bifurcating embedded derivatives under FAS 133. They say that bifurcated embedded features often are incredibly difficult to value when the components do not trade separately in the marketplace. Moreover, they point out that macro-economic factors, such as market interest rates, affect the value of each element in a compound instrument but, because of the interaction among the various elements, models do not exist that can determine how to attribute changes in value of the instrument as a whole to its hypothetical free-standing parts. One analogy provided by a valuation expert is illustrative of the problem: consider a chemist who mixes 2 liquids, then heats

them in the presence of a catalyst to form a solid. No chemist would purport that it is feasible to disaggregate the solid into the two liquids. Moreover, if one were to attempt to do so, no two chemists would likely follow the same approach to solve this difficult problem. So it is with financial instruments. At least under FAS 133, we can take some solace from the fact that, over time, these valuation discontinuities will reverse into earnings as the host instruments are ultimately settled. In other words, the measurement problems create timing differences that later reverse. In contrast, the categorization of the embedded elements into debt and equity required by the ED will create permanent differences in amount of cumulative gains or losses recognized in earnings.

For reasons discussed above, CCR believes that accounting for compound instruments based on their predominant characteristics, as presently required under GAAP, yields the most meaningful financial reporting results achievable.

<u>Financial Instruments With Multiple Settlement Alternatives</u>

The Board also proposes to change the accounting and classification of financial instruments that can be settled in cash or shares. The accounting for such derivatives has been debated extensively by the Emerging Issues Task Force and, through its efforts, a robust, tested framework has been developed for analyzing these arrangements. Instead of adopting this proven approach, the Board proposes a much narrower definition of equity based on whether or not it establishes an "ownership" relationship, which includes the following criteria:

> "...A financial instrument component establishes an ownership relationship if it (1) is an outstanding equity share that is not subject to mandatory redemption provisions or (2) is an obligation that can or must be settled by issuance of the issuer's equity shares and, to the extent the value that must be conveyed to the holder of the financial instrument upon settlement of the obligation at its maturity changes, the change is attributable to, equal to, and in the same direction as the change in fair value of the issuer's equity shares."

The conceptual grounding for the definition and its operationality are, at best, unclear. We believe that the approach taken by the EITF in Issue 00-19, which focuses solely on whether the obligation is to deliver shares and whether it is under the issuer's control, is far clearer and more understandable than the one proposed above. We concur with the views expressed by others that the relevant distinction between equity instruments and liabilities is the degree to which the capital provided is permanent: liabilities must be repaid, equity has no such requirement. This attribute is more important than whether there is an "ownership relationship" between the holder and the issuer. If an obligation can be satisfied by delivering an equity instrument in lieu of an asset, then the issuer has the ability to keep the proceeds or assets it received in exchange for the instrument. Conversely, if the issuer of a financial instrument is required to settle the instrument through the delivery of cash and/or another asset, then the capital raised is not permanent and should be classified as a liability or temporary equity (assuming the instrument does not provide creditor rights in bankruptcy).

We believe that the model developed by the EITF in Issue 00-19 identifies the relevant criteria necessary to determine whether an issuer has the ability to keep the proceeds of issuance, regardless of ownership relationship. The holders of such instruments

would be treated similar to common shareholders in bankruptcy and thus have no creditor rights. We support the conceptual basis of this guidance and believe it is superior to the guidance proposed in the EDs.

The Economic Unit Model

Although the ED makes no mention of this concept by name, the Board is employing the same "economic unit" model of the reporting entity which failed to gain any support from constituents in its last manifestation as the procedural cornerstone of the 1995 Consolidations ED. CCR certainly understands the Board's view that the Concepts Statements don't recognize minority interest as a separate category, that minority interest does not meet the conceptual framework's definition of a liability and that minority interest can therefore only be equity.

However, those who prepare and use financial statements have a substantially different view of equity than the Conceptual Framework appears to permit. We believe that the interests and rights of minority interest investors are so fundamentally different from the interests and rights held by parent company share owners that the two must never be confused. Moreover, the unique rights provided to minority share owners under state law and in bankruptcy, including the ability to sue the controlling interest, are more like those of debt-holders than share owners.

As to the relevance of combining minority interests with parent company equity interests, the ED does not clearly identify the financial reporting issue it is seeking to solve. The ED states that its proposed approach provides information that "is representationally faithful, understandable, and relevant to owners of the parent as well as to creditors and other resource providers of the parent," but it declines to explain exactly how that is so. It is unequivocally clear, as we have stated previously, that minority investors cannot hope to discern what portion of the enterprise their share represents, and thus are left to the subsidiary's financial statements for information. That aspect of the proposal is "no cost" because it will not change the behavior of those users. For investors in the parent, quite the opposite result occurs. Those users must ascertain how much of the consolidated position is attributed to minority, and re-create (at some cost) the current mezzanine financial reporting approach.

We strongly believe that the Board has no choice but to abandon the "economic unit" approach. We leave to the Board's discretion the challenge of devising a solution to the conceptual framework problem, but would not find any of the following as objectionable as the current proposal:

- Acknowledge the inconsistency but endorse existing practice
- Display minority interest as a contra-asset
- Revise the conceptual framework to include mezzanine instruments as liabilities.

As indicated in paragraph 236 of the basis for conclusions, the Board is well aware of the economic unit model's problems arising from dispositions of partial interests in subsidiaries that do not result in a loss of control. This is an area rife with opportunities for structuring transactions to put losses on such partial dispositions in equity and take gains through earnings. It is hard to imagine users continuing to give credence to financial statements containing such obvious gaming opportunities.

We also strongly disagree with the disclosure requirements proposed in paragraph 46. We suspect that the proposed display, which can best be described as a puzzle, will create enormous confusion among the few financial statement users who will attempt to understand the data. And yet at the consolidated level, there is no decision-useful information that can be derived from knowing the amount of minority interests attributable to specific financial statement line items between parent and minority interests. Without knowing the specific subsidiary to which those minority interests relate, this category is simply an amalgam of disparate and unrelated share owner holdings. We are therefore at a loss to explain what an investor will do differently as a result of knowing the amount of "other comprehensive income" attributable to minority share owners. After reviewing the proposed displays in Appendix B, our guess is that investors are likely to avoid that portion of the financial statements completely, as they seem to do with the simpler SFAS 130 display now.

****

CCR appreciates the opportunity to comment on these issues. We shall be pleased to answer any questions you may have regarding the views expressed above.

Sincerely,

Philip D. Ameen
Chair, Committee on Corporate Reporting
Financial Executives International

Attachment A
Responses to Specific Issues

Issue 1: Certain financial instruments that have the characteristics of liabilities, equity, or both also contain components that, if freestanding, would be assets. The Board decided not to address separation of asset components in the proposed Statement. Separate recognition of those components might be required by other authoritative pronouncements. Is the Board's decision not to address separation of asset components appropriate? If so, why? If not, why not?

We do not support the bifurcation of compound financial instruments that are issued and traded as one financial instrument. As discussed in our cover letter, the difficulties being experienced with implementing FAS 133 call into question the legitimacy of this approach. However, if a bifurcation approach is to be the framework for the accounting for these compound instruments, it is not clear why one would ignore imbedded assets. Why would the reclassification of an asset by allocation to a liability or equity component be better financial reporting?

Issue 2: This proposed Statement would require that the issuer of a compound financial instrument separate that instrument into its liability components and its equity components if certain conditions are met…

a. *Is the requirement to separate a compound financial instrument into its liability components and its equity components appropriate? If so, why? If not, why not?*
b. *Does this proposed Statement provide enough guidance for determining when and how a compound financial instrument should be separated into components? If not, what additional guidance would be helpful?*
c. *What implementation issues can be expected to arise as a result of the requirement to separate a compound financial instrument into its components?*

We do not support the bifurcation of compound financial instruments that are issued and traded as one financial instrument. The evolution of new instruments to provide capital to organizations has blurred the lines between equity and debt, and the display of compound instruments between equity and liabilities sometimes creates confusion for users of financial statements. However, as noted below, we believe a framework that would continue with present practice to assign the entire financial instrument to either liabilities or equity based on its predominant characteristics is a more sound approach.

The Board's approach will create major implementation issues related to non-traded, thinly traded and illiquid instruments. For these financial instruments and their separate components, valuation will be very problematic. Our experience implementing FAS 133 demonstrates the difficulties in valuing these financial instruments and the various imbedded financial components. Without observable transactions, preparers use various methods of valuation using models. We do not believe the reliability of these measurements is sufficient to support bifurcation.

Issue 3:

a. *Do you agree with the Board's conclusion that certain obligations that permit or require settlement by issuance of the reporting entity's shares should be classified as liabilities?*

b. *Do you agree with the Board's conclusion that a financial instrument component that does not establish an ownership relationship should not be classified as equity?*
c. *Do you believe that the Board has made an appropriate distinction between equity-settled obligations that should be classified as equity and equity-settled obligations that should be classified as liabilities?*

We do not agree with this proposal, but rather believe that EITF Issues 96-13, 00-7 and 00-19 provide a much better framework for determining whether a financial instrument is a liability or equity.

Ownership is only one criterion that should be considered. As the EITF issues illustrate, other factors are also relevant to this classification -- for example, the method of settlement, whether the issuer or counterparty determines method of settlement, requirements to post collateral, and the nature of events that trigger settlement that are out of the control of the issuer.

We do not support the Board's conclusion that obligations that permit or require settlement by issuance of the reporting entity's shares should be classified as liabilities if the monetary value of the shares to be issued is fixed. Whether the number of shares to be issued is fixed or variable should not determine whether the financial instrument is a liability or equity. The framework to account for a variable number of shares to be issued has been effectively addressed in the EITF issues. In addition, we are concerned that the framework would result in different accounting for economically similar transactions.

Issue 4: Under the approach in this Statement, any financial instrument that is issued in the form of shares that are subject to mandatory redemption provisions (that is, subject to redemption upon a specified date or upon the occurrence of an event that is certain to occur) are classified as liabilities. That would include shares issued by some privately held companies that require that the share be resold to the issuer upon the holder's termination of its ownership position (whether by selling the shares of by death). That conclusion would reduce (and in some cases eliminate) the equity of some privately held entities. (Alternatively, a privately held entity's shares may be puttable to the issuer at the fair value of the shares at the date the put option is exercised. …) Are there other factors that the Board should consider regarding the applicability of its conclusion on shares subject to mandatory redemption provisions to privately held entities that issue that type of security?

We agree that mandatorily redeemable financial instruments should be classified as liabilities. However, the private company example illustrates the difficulty with the proposed obligation based standard. Many private companies have some form of repurchase to assist with management/ownership transition or provide liquidity to the shares. As this question clearly illustrates, this standard could dramatically change the financial statements of closely held companies where ownership and management interests are so closely intertwined. Creditors of these organizations routinely look to the specific nature of the puts, redemption provisions, age of owner, financial means to execute the buyback, etc. Thus, many factors are considered by the lender to determine the quality of equity instruments. We expect that this would continue no matter how these financial instruments are classified. The results of applying these requirements are so counterintuitive that we had

considered proposing that private companies should be exempt from this requirement if all of the equity holders are subject to the same redemption provisions. Upon further consideration, however, we concluded that the need to do so is indicative that there is a fundamental problem with the principle and that proposal requirements should be fixed instead.

Issue 5: If a financial instrument has multiple settlement alternatives and the monetary values of those settlement alternatives have the potential to differ, this proposed Statement would require that the settlement alternatives be considered separate components of a compound financial instrument. For purposes of initial measurement of those components, the following general rules would apply:

a. *If a compound financial instrument has no component that is an outstanding share of stock, the obligations that is classified as a liability should be considered an unconditional obligation and the obligation that is classified as equity should be considered a conditional obligation.*
b. *If a compound financial instrument has a component that is an outstanding share of stock (other than mandatorily redeemable stock), the instrument should be considered to comprise (1) an outstanding share of stock and (2) a conditional obligation.*

Do you agree with the Board's conclusions? Are there circumstances in which those general rules would result in initial measurement of components that you consider inappropriate? If so, what are those circumstances?

These issues again point out the implementation difficulties that are created when the financial instruments are bifurcated. To further complicate the measurement by introducing a concept based on conditional and unconditional obligations makes it exceptionally difficult for preparers and increases confusion for users. In the EITF framework, the issue of a variable number of shares is dealt with by setting rules that require valuation at a specified date, in a specified manner, which eliminate the need for further bifurcation and accounting.

Issue 6: This proposed statement would require that the issuer of a compound financial instrument allocate the proceeds of issuance of the instrument to its separately classified liability components and equity components using the relative-fair-value method. That requirement would apply in all circumstances except when (a) the instrument contains a component that is a derivative subject to the requirements of FASB Statement 133 or (b) application of the relative –fair-value method is impracticable because the fair value of one or more components cannot be reliably determined. Is the requirement to use the relative-fair-value method appropriate? If not, why not? Are there other circumstances in which that method should not be required?

If the compound financial instrument is to be bifurcated, these methods are acceptable, but the intrinsic value method may also be appropriate for some instruments.

Issue 7: This proposed Statement would require that an equity instrument that is issued by a consolidated subsidiary of the reporting entity and that represents the noncontrolling interest in that subsidiary be reported in the consolidated financial statements as a

separate component of equity. Do you agree with the Board's conclusion that the noncontrolling interest is part of the equity of the consolidated group? If not, why not? What implementation issues can be expected to arise as a result of that decision?

We do not understand how the inclusion of minority investors' interests in subsidiaries is consistent with the Statement's concept of ownership relationship. The minority investors in a subsidiary do not have the same interests as the investors in the consolidated group, and often interests that are in direct conflict. We do not believe these interests should be reported as a component of consolidated equity, but rather should continue to be a separate classification outside of equity.

Issue 8: In accordance with the Board's conclusion that shares of a consolidated subsidiary that represent the noncontrolling interest are equity of the consolidated entity, sales of those shares to entities outside the consolidated group would be considered equity transactions. Accordingly, no gain or loss would be recognized on those sales as long as the subsidiary remains consolidated. Do you agree with the Board's conclusion related to recognition of gain or loss on sales of subsidiary shares? If so why? If not, why not?

Minority interests should not be addressed in this Statement. However, if the Board chooses to retain this issue within the Statement, we do not agree with the proposed treatment. Gains and losses on all sales of shares of subsidiaries should be accounted for in the same manner, whether or not they are consolidated. To classify sales of shares in consolidated subsidiaries as an equity transaction does not properly reflect the transfers of future economic benefits of ownership of the subsidiary to outside interests.

Issue 9: For an entity with one or more less-than-wholly-owned subsidiaries, this proposed Statement would require that amounts displayed as line items in the income statement and amount displayed as components of other comprehensive income include amounts attributable to both the controlling interest and the noncontrolling interest. An entity with one or more less-than-wholly-owned subsidiaries would be required to disclose the amounts attributable to the controlling interest for the following items if they appear in the financial statements:

- *Income from continuing operations*
- *Discontinued operations*
- *Extraordinary items*
- *Cumulative effect of changes in accounting principle*
- *Net income or net loss*
- *Total comprehensive income*
- *Each component of other comprehensive income.*

An entity with one or more less-than-wholly-owned subsidiaries that displays comprehensive income and its components in a statement of changes in equity would be required to display aggregate amounts and amount attributable to the controlling interest and the noncontrolling interest for each component of comprehensive income. Do you agree with the Board's conclusions related to presentation and disclosure requirements for an entity with one or more less-than-wholly-owned subsidiaries?

This question demonstrates the confusing presentation resulting from the proposed Statement. On the other hand, it appears that this array of data is absolutely necessitated by the approach to minority interest accounting. It appears that the Board is violating one of the fundamental tenets of successful standards setting, namely, never attempt to cure bad accounting with disclosure.

Issue 10: This proposed Statement would require that an entity that presents earnings-per-share information in accordance with FAS 128 present on the face of the income statement a total for adjustments to net income (or net loss) or to net income (or net loss) attributable to the controlling interest to arrive at the numerator for the calculation of basic earnings per share. Do you agree with the requirement to present that total on the face of the income statement?

No. Earnings per share should only include net income attributable to the controlling interest shareholders.

Disclosures

Issue 11: The disclosure requirements of the proposed Statement are included in paragraph 45. Do you agree with those requirements? If not, why what disclosure requirements would you omit or add?

This amount of disclosure is not necessary. Only the nature of the financial instrument should be described.

Effective Date and Transition

Issue 12: This proposed Statement would require that in the initial year of adoption an entity restate all financial statements for earlier years presented for the effects of financial instruments with the scope of this Statement that were outstanding at any time during the initial year of adoption. An entity would be permitted, but not required to restate all financial statements presented for the effects of financial instruments that were not outstanding at any time during the initial year of adoption. An entity that elects to restate for those financial instruments would be required to restate all financial statements presented for the effects of all financial instruments within the scope of the Statement that were outstanding in any period presented, beginning with the earliest year presented. The cumulative effect of adopting this proposed Statement would be required to be included in the earliest year restated.

This proposed Statement also would require that an entity whose consolidated financial statements include one or more less-than-wholly-owned subsidiaries at any time during the initial year of adoption restate all financial statements presented for earlier years that include those subsidiaries to classify the noncontrolling interest as equity. The entity also would be required to restate all financial statements presented for the effects of any gains or losses on any sales of a subsidiary's shares that were not accounted for in accordance with paragraphs 37 and 38 of this Statement. An entity would be permitted but not required to restate all financial statements presented for the classification of the noncontrolling interest and any gains or losses recognized on sales of a subsidiary's shares for the noncontrolling interests that did not exist at any time during the initial year of adoption. An entity that elects to restate for those noncontrolling interests and associated gains and loses would be required to restate all financial statements presented for the effects of all noncontrolling interests that existed and all those gains and losses that were

recognized in any period presented, beginning with the earliest year presented. This proposed Statement would not require that an entity recognize a cumulative effect for gains of loses on sales of a subsidiary's shares in periods that are not restated.

Would another transition method be more appropriate? If so, what method and why?

We believe it will be extremely difficult to try to restate financial statements, and determine relative fair values for compound instruments that have never been measured by component. If the Board proceeds with the ED's in something approximating their present form, we prefer that the fair value of each outstanding financial instrument be established on the initial day of adoption, with prospective application. This would be consistent with transition provisions of FAS 125 and 133 that also use a financial components approach.

Public Hearings

Issue 13: The Board has not yet determined whether there is a need for a public hearing or other forum. The Board will assess that need based on comment letters received. Any respondent that wishes to participate in such a meeting, if one is held, should indicate a desire to do so.

Due to the significant changes in the accounting for many financial instruments, and the controversial nature of its proposals on minority interests, we urge the Board to hold public hearings on these changes before finalizing the EDs.

Proposed Amendment to FASB Concepts Statement No. 6 to Revise the Definition of Liabilities

Since we do not support the proposed Statement for liabilities and equity, we do not believe an amendment is needed. On the other hand, if the minority interest issue can be solved by changing the definition of what constitutes a "liability," we urge the Board to proceed.