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4 September 2008

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Re: Discussion Paper, *Financial Instruments with Characteristics of Equity*

Deloitte Touche Tohmatsu is pleased to comment on the IASB Discussion Paper, *Financial Instruments with Characteristics of Equity.*

We strongly support the development of a high-quality standard addressing how to distinguish between liabilities and equity. Accounting for financial instruments with characteristics of both liabilities and equity is one of the most complex and challenging areas of existing accounting literature for preparers, auditors, and users of financial statements (particularly the accounting for convertible debt securities and derivatives indexed to, and potentially settled in, an entity's own equity shares). In addition, current accounting is sometimes driven more by how a transaction is structured (e.g., whether a feature or option will be settled in a fixed number of shares for a fixed amount of cash) than by the transaction's economic characteristics and risks. Therefore, we believe that establishing a set of internally consistent principles that produce relevant financial information and reduce accounting complexity in this area of financial reporting should be a high priority for both the IASB and the FASB.

Because of the pervasiveness of these issues, we strongly encourage the IASB, jointly with the FASB, to develop a new classification approach. Given the high degree of interdependence between this project and the joint projects on financial statement presentation and the conceptual framework, we recommend that these projects be closely coordinated. In addition, because the classification and measurement of certain instruments under the basic ownership approach would be a significant change to — and present more variability in — the statements of position and performance, the effects of these changes on regulatory guidance should be studied further, particularly when regulatory guidance is globally promulgated.

While each of the three classification approaches outlined in the Discussion Paper addresses some of the problems with existing accounting literature, we do not support any of these approaches in their current form. As more fully discussed in the attachment to this comment letter, we believe that each approach currently has a number of fundamental conceptual and operational deficiencies that need to be addressed before it can be an effective classification principle.

Although the basic ownership approach in its current design has certain fundamental deficiencies, we believe that approach — appropriately modified — is a suitable starting point for a project to improve and simplify IAS 32.[1] In the Appendix, we propose certain modifications to the basic ownership approach that we believe are necessary to create an effective conceptual classification principle and to make the basic ownership approach operational and useful to financial statement users. We believe that if those proposed

[1] IAS 32, *Financial Instruments: Presentation*.

modifications are made, the basic ownership approach has the potential to improve financial reporting significantly by (1) reducing complexity, (2) providing a clear and conceptually coherent distinction between liabilities and equity, (3) classifying instruments on the basis of their economic characteristics and risks rather than their form, (4) reflecting the dilutive effect of derivatives indexed to an entity's basic ownership instruments on current owners, and (5) reducing the ability to structure various instruments to achieve a desired accounting result.

Because the classification principles in the ownership-settlement approach rely more on an instrument's form of settlement than on its economic characteristics and risks, we prefer an appropriately modified basic ownership approach to the ownership-settlement approach. In particular, we believe that instruments with similar economic characteristics and risks should be classified consistently irrespective of their form of settlement. Finally, while the reassessed expected outcomes approach has some conceptual merits, we believe its complexity and operational challenges significantly outweigh its benefits.

The Appendix to this comment letter provides our responses to the questions raised by the IASB in its Invitation to Comment on the FASB's Preliminary Views document. In addition, attached at the end is the comment letter submitted by Deloitte & Touche LLP (United States) to the FASB on May 30, 2008, along with responses to each of the questions raised by the FASB in its Preliminary Views document (with minor editorial modifications). We share the views expressed in that letter.

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We appreciate the opportunity to comment on the Preliminary Views document. If you have any questions concerning our comments, please contact Ken Wild in London at +44 (0) 207 007 0907 or Robert Uhl in Wilton, the United States, at +1 (203) 761-3152.

Yours truly,

Ken Wild
Global IFRS Leader

APPENDIX
Deloitte Touche Tohmatsu
Reponses to IASB's Invitation to Comment

Question 1: Are the three approaches expressed in the FASB Preliminary Views document a suitable starting point for a project to improve and simplify IAS 32? If not, why?

We do not support any of the approaches in the Discussion Paper in their current form because we believe that each approach has conceptual and operational deficiencies that need to be addressed before the issuance of a final standard to improve and simplify IAS 32. However, we believe that an appropriately modified basic ownership approach has the potential to improve current financial reporting significantly. In Attachment to this comment letter, we propose certain modifications to the basic ownership approach that we believe are necessary to create an effective conceptual classification principle. Under this modified approach, and as explained more fully in the Attachment, only instruments meeting the characteristics of a direct equity ownership interest would be classified within equity. The Attachment proposes the following definition for a direct equity ownership interest:

> A direct interest in an issuer that provides the holder with a claim to a share of the issuer's assets (such as a common or preferred share or partnership interest, but not an indirect ownership interest or contract — such as a derivative — that is indexed to, and potentially settled in, direct equity ownership interests) that in a *going concern* meets all of the following conditions:
>
> 1. It shares substantially in the risks and rewards of ownership of the issuer's net assets through any of the following:
>
>   a. Payments of discretionary amounts of dividends or distributions (or a participation right in such amounts).
>   b. A requirement to pay an amount designed to approximate the holder's proportionate share of the issuer's net assets (e.g., a common share redeemable at fair value).
>   c. A requirement imposed by contract, law, or statute to distribute a proportion of the holder's share of the current-period change in the issuer's net assets.
>
> 2. It does not contain a requirement to (a) deliver assets, services, or direct equity ownership interests or (b) exchange assets, liabilities, services, or direct equity ownership interests, other than a requirement described in (1) above.
>
> 3. It is an interest in an entity that remains after all requirements to (a) deliver assets, services, or direct equity ownership interests or (b) exchange assets, liabilities, services, or direct equity ownership interests on terms that are unfavorable to the entity are satisfied (other than the exceptions discussed in (1) above).

We believe our proposed definition of a direct equity ownership interest is conceptually superior to the definition of a basic ownership instrument because it classifies instruments on the basis of their economic characteristics and risks while taking into account the issuer as a going concern. As more fully discussed in the Attachment, we believe two fundamental deficiencies of the basic ownership approach are that it classifies a financial instrument (1) on the basis of its priority in liquidation rather than its economic characteristics and risks in a going concern and (2) irrespective of whether the instrument embodies an obligation or requirement to transfer economic resources to the holder. Therefore, we do not support the classification approach in the basic ownership approach in its current form. For example, the current definition of a basic ownership instrument excludes some perpetual instruments from equity classification (e.g., certain perpetual preferred securities, senior common shares, and limited partnership interests) solely because an instrument is senior in priority to the most residual common share in the event of liquidation.

Our proposed definition of a direct equity ownership interest allows existing ownership interests with economic characteristics and risks similar to those of the most subordinate class of common shares in a going concern — such as senior classes of common shares with preferential rights in liquidation, perpetual preferred securities with a liquidation preference but without a fixed or determinable redemption or payment requirement, limited partnership interests, and existing ownership instruments that are redeemable at fair value — to be classified within equity. We believe this classification principle is conceptually superior to the definition of a basic ownership instrument because it better reflects the going-concern assumption of preparing financial statements and the economic characteristics and risks of various instruments.

Question 1(a): Do you believe that the three approaches would be feasible to implement? If not, what aspects do you believe could be difficult to apply, and why?

Basic Ownership Approach

As discussed more fully in the Attachment, we do not agree with the proposal under the basic ownership approach to classify as liabilities perpetual instruments that, in a going concern, have economic characteristics and risks similar to those of the most subordinate class of interests. Moreover, we believe the Board should further consider how to present, in a comprehensive income statement, changes in value of instruments that would be classified as assets or liabilities under the basic ownership approach. In addition, we believe the Board should carefully consider the following implementation issues:

- Measuring perpetual instruments at fair value through current-period earnings may increase the subjectivity of reported earnings. Many perpetual instruments are not actively traded and therefore do not have readily determinable fair values.

- Classifying perpetual instruments as liabilities may affect the amount of capital an entity is considered to have under certain regulatory regimes.

- Classifying perpetual instruments as liabilities may cause entities to appear significantly more leveraged than they are under current accounting literature. This may result in the need to renegotiate debt agreements to avoid violating debt covenants that are based on an entity's leverage.

Ownership-Settlement Approach

Relative to the other approaches in the Discussion Paper, the classification principles in the ownership-settlement approach most closely resemble the existing accounting literature in IAS 32. However, we believe that the ownership-settlement approach still has significant implementation and conceptual issues that the Board needs to consider carefully, including the following:

- The ownership-settlement approach requires that to achieve equity classification, an equity derivative must be settled in a fixed number of equity shares for a fixed amount of cash. In practice, this "fixed-for-fixed" concept already exists in IAS 32 but can be difficult to interpret and apply because almost all freestanding and embedded derivatives indexed to, and potentially settled in, the entity's equity shares have terms that permit exercise or adjustment of the settlement amount if certain events occur (e.g., standard provisions in ISDA master agreements that are intended to compensate the holder for dilutive actions or events). Determining whether a settlement formula is truly fixed-for-fixed is an implementation issue under IAS 32 and, under U.S. GAAP, was a focus in the recently ratified Issue 07-5.[2]

- Even if a contract indexed to, and potentially settled in, the entity's equity shares provides for gross physical settlement and meets the fixed-for-fixed principle in IAS 32, the issuer may, in certain circumstances, be forced to cash-settle the contract. Under U.S. GAAP, Issue 00-19[3] includes a list of conditions that must be assessed to determine whether an issuer "truly" has the ability to share-settle a contract. Such assessments may require significant judgment and increase accounting complexity.

- The ownership-settlement approach classifies some instruments as liabilities or equity on the basis of their form of settlement rather than their economic characteristics and risks (e.g., some derivatives on an entity's own equity shares). Classifying contracts on the basis of their form of settlement rather than their economic characteristics and risks increases opportunities for structuring.

- The ownership-settlement approach classifies some instruments within equity that do not represent *current* ownership interests. For example, certain derivatives indexed to an issuer's equity shares, such as an outstanding call option or warrant, may result in the issuer's delivering its common shares to the holder on a future date. However, the call option or warrant does not represent a *current* ownership interest until the shares are actually delivered. In this case, the holder of the derivative typically has economic characteristics and risks different from those of a common shareholder and lacks rights held by current holders of common shares, such as the ability to vote or the right to dividend distributions. Therefore, equity under the ownership-settlement approach does not represent only the interests of current owners of an entity.

Reassessed Expected Outcomes (REO) Approach

Because of the complexities associated with the REO approach, we believe it would not achieve the Board's objective of reducing complexity in financial reporting. In addition, we are concerned that the REO approach may yield information that is not easily understandable to financial statement users. While the REO approach has some conceptual merits, we believe that the following operational challenges significantly outweigh its benefits:

- Determining the appropriate probability weight of a particular outcome may be subjective and require the use of complex models. In addition, such a determination may require an issuer to consider the behavioral characteristics of an instrument's holder as well as the issuer's own intentions.

[2] EITF Issue No. 07-5, "Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock."
[3] EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock."

- Reassessing an instrument's classification as of each reporting date significantly increases the complexity of the classification assessment relative to current accounting literature. Continually reconsidering an instrument's classification may result in volatility of stockholders' equity as an instrument's classification changes each period.

- Separating hybrid instruments and all derivatives indexed to, and potentially settled in, an entity's equity shares into component parts requires careful consideration of the appropriate separation method.

- Requiring all instruments, including equity instruments, to be remeasured at fair value through current-period earnings significantly increases complexity and the subjectivity of reported earnings. Determining the fair value of an instrument may be particularly difficult when the instrument is not traded in an active market (e.g., nonpublic entities) or the separated component of an instrument does not actually exist in the marketplace.

Question 1(b): Are there alternative approaches to improve and simply IAS 32 that you would recommend? What are those approaches and what would be the benefit of these alternatives to users of financial statements?

As discussed in the Attachment, we propose that the Board use an appropriately modified basic ownership approach as the starting point for a project to improve and simplify IAS 32.

Question 2: Is the scope of the project as set out in paragraph 15 of the FASB Preliminary Views document appropriate? If not, why? What other scope would you recommend and why?

We question whether the language about the project's scope in paragraph 15 of the FASB Preliminary Views document is necessary. We believe that for a conceptual classification principle to be effective, it must apply equally to **all** instruments entered into or issued by an entity, regardless of the form of the instrument or whether the instrument meets certain prescriptive conditions. Because a conceptual classification principle must include conceptual definitions of both a liability and equity, we believe that **any** instrument issued or entered into by an entity must be assessed for appropriate classification on the basis of these definitions. Therefore, we do not believe that the Board needs to identify specific instruments that are within the scope of the Discussion Paper.

Question 3: Are the principles behind the basic ownership instrument appropriate to any types of entities or in any jurisdiction? If so, to which types of entities or in which jurisdictions are they inappropriate, and why?

As discussed in more detail in the Attachment, we believe that the principles behind the basic ownership approach are not appropriate to perpetual instruments that, in a going concern, have economic characteristics and risks similar to those of basic ownership instruments. We have identified several situations below in which we believe the principles in the basic ownership approach in its current form do not provide an appropriate classification result:

- *Senior classes of common shares or other equity interests* — We believe it is inappropriate to classify senior classes of common shares or other equity interests as liabilities solely because they have preferential rights in liquidation. If their economic characteristics and risks, in the absence of liquidation, are similar to those of a basic ownership interest (such as proportionate participation rights in common share dividends), we believe they should be classified as equity.

- *Certain preferred securities* — Some perpetual preferred shares or components thereof in a going concern have economic characteristics and risks similar to those of basic ownership interests. We believe that such preferred shares should be classified as equity. One example is a perpetual preferred share with a liquidation preference and a participation right in common share dividends, but without a fixed or specified redemption or payment requirement.

- *Limited partnerships* — Limited partnerships are entities made up of at least one general partner and at least one limited partner. In many partnership agreements, the rights of the limited partner to distributions of profit and loss or to the net assets of the partnership in liquidation are senior to those of the general partner. Under the basic ownership approach, this priority over the general partners would result in classification of the limited partnership interest as a liability rather than equity. However, distributions to holders of limited partnership interests often are not fixed or determinable but represent a participation right in the profit and loss of the entity's operations. We believe the principles in the basic ownership approach may not faithfully represent the capital structure or ownership characteristics of the limited partnership.

- *Certain entities incorporated in jurisdictions that require distributions of earnings* — In certain jurisdictions, some entities are legally required to distribute a specified amount of their retained earnings or operating income each year to their equity holders. Under the basic ownership approach, this required dividend payment may require separation from the equity interest or may cause the entire equity interest to be classified as a liability. We believe the principles in the basic ownership approach may not faithfully represent the capital structure or ownership characteristics of these entities.

Question 4: Are the other principles set out in the FASB Preliminary Views document inappropriate to any types of entity or in any jurisdictions (Those principles include separation, linkage, and substance)? If so, to which types of entities or in which jurisdictions are they inappropriate, and why?

Please refer to our response to Question 4 above and our responses to the questions posed by the FASB in the attachment to this letter.

Question 5: Please provide comments on any other matters raised by the discussion paper.

Please see our responses to the questions posed by the FASB in the attachment to this letter.

ATTACHMENT
Deloitte & Touche LLP
Comment Letter Submitted to the FASB

May 30, 2008

Ms. Suzanne Bielstein
Director of Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

File Reference: 1550-100
Re: Preliminary Views — *Financial Instruments With Characteristics of Equity*

Dear Ms. Bielstein:

Deloitte & Touche LLP is pleased to comment on the FASB's Preliminary Views document, *Financial Instruments With Characteristics of Equity*.

We strongly support the FASB's initiative to develop a high-quality standard to address how to distinguish between liabilities and equity. Accounting for financial instruments with characteristics of both liabilities and equity is one of the most complex and challenging areas of existing U.S. GAAP for preparers, auditors, and users of financial statements (in particular the accounting for convertible securities and derivatives indexed to, and potentially settled in, an entity's own shares). In addition, current accounting is sometimes driven more by how a transaction is structured (such as whether a feature or option is freestanding or embedded) than by the transaction's economic characteristics and risks. Therefore, we believe that establishing a set of internally consistent principles that produce relevant financial information and reduce accounting complexity in this area of financial reporting should be a high priority for the FASB.

Because of the pervasiveness of these issues and the importance of international convergence, we strongly encourage the FASB and IASB to jointly develop a new classification approach. Given the high degree of interdependence between this project and the projects on financial statement presentation and the conceptual framework, we recommend that these projects be closely coordinated. Also, the classification and measurement of certain instruments under the basic ownership approach will be a significant change to and present more variability in the statements of position and performance; the effect of these changes on other FASB projects, issued accounting guidance, and regulatory guidance should be studied further.

While the basic ownership approach as outlined in the Preliminary Views document is effective in addressing some of the problems with existing accounting literature, we believe its current design has a number of fundamental deficiencies. As a result, we do not support the basic ownership approach in its current form. We believe that certain fundamental modifications are necessary to create an effective conceptual classification principle and to make the basic ownership approach operational and useful to financial statement users. We do believe that if it is appropriately designed, a modified basic ownership approach has the potential to significantly improve financial reporting by (1) reducing complexity, (2) providing a clear and conceptually coherent distinction between liabilities and equity, (3) classifying instruments on the basis of their economic characteristics and risks rather than their form, (4) reflecting the dilutive effect of derivatives indexed to an entity's basic ownership instruments on current owners, and (5) reducing the ability to structure various instruments to achieve a desired accounting result.

Because the classification principles in the ownership-settlement approach rely more on an instrument's form of settlement than its economic characteristics and risks, we prefer an appropriately modified basic ownership approach to the ownership-settlement approach. In particular, we believe that instruments with similar economic characteristics and risks should be classified consistently irrespective of their form of settlement, such as according to whether they may be settled in cash or shares.

The body of this comment letter is divided into two sections. The first section discusses the fundamental deficiencies in the current design of the basic ownership approach that we believe the Board needs to address before proceeding. The second section discusses our proposed modifications to the basic ownership approach to address those deficiencies and create an effective classification principle. Finally, the Appendix to this comment letter articulates our responses to each of the questions posed by the FASB in the Preliminary Views document.

1. Fundamental Deficiencies in the Current Design of the Basic Ownership Approach

Three fundamental deficiencies prevent the basic ownership approach, as currently outlined in the Preliminary Views document, from being an effective and conceptually coherent classification approach:

- First, as discussed in subsection 1.1 below, the Preliminary Views document fails to identify and clearly articulate the objectives of distinguishing between liabilities and equity. We believe a primary objective is to provide a clear principle of which changes in value of issued instruments should and should not be included in the determination of income. Another primary objective is to provide a clear indicator of an entity's leverage, solvency, and liquidity. We are concerned that the basic ownership approach, in its current design, does not appropriately address these objectives.

- Second, as discussed in subsection 1.2 below, classifying instruments as liabilities or equity principally on the basis of an instrument's priority in liquidation does not provide the most relevant and useful information to users of financial statements. Such users look for information about an entity's financial position as a going concern. We believe that classifying an instrument principally on the basis of its priority in liquidation is inconsistent with the fundamental assumption that the financial statements portray the financial position of an issuer as a going concern.

- Third, as discussed in subsection 1.3 below, an effective classification approach should provide a clear conceptual definition of an obligation. The absence of a clear definition of an obligation could throw into confusion other areas of financial reporting, such as revenue recognition, classification of noncontrolling interests, accounting for loss contingencies (in particular noncontractual contingencies), and accounting for costs associated with exit or disposal activities. We believe that in conjunction with this project on defining equity, the Board also needs to address the characteristics of an obligation.

1.1 Objectives for Distinguishing Between Liabilities and Equity

It is critical that the FASB clearly articulate its objectives for distinguishing between liability and equity instruments. While reducing accounting complexity in financial reporting is an important consideration in the development of all accounting standards, it cannot be the sole or principal underlying factor in developing a classification principle, which appears to be the case in the Preliminary Views document. In addition to reducing accounting complexity, an effective classification approach must have a clearly articulated conceptual basis that addresses the needs of users of financial statements for relevant and understandable information regarding the various claims of an issuer.

We believe that the most important objective in distinguishing between liability and equity instruments is to provide a clear principle of which changes in value of issued instruments should and should not affect the determination of income in a performance statement. An important effect of distinguishing between liability and equity instruments, which is not adequately addressed in the Preliminary Views document, is that changes in the value of instruments classified in equity do not affect the determination of income, whereas changes in the value of instruments classified as assets or liabilities do affect the determination of income in a performance statement.

Transactions with external parties (other than transactions with existing owners in their capacity as owners) *should* factor into the determination of income. However, we do not support an approach that requires *discretionary* dividend payments or *discretionary* distributions on perpetual instruments (including some preferred securities, senior classes of common shares, and limited partnership interests) to be included in the determination of income. Classifying discretionary dividend payments or discretionary distributions as expense allows entities to manage earnings to achieve desired results. To illustrate, if a company desires to increase earnings for a period, it could elect to reduce or delay its discretionary dividend payments to holders of preferred securities. If it desires to reduce earnings, it could elect to increase its dividends to holders of preferred securities. In addition, recording changes in the value of such securities in earnings may not provide useful information to users of financial statements if the entity has no obligation to pay such amounts or an ability to realize such changes in value. For these reasons, we believe that an effective classification principle can only be developed by carefully considering which instruments should and should not factor into the determination of net income.

We believe another primary objective of an effective classification principle is to provide a clear indicator of an entity's leverage, solvency, and liquidity. Many financial metrics that are currently relied upon by analysts, rating agencies, and investors focus on assessing an entity's leverage and the potential for insolvency. Because the basic ownership approach would include as a liability certain perpetual instruments (e.g., perpetual preferred securities, senior classes of common shares, and limited partnership interests), which do not embody an obligation of the issuer to transfer economic resources, we do not believe that the current design of that approach provides an optimal means to assess the leverage, solvency, and liquidity of an entity. As a result, we suggest that the Board carefully consider the information needs of users of financial statements and develop a classification principle that provides this information in a representationally faithful manner.

Finally, we believe it is important that the Board consider whether its concept of a liability under the Preliminary Views document is consistent with its views about whether the performance of an entity as captured in the financial statements should be measured from the perspective of the economic entity or from the perspective of current owners. As currently drafted, the Board's definition of a basic ownership interest appears to be based on a narrow, proprietary view of equity. This supports a position that the performance of a reporting entity should be measured from the perspective of current holders of basic ownership interests. However, this view appears inconsistent with the Board's recent conclusion that noncontrolling interests be classified within equity under the economic entity theory of consolidated financial statements in Statement 160.[1] We believe that the Board should address this apparent inconsistency.

We note that the issue of whether financial performance should be measured from the perspective of the consolidated economic entity or that of current owners of the parent company was one of the key questions that the FASB staff discussed in its 1990 Discussion Memorandum, "Distinguishing Between Liability and Equity Instruments and Accounting for Instruments With Characteristics of Both." In that Discussion Memorandum, the FASB staff acknowledged that a critical question in determining the appropriate conceptual definition of a liability and what instruments should be included in the determination of income is whether financial performance should be measured from the perspective of the consolidated economic entity or current owners of the parent entity. We believe resolution of this issue continues to be critical in developing an effective and conceptually coherent classification approach. Accordingly, we believe the Board should carefully consider this issue as it develops a joint conceptual framework with the IASB and as it proceeds with development of a conceptual classification principle to distinguish liabilities from equity.

1.2 Classification Based on Priority in Liquidation

In our view, another fundamental deficiency of the basic ownership approach in its current design is that it classifies financial instruments as liabilities or equity based on the assumption that the entity is being liquidated. We do not support a classification approach that focuses on the priority of an instrument in the event of liquidation. While disclosure of information about the priority of various claims in liquidation may be useful to readers of financial statements, we believe it is conceptually inconsistent to define equity on a liquidation basis of accounting when financial statements are prepared on the basis of a going concern assumption. We believe priority of an instrument is an important consideration but should not be a determinative factor in the classification. Rather, we believe classification should be based on the economic characteristics and risks of an instrument considering the issuer as a going concern unless the entity is a finite-life entity or a going concern assumption is no longer appropriate.

We note that an instrument that has priority to the assets of an issuer in the event of liquidation may not necessarily provide its holder with payment or settlement rights that are different from a common share absent liquidation. For example, in liquidation, senior classes of common shares and perpetual preferred securities receive distributions of the net assets of the issuer before the most subordinate common shareholders, but may have rights and obligations virtually identical to those of the most subordinate class of common shares in all other circumstances (e.g., voting rights and discretionary dividends). As a result, in the absence of the preference in liquidation, these securities have economic characteristics and risks similar to the most subordinate class of common shares.

Further, we believe it is inconsistent to classify a perpetual instrument without a settlement or payment requirement as a liability when that instrument does not embody a requirement to transfer economic resources to the holder other than in the liquidation of the entity. As discussed in more detail in section 1.3 below, classifying perpetual instruments without payment or settlement requirements as liabilities also makes it unclear how to conceptually define an obligation of an entity.

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[1] FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements* — an amendment of ARB No. 51.

We believe that classifying an instrument considering the issuer as a going concern provides readers of financial statements more relevant information regarding nature of the various ownership interests of an entity and their effect on the issuer's operations, leverage, solvency, and liquidity.

1.3 Conceptual Definition of an Obligation

We believe that an effective classification principle must have a clear conceptual definition of an obligation as a second order principle after defining equity. Because of its relevance to other areas of financial reporting, this definition of an obligation may be encompassed within a definition of a liability that does not overlap with equity.

Consider the following example: Under the contract-based revenue recognition model being considered by the FASB and IASB in their joint revenue recognition project, recognition of revenue explicitly focuses on the recognition and measurement of the rights and obligations associated with individual customer contracts. Under the proposed approach, revenue is recognized when a contract asset (the right to consideration) increases or a contract liability (the performance obligation) decreases. As a result, the definition of an obligation associated with a customer contract and whether that obligation is satisfied is critical to determining when revenue recognition is appropriate.

Other areas of financial reporting that rely on the definition of a liability as an obligation to transfer economic resources include the classification of noncontrolling interests, the accounting for contingencies, and the accounting for exit and disposal costs. Each of these areas of financial reporting will be thrown into confusion if a definition of an obligation that focuses on a duty or responsibility to transfer economic resources is not retained.

2. Proposed Modifications to the Basic Ownership Approach

We believe that several modifications are necessary to address the fundamental deficiencies identified above and to make the basic ownership approach an effective and conceptually coherent classification approach.

2.1 Proposed Modification to the Definition of a Basic Ownership Instrument

For the basic ownership approach to be an effective and conceptually coherent classification approach, we propose that it classify within equity only instruments that meet the following definition of a direct equity ownership interest:

> A **direct equity ownership interest** is a *direct interest* in an issuer that provides the holder with a claim to a share of the issuer's assets (such as a common or preferred share or partnership interest, but not an indirect ownership interest or contract (such as a derivative) that is indexed to, and potentially settled in, direct equity ownership interests), that in a *going concern* meets all of the following conditions:
>
> 1. It shares substantially in the risks and rewards of ownership of the issuer's net assets through any of the following:
>
>   a. Payments of discretionary amounts of dividends or distributions (or a participation right in such amounts).

   b. A requirement to pay an amount designed to approximate the holder's proportionate share of the issuer's net assets (e.g., a common share redeemable at fair value).
   c. A requirement imposed by contract, law, or statute to distribute a proportion of the holder's share of the current period change in the issuer's net assets.

2. It does not contain a requirement to (a) deliver assets, services, or direct equity ownership interests or (b) exchange assets, liabilities, services, or direct equity ownership interests, other than a requirement described in (1) above.

3. It is an interest in an entity that remains after all requirements to (a) deliver assets, services, or direct equity ownership interests or (b) exchange assets, liabilities, services, or direct equity ownership interests on terms that are unfavorable to the entity are satisfied (other than the exceptions discussed in (1) above).

Our proposed definition of a direct equity ownership interest would allow existing ownership interests — such as senior classes of common shares with preferential rights in liquidation, preferred securities with a liquidation preference but without a fixed or determinable redemption or payment requirement, limited partnership interests, and existing ownership instruments that are redeemable at fair value — to be classified within equity. The value of each of these instruments depends primarily on the *potential* that the issuer distributes its earnings. These instruments do not include an obligation or requirement of the issuer to transfer economic resources to the holder of that instrument (other than a redemption obligation at fair value). Because the value of these instruments depends primarily on the potential that the issuer distributes its earnings rather than value of a right to a stream of fixed or determinable cash flows, we believe that these instruments in a going concern have economic characteristics and risks that are more closely akin to equity than a liability and, therefore, should not factor into the determination of current period earnings.

2.2 Conceptual Definition of an Obligation

In addition to our above proposed definition of a direct equity ownership interest, we recommend that the modified basic ownership approach retain a clear and concise conceptual definition of an obligation for the reasons discussed above. In addition, the Board may consider modifying the current conceptual definition of a liability to the following:

A **liability** is any conditional or unconditional requirement (including a claim contingent upon liquidation), other than a requirement that qualifies as a direct equity ownership interest, to do either of the following:

1. Deliver assets, services, or direct equity ownership interests (e.g., share-settled debt or a written option indexed to, and potentially settled net in, the issuer's direct equity ownership interests).

2. Exchange asset, liabilities, services, or direct equity ownership interests on terms that are unfavorable to the entity (e.g., a written option indexed to the issuer's direct equity ownership interests that is settled gross by delivering direct equity ownership interests and receiving cash).

2.3 Display of Instruments Indexed to the Entity's Direct Equity Ownership Interests

Some instruments contain some characteristics of equity but do not meet our proposed definition of a direct equity ownership interest (or the Board's proposed definition of a basic ownership interest), such as (1) freestanding and embedded derivatives indexed to the value of an ownership instrument classified in equity and (2) ownership interests that are redeemable at a fixed price either mandatorily or at the option of the holder.

We believe the Board should consider separately displaying such instruments in an entity's statement of financial position apart from an entity's other assets or liabilities in recognition of the fact that these instruments have characteristics and risks that are closely linked to the entity's equity. In addition, we propose that instruments with characteristics of equity but that do not qualify for classification in equity be separately displayed in the asset and liability section of the balance sheet on the basis of the settlement characteristic of the instrument. Separately displaying various instruments according to whether the instrument is settled in shares or cash provides users of financial statements useful information about the entity's liquidity, including the potential cash obligations of an issuer.

The Board should also consider the separate presentation of changes in value of such instruments in the statement of performance. The changes in value of non-equity instruments directly attributable to a change in price of a direct ownership equity interest is akin to a change of value due to denomination in a different currency. Calling out such changes separately is useful to users of the financial statements.

We propose that the change in value of an instrument that is directly linked to the change in value of instruments classified in the issuer's equity be separately displayed in a comprehensive statement of financial performance *immediately* before income available to holders of direct equity ownership interests (or basic ownership interests, if the Board were to retain that term). This display approach provides useful information to users of financial statements about the effect to income available to holders of direct equity ownership interests related to the change in value of an instrument that is indexed to changes in the value of an entity's direct equity ownership interests. We believe this approach underscores the close relationship between changes in the value of direct equity ownership interests and the change in value of instruments that are indexed to the entity's direct equity ownership interest. In addition, this display approach highlights the dilutive effect of instruments indexed to direct equity ownership interests on current owners.

The change in the value of other components of an instrument indexed to direct equity ownership interests effectively can be viewed as either investing income (e.g., for a purchased put or call option on the entity's basic ownership instruments) or a financing cost of the issuer (e.g., for a written put or call option on the entity's basic ownership instruments). Therefore, we believe such changes should be displayed in the income statement in the same manner as other investing income and financing costs.

Regardless of which method is ultimately selected, we believe that it is critical that the Board develop its classification and display principles in conjunction with its project on financial statement presentation.

2.4 Separation of Multiple Component Instruments

While we agree that separation adds complexity to financial reporting, we believe separating multiple component instruments into their components parts may give users of financial statements important information about the rights and obligations of various instruments and more accurately depict the economic characteristics and risks of the components of various arrangements. As a result, we recommend that the Board consider whether instruments that contain multiple components (including any combination of an asset or liability component, a component indexed to the value of an instrument classified in equity, or a direct equity ownership interest component) should be separated into their component parts and classified within the appropriate balance sheet category.

For example, we suggest a perpetual instrument that includes (1) a fixed dividend requirement and (2) a participating dividend requirement be separated into a liability component (equal to the present value of the fixed dividend requirement) and a direct equity ownership interest component associated with the participating dividend feature. Similarly, we suggest that the Board consider requiring separation of instruments that in their entirety are classified as assets or liabilities but that include an embedded feature that is linked to the change in value of an entity's direct equity ownership interests. We suggest that to avoid separation being dependent on the instrument's form of settlement, the Board consider whether separation of an embedded feature that is indexed to an entity's direct equity ownership interest should be required irrespective of whether the embedded feature would require bifurcation under Statement 133.[2] For example, we believe the Board should consider requiring separation of an issued convertible debt instrument into its debt and derivative components for display and subsequent measurement purposes. Once separated, the derivative component would be displayed separately in the asset or liability section of the balance sheet on the basis of its settlement characteristics and subsequently measured at fair value.

2.5 Performance Measures

We believe that one of the significant benefits of our proposed classification approach is that it clearly displays — in a comprehensive statement of financial performance — the effects of instruments indexed to instruments classified in equity on income available to holders of direct equity ownership interests. In particular, our approach presents changes in the value of instruments that are directly linked to an entity's equity separately from operating income, investing income, and financing cost to facilitate analysis of an entity's performance and satisfy the varied information needs of different types of users of financial statements. In addition, our approach highlights the dilutive effects on current holders of direct equity ownership interests from instruments that are indexed to such interests with separate display of the impact from share-settled and cash-settled instruments, respectively. We encourage the Board to carefully consider the information needs of different groups of users of financial statements to allow them to compare performance across various entities on the basis of their information needs.

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We appreciate the opportunity to comment on the Preliminary Views document. If you have any questions concerning our comments, please contact Magnus Orrell at (203) 761-3402.

Yours truly,

Deloitte & Touche LLP

cc: Robert Uhl
James A. Johnson

[2] FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (as amended and interpreted).

APPENDIX
Deloitte & Touche LLP
Reponses to Preliminary Views Questions

The Basic Ownership Approach

Question 1: Do you believe that the basic ownership approach would represent an improvement in financial reporting? Are the underlying principles clear and appropriate? Do you agree that the approach would significantly simplify the accounting for instruments within the scope of this Preliminary Views and provide minimal structuring opportunities?

While we believe the Board should revise the definition of a basic ownership instrument and modify certain other aspects of the basic ownership approach (as discussed in the body of our comment letter), we believe the basic ownership approach — appropriately designed — has the potential to simplify and improve financial reporting. Appropriately designed, we believe the a modified basic ownership approach would improve financial reporting by (1) simplifying financial reporting, (2) providing a clear distinction between liabilities and equity, (3) classifying instruments on the basis of their economic characteristics and risks rather than their form, (4) reflecting the dilutive effect of derivatives indexed to an entity's basic ownership instruments on current owners, and (5) reducing the ability to structure various instruments to achieve a desired accounting result.

We believe it is critical that before it reaches any final conclusions, the Board should explore and appropriately revise the basic ownership approach to address (1) the conceptual definition of a basic ownership instrument, (2) the conceptual definition of an obligation, and (3) financial statement presentation and display. Each of these issues is discussed more fully in the body of this comment letter.

In addition, we believe the Board should further consider the subsequent measurement of instruments that would not be classified within equity. We agree that fair value is the most appropriate measurement attribute for derivative instruments. However, as discussed further in Question 3, we do not believe that fair value is the most relevant measurement attribute for perpetual instruments that are classified as liabilities under the basic ownership approach, but that would be classified in equity under our proposed modified classification approach. If the Board were to move forward with the basic ownership approach in its current form, we suggest that the Board consider whether measuring such instruments at their liquidation value would be more appropriate.

Question 2: Under current practice, perpetual instruments are classified as equity. Under the basic ownership approach (and the REO approach, which is described in Appendix B) certain perpetual instruments, such as preferred shares, would be classified as liabilities. What potential operational concerns, if any, does this classification present?

As discussed in more detail in section 1.2 of our comment letter, we disagree with the Board's proposal to classify as liabilities perpetual instruments that in a going concern have economic characteristics and risks similar to the entity's common shares, but do not meet the Board's proposed narrow definition of a basic ownership interests.

We suggest that in addition to evaluating the conceptual and operational concerns discussed in the body of our comment letter, the Board carefully consider the following potential implementation issues that may result from classifying certain perpetual instruments (including preferred securities, senior classes of common stock, and limited partnership interests) as liabilities:

- Classifying preferred securities (including senior classes of common stock and limited partnership interest) as liabilities may result in certain entities being considered variable interest entities under paragraph 5 of FASB Interpretation No. 46(R).[3] Because equity at risk is defined as GAAP equity, the GAAP equity of many entities may not be considered sufficient to finance the activities of the entity without additional subordinate financial support resulting in the entity being considered a variable interest entity and within the scope of Interpretation 46(R).

- Measuring perpetual instruments at fair value through current period earnings may increase the subjectivity of reported earnings. Many perpetual instruments are not actively traded and therefore do not have readily determinable fair values. If the Board decided that perpetual instruments classified as liability must be subsequently measured at fair value, the subjectivity of reported earnings will likely increase.

- Classifying perpetual instruments as liabilities and measuring them at fair value may affect the amount of capital an entity is considered to have under certain regulatory regimes.

Question 3: The Board has not yet concluded how liability instruments without settlement requirements should be measured. What potential operational concerns, if any, do the potential measurement requirements in paragraph 34 present? The Board is interested in additional suggestions about subsequent measurement requirements for perpetual instruments that are classified as liabilities.

As discussed in more detail in our comment letter, we disagree with the Board's proposal to classify as liabilities perpetual instruments that do not meet the Board's proposed narrow definition of basic ownership instruments, but have economic characteristics and risks similar to the entity's basic ownership instruments. However, if the Board is to retain its proposed classification principle, we believe a perpetual instrument that is classified as a liability solely because of its liquidation preference should be measured each period on the basis of its liquidation preference (ignoring any participation right in residual net assets). The liquidation preference of a perpetual instrument represents the maximum amount that residual interest holder has a claim to in the event of liquidation. This measurement attribute is more consistent with the classification principles in paragraph 18 than fair value or amortized cost.

While fair value is the appropriate measurement attribute for many financial instruments, we have significant concerns with recognizing the changes in value of a perpetual instrument without settlement requirements in earnings. For example, if a perpetual instrument contains no dividend or redemption provisions, it seems inconsistent to recognize changes in the value of that instrument in earnings because the issuer is not required to transfer economic resources, and the counterparty has no claim to the assets of the issuer other than in the event of liquidation. In a manner similar to basic ownership instruments, the fair value of a perpetual instrument without a settlement or payment requirement is driven by expectations about the entity's future dividend decisions and dividend-paying ability (which will depend on the entity's future earnings). Because perpetual instruments are more akin to equity than debt, we do not support measuring them without settlement requirements at fair value.

While we believe that perpetual instruments without settlement or payment requirements should be classified within equity and not remeasured, we note that some equity securities or components thereof economically are more akin to debt than equity. For equity securities that

[3] FASB Interpretation No. 46(R), *Consolidation of Variable Interest Entities — an interpretation of* ARB No. 51.

specify fixed dividend requirements or redemption obligations, we believe the issuer should separate the fair value of the payment or settlement requirements from the perpetual instrument and classify the separated component as a liability. If a component of a perpetual instrument is classified as a liability because it includes payment or settlement requirements (such as a fixed dividend requirement), we believe that component should be measured using the same measurement attribute or attributes as other similar financial liabilities (whether amortized cost or fair value). For example, if a fair value option is available for other similar financial liabilities, we believe the issuer should have an option but not be required to measure such liability components at fair value.

Question 4: Basic ownership instruments with redemption requirements may be classified as equity if they meet the criteria in paragraph 20. Are the criteria in paragraph 20 operational? For example, can compliance with criterion (a) be determined?

We believe that as currently drafted, the criteria in paragraph 20 are *not* operational. The redemption right of *any* perpetual instrument that is redeemable at fair value impairs the claims to a share of the issuer's net assets of the holders of nonredeemable basic ownership instruments, especially when the remaining assets of the issuer are relatively less liquid. More specifically, the ability to put an instrument to its issuer rather than sell that instrument into the secondary market, in and of itself, provides liquidity to the holder that a holder of a nonredeemable basic ownership instrument does not have. Similarly, unless a basic ownership instrument is trading in a liquid market, the ability to put a redeemable basic ownership instrument back to the issuer rather than sell that instrument into the secondary market provides value to the holder that other holders of basic ownership instruments without the redemption right do not have. As a result, we believe that most, if not all, instruments that are redeemable at fair value will fail the Board's proposed definition of a basic ownership instrument in paragraph 18 and will require liability classification.

In addition, we believe that the classification principles in paragraph 18 and paragraph 20 are inconsistent. As currently drafted, the classification principle for redeemable basic ownership interest in paragraph 20 appears to focus on an issuer that is a going concern. That is, a redeemable instrument is a basic ownership instrument only if it is redeemable at fair value at the classification date. In contrast, the classification principles in paragraph 18 focus on the priority of an interest in the event of liquidation.

Q5: A basic ownership instrument with a required dividend payment would be separated into liability and equity components. That classification is based on the Board's understanding of two facts. First, the dividend is an obligation that the entity has little or no discretion to avoid. Second, the dividend right does not transfer with the stock after a specified ex-dividend date, so it is not necessarily a transaction with a current owner. Has the Board properly interpreted the facts? Especially, is the dividend an obligation that the entity has little or no discretion to avoid? Does separating the instrument provide useful information?

We agree that a requirement to pay a fixed or determinable dividend should be classified as a liability. As a result, we believe that a perpetual instrument with such a dividend requirement should be separated into its equity and liability components. This provides more useful information than classifying the entire perpetual instrument as either equity or a liability (please refer to our proposed revised definition of a basic ownership instrument in our comment letter). We believe that the present value of the required dividend stream should be recognized as a liability. The difference between the present value of the dividend stream and the transaction price of the instrument is then allocated to equity.

Q6: Paragraph 44 would require an issuer to classify an instrument based on its substance. To do so, an issuer must consider factors that are stated in the contract and other factors that are not stated terms of the instrument. That proposed requirement is important under the ownership-settlement approach, which is described in Appendix A. However, the Board is unaware of any unstated factors that could affect an instrument's classification under the basic ownership approach. Is the substance principle necessary under the basic ownership approach? Are there factors or circumstances other than the stated terms of the instrument that could change an instrument's classification or measurement under the basic ownership approach? Additionally, do you believe that the basic ownership approach generally results in classification that is consistent with the economic substance of the instrument?

Generally, we agree that an assessment of the substance of an instrument may be necessary to achieve representational faithfulness in the financial statements and counter attempts to circumvent GAAP through abusive structuring. However, we also note that assessing substance may be subjective and challenging without a clear framework. We welcome the fact that under the basic ownership approach as currently drafted, assessing the substance of an instrument is not as essential relative to the ownership-settlement approach.

Without explicit application guidance, a requirement to assess substance may result in inconsistent classifications across entities. As noted in the FASB's conceptual framework (paragraph 160 of Concepts Statement 2[4]), "substance over form" is a rather vague idea that defies precise definition. As a result, any substance assessment may be very subjective and judgmental and may be challenged by regulators and auditors that have the benefit of hindsight.

The assessment of substance as proposed in the basic ownership approach has significant conceptual and operational issues that we believe must be addressed. For example, we note the term "remote" as used in paragraph 44 of the basic ownership approach is vague and undefined. It is unclear based on the language in paragraph 44 whether the FASB intended the definition of "remote" in FASB Statement No. 5, *Accounting for Contingences*, to be applied in the Preliminary Views document.

Further, the Board should be cognizant that certain terms and features that have only a remote chance of affecting the outcome of an instrument in more than a minimal way do have economic substance and are considered by market participants when evaluating an instrument. A principle that ignores terms or features that have only a remote chance of affecting an outcome in certain instances appears inconsistent with how the market perceives various instruments (e.g., insurance contracts, financial guarantees, and out-of-the money written options). We do acknowledge, however, that the opposite of this statement is equally true. That is, certain terms and features that have more than a remote chance of affecting an instrument's outcome actually may have little, if any, impact on how the market perceives or values an instrument (e.g., whether a contract is settled in cash or shares that are readily convertible to cash). For these reasons, we believe a principle that is based on probability of an outcome does not produce classification results that are always consistent with the economics of an instrument.

Finally, it appears unclear whether the principle in paragraph 44 applies equally to stated and unstated features. In other words, if the exercise of a *stated* put option embedded in a basic ownership instrument is deemed remote, can that put feature be ignored, resulting in the puttable share being classified as a basic ownership instrument?

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[4] FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*.

We suggest that to improve the substance principle in paragraph 44 of the basic ownership approach and to make it operational, the Board should consider carrying forward the substance principle in paragraph 8 of FASB Statement No. 150, *Accounting for Certain Financial Instruments With Characteristics of Both Liabilities and Equity*. Paragraph 8 of Statement 150 requires any nonsubstantive or minimal feature to be disregarded in applying the classification provisions of that Standard. If this principle is applied under the basic ownership approach, all features embedded in an instrument that are nonsubstantive or minimal are ignored.

Alternatively, the Board could consider a principle that determines whether a term or feature should be considered in classification on the basis of whether the term or feature affects (or could be reasonably expected to affect) the fair value of the instrument by more than a minimal amount. In this case, the substance principle focuses on the economics of the terms or features rather than the probability of a particular outcome.

Q7: Under what circumstances, if any, would the linkage principle in paragraph 41 not result in classification that reflects the economics of the transaction?

If the purpose of linkage in the basic ownership approach is to ensure that the economic substance of various interests is faithfully represented, we believe the linkage requirements in paragraph 41 of the basic ownership approach are too narrow in their current form. From an economic perspective, we do not believe that it matters whether separate instruments (1) are with the same or different counterparties or (2) issued at or near the same time. In many cases, an issuer can achieve the same economic result regardless of when various instruments are entered into or who is the counterparty to the instrument.

To illustrate this concept, consider the following example: An entity issues basic ownership instruments to investors and subsequently writes a put option to a third party. While the holder of the put option does not hold the basic ownership instrument, it can obtain the basic ownership instrument in the open market and put it to the issuer. From the issuer's perspective, the economic outcome of the combined transaction is the same as if the entity had issued its basic ownership instrument with an embedded put option. We believe there is merit in a view that the accounting treatment of both alternatives should be the same because the entity has the same economic exposure.

We believe that in addition to considering the narrowness of the linkage requirements in paragraph 44, the Board should carefully consider the potential operational issues regarding the requirements in paragraph 44:

- Linkage of separate financial instruments increases complexity and raises operational issues. It will require the issuer and its auditors to perform an extensive review of financial instruments (some of which may not have been issued on the same date) to determine whether the instruments should be reported as a single instrument (see the Emerging Issues Task Force discussions in EITF Issue No. 02-2, "When Certain Contracts That Meet the Definition of Financial Instruments Should Be Combined for Accounting Purposes").

- Paragraph 44 requires an assessment of whether the overall economic outcome of two separate instruments could have been achieved by issuance of a single instrument. In practice, it may be difficult and burdensome to determine whether the overall economic outcome of two separate instruments could have been achieved through a single instrument. We note that an entity can easily circumvent the proposed condition in paragraph 43(b) by entering into transactions at different times or with different counterparties. We believe that from an economic perspective, an issuer is often indifferent regarding (1) the timing of different transactions or (2) who is the counterparty of the transaction.

- We believe the criteria for determining whether instruments should be linked in paragraph 44 lack a clear conceptual basis and do not always result in consistent accounting for economically similar contracts. Rather than provide specific conditions that if met require linkage, the Board may wish to consider a more judgment-based approach that relies on a set of indicators requiring linkage.

We suggest that as a potential alternative approach to the linkage requirements in paragraph 44, the Board consider requiring a continual reassessment of the classification of basic ownership instruments. In the example above, once the put option is written, a reassessment of the classification of the basic ownership instrument is required. Because the put option allows the issuer to redeem its basic ownership instruments, the redemption obligation under the put option is recorded as a liability and the basic ownership instrument is removed from equity consistent with the classification requirements in IAS 32, *Financial Instruments: Presentation*.

Finally, we note that the linkage requirements in paragraphs 41 and 43 are not consistent with the linkage requirements that currently exist in U.S. GAAP (e.g., Statement 133 Implementation Issue No. K1, "Determining Whether Separate Transactions Should Be Viewed as a Unit"; EITF Issue No. 98-15, "Structured Notes Acquired for a Specified Investment Strategy"; EITF Issue No. 00-4, "Majority Owner's Accounting for a Transaction in the Shares of a Consolidated Subsidiary and a Derivative Indexed to the Minority Interest in That Subsidiary"; EITF Issue No. 04-13, "Accounting for Purchases and Sales of Inventory With the Same Counterparty"; and FASB Staff Position No. FAS 140-3, "Accounting for Transfers of Financial Assets and Repurchase Financing Transactions.") We believe that instead of adding yet another linkage model, the Board should explore developing a consistent linkage approach for different types of financial instruments.

Q8: Under current accounting, many derivatives are measured at fair value with changes in value reported in net income. The basic ownership approach would increase the population of instruments subject to those requirements. Do you agree with that result? If not, why should the change in value of certain derivatives be excluded from current-period income?

We agree that fair value is the most appropriate measurement attribute for derivative instruments. However, we are not ready at this stage to support including all changes in the fair value of derivatives indexed to an entity's basic ownership instruments in the operating, investing, or financing sections of a comprehensive statement of financial performance.

We believe that the Board should carefully consider the presentation in a comprehensive statement of performance of changes in value of instruments indexed to an issuer's basic ownership instruments considering the information needs of users of financial statements. We suggest the Board explore whether to present some or all changes in the fair value of such instruments as a separate line item in a comprehensive statement of financial performance immediately before income available to holders of basic ownership instruments, but apart from the operating, investing, and financing sections of that statement, to reflect that the changes in the value of these instruments are closely linked to changes in the value of the entity's own equity.

Under our proposed classification approach described in more detail in section 2 of our comment letter, derivative instruments indexed to an issuer's basic ownership instruments are classified as assets or liabilities outside of equity, but are separately displayed. Further, changes in value of such instruments are separately displayed in a comprehensive statement of financial performance *immediately* before income available to holders of basic ownership interests, to the extent those changes are directly linked to the change in value of the issuer's basic ownership interests. This display approach provides information to users of financial statements about the effect to income available to holders of basic ownership interests related to the change in value of an instrument that is indexed to changes in the value of an entity's basic ownership interests. We believe this approach underscores the close relationship between changes in the value of basic ownership interests and the change in value of instruments that are indexed to such interests. In addition, this display approach highlights the dilutive effect of instruments indexed to basic ownership interests on current owners.

The change in the value of the other components of instruments indexed to basic ownership interest effectively can be viewed as investing income or a financing cost. Therefore, we believe it should be classified in a comprehensive statement of financial performance similar to other investing income or financing cost, as applicable.

We believe that separate presentation of some or all of the value of derivatives indexed to an entity's basic ownership interests in a comprehensive statement of financial performance is justified for the following reasons:

- If written call options or forward sale contracts are measured at fair value with changes in fair value recognized in earnings, an issuer will recognize a gain in the income statement when the market value of the issuer's equity declines and conversely a loss when the market value of the issuer's equity increases. These changes should be separately presented for users.

- Claim holders other than holders of a basic ownership instrument may be indifferent about the earnings impact of a derivative that requires settlement in shares (whether physically or net share settled). Therefore, separately displaying the change in fair value of such an instrument may facilitate analysis of the entity's financial performance.

- We believe it is important to consider the effect of derivatives from the perspective of the current owners of the issuer. Isolating gains and losses associated with changes in value of derivatives and recognizing that change in a comprehensive statement of financial performance more appropriately reflects the shift in value between different groups of claim holders (i.e., the shift in value to or from the current owners to potential future owners upon settlement of a derivative on an entity's basic ownership interests).

- We believe that highlighting the change in value of derivatives more appropriately captures the effect of an issuer speculating in its own shares and its impact on current owners.

Q9: Statement of financial position. Basic ownership instruments with redemption requirements would be reported separately from perpetual basic ownership instruments. The purpose of the separate display is to provide users with information about the liquidity requirements of the reporting entity. Are additional separate display requirements necessary for the liability section of the statement of financial position in order to provide more information about an entity's potential cash requirements? For example, should liabilities required to be settled with equity instruments be reported separately from those required to be settled with cash?

We agree that basic ownership instruments with redemption requirements and that qualify for classification in equity should be separately displayed in the equity section of the balance sheet to highlight the different potential settlement obligations of the issuer. For similar reasons, we believe that derivatives indexed to an entity's basic ownership instruments with cash settlement requirements should be either (1) displayed separately from those with share-settlement requirements in the asset and liability sections of the balance sheet or (2) separately displayed in the footnotes to the financial statements with a total that ties to the appropriate line item(s) in the balance sheet.

Q10: Income statement. The Board has not reached tentative conclusions about how to display the effects on net income that are related to the change in the instrument's fair value. Should the amount be disaggregated and separately displayed? If so, the Board would be interested in suggestions about how to disaggregate and display the amount. For example, some constituents have suggested that interest expense should be displayed separately from the unrealized gains and losses.

As discussed in our comment letter and in Question 2 above, we believe that certain perpetual instruments that do not meet the proposed narrow definition of a basic ownership instrument, but that have economic characteristics and risks similar to basic ownership instruments, should be classified as equity. We believe that changes in the fair value of such instruments should not be recognized in earnings.

As discussed in more detail in Question 8 above, we suggest that the Board explore whether to present some or all changes in the fair value of instruments indexed to an issuer's basic ownership instruments separately in a comprehensive statement of financial performance. We suggest that the Board consider splitting the change in value of an instrument indexed to an issuer's basic ownership instrument between the change in value that is directly linked to a change in value of the issuer's basic ownership interests and the change in value of the instrument's other components (such as time value). We believe this presentation approach appropriately reflects the fact that changes in the value of these instruments are closely related to changes in the value of the entity's equity, while changes in time value are more akin to investing income or financing cost, as applicable.

We believe that gains and losses from instruments with cash settlement requirements should be displayed separately from those with share settlement requirements either on the face of a comprehensive statement of financial performance or in the notes to the financial statements. Finally, as noted previously in the main body of our comment letter, we believe it is critically important that the Board coordinate its project to define equity with its project on financial statement presentation.

Q11: The Board has not discussed the implications of the basic ownership approach for the EPS calculation in detail; however, it acknowledges that the approach will have a significant effect on the computation. How should equity instruments with redemption requirements be treated for EPS purposes? What EPS implications related to this approach, if any, should the Board be aware of or consider?

While we do not express a view in this comment letter on how earning per share (EPS) should be computed, we suggest that the Board carefully consider the interaction between its EPS project and the provisions of the basic ownership approach.

The Ownership Settlement Approach — Preliminary Views Questions:

Q1. Do you believe the ownership-settlement approach would represent an improvement in financial reporting? Do you prefer this approach over the basic ownership approach? If so, please explain why you believe the benefits of the approach justify its complexity.

We believe the ownership-settlement approach would represent an improvement to current financial reporting because it (1) codifies applicable accounting literature into a single standard, (2) eliminates inconsistencies in existing accounting literature, and (3) provides a clearer conceptual basis than current accounting literature for how to distinguish liabilities from equity. Further, in many respects, it affirms the conceptual definition of a liability used in current practice.

However, while we believe that the Board should revise the definition of a basic ownership interest and modify certain other aspects of the basic ownership approach (as discussed in more detail in the main body of our comment letter), we believe an appropriately modified basic ownership approach is preferable to the ownership-settlement approach. We prefer an appropriately modified basic ownership approach to the ownership-settlement approach because a modified basic ownership approach (1) provides a clearer and simpler distinction between liability and equity instruments and limits the need for subjective judgments and (2) focuses classification on economic characteristics and risks of an instrument rather than its form (e.g., settlement form). In particular, we believe that instruments with similar economic characteristics and risks should be classified consistently irrespective of whether they may be settled in cash or shares.

Q2. Are there ways to simplify the approach? Please explain.

We believe that modifications to the requirements for analyzing substance and linkage as discussed in the Questions 6 and 7 under the basic ownership approach above are necessary to make the ownership-settlement approach operational. We also believe that a requirement to continually reassess the classification of basic ownership instruments should complement an assessment of separate instruments for potential linkage. For example, if an entity writes a put option on its own shares, we believe a reassessment of those shares considering the newly issued put option may result in the issuer removing that share from equity.

Q3: Paragraph A40 describes how the substance principle would be applied to indirect ownership instruments. Similar to the basic ownership approach, an issuer must consider factors that are stated in the contract and other factors that are not stated in the terms of the instrument. Is this principle sufficiently clear to be operational?

The substance principle in the ownership-settlement approach is the same as that in the basic ownership approach. Please refer to our response to Question 6 under the basic ownership approach above for a discussion of our views about the proposed principle. We note that the substance principle is more relevant under the ownership-settlement approach than the basic ownership approach because of its broader definition of equity. Therefore, the operational concerns discussed in our response to Question 6 under the basic ownership approach are more significant under the ownership-settlement approach than under the basic ownership approach.

Q4. Statement of financial position. Equity instruments with redemption requirements would be reported separately from perpetual equity instruments. The purpose of the separate display is to provide users with information about the liquidity requirements of the reporting entity. What additional, separate display requirements, if any, are necessary for the liability section of the statement of financial position in order to provide more information about an entity's potential cash requirements? For example, should liabilities required to be settled with equity instruments be reported separately from those required to be settled with cash?

Please refer to our comments on presentation and display under the basic ownership approach.

Q5. Are the proposed requirements for separation and measurement of separated instruments operational? Does the separation result in decision-useful information?

As discussed in section 2.4 of our comment letter, we conceptually agree with separating multiple component instruments because separation more accurately portrays an instrument's (1) rights and obligations, (2) economic characteristics and risks, and (3) financing costs. We believe that arguments that bifurcation is too complex are no longer as persuasive as they were in the past given the bifurcation requirements that exist in other accounting literature and the fact that markets and fair value measurement techniques have evolved.

While we generally support the separation of multiple component instruments, we believe that the Board should carefully consider the appropriate separation methods under various circumstances. Under current U.S. GAAP and IFRS guidance, there are multiple methods for separating multiple component instruments. We believe that the Boards should carefully consider what approach appropriately reflects the economics of both separated components.

Q6. The Board has not discussed the implications of the ownership-settlement approach for the EPS calculation in detail. How should equity instruments with redemption requirements be treated for EPS purposes? What EPS implications related to this approach, if any, should the Board be aware of or consider?

Please see our response to Question 11 under the basic ownership approach. Under the ownership-settlement approach, careful consideration needs to be applied to determine the appropriate method of capturing the dilutive effect of certain instruments that are indexed to an issuer's basic ownership instrument that are not classified as liabilities at fair value.

Q7. Are the requirements described in paragraphs A35–A38 operational? Do they provide meaningful results for users of financial statements?

We are concerned that the guidance on modification, exchange, conversion and settlement under the basic ownership approach and the ownership-settlement approach seems to imply that *any* modification of an instrument is treated as an extinguishment, with the difference between the carrying value of the old instrument and the fair value of the new instrument recognized *immediately* in income. That is, even a minor or nonsubstantive modification to an instrument effectively allows an issuer to remeasure that instrument to fair value through earnings. This guidance is inconsistent with the concepts in Issue 96-19.[5] Unless all financial instruments are measured at fair value on an ongoing basis, the approach described in paragraphs A35–A38 of the ownership-settlement approach permits an issuer to "cherry-pick" the timing of recognizing unrealized gains and losses by making nonsubstantive modifications.

We also believe that the settlement, conversion, expiration, and modification requirements in the ownership settlement approach are significantly more complex and require an assessment of whether the settlement or conversion of an instrument occurred at its *expected settlement* date and its contractual amount. Determining the *expected settlement* date of an instrument increases the subjectivity of the ownership settlement approach.

The Reassessed Expected Outcomes Approach — Preliminary Views Questions:

Q1. Do you believe that the REO approach would represent an improvement in financial reporting? What would be the conceptual basis for distinguishing between assets, liabilities, and equity? Would the costs incurred to implement this approach exceed the benefits? Please explain.

We recognize that the REO approach has certain conceptual merits. However, we believe the significantly increased complexity of the approach does not outweigh its potential benefits. We are also concerned that the REO approach may not yield information that is understandable to users of financial statements. In addition, the same issues with perpetual instruments discussed in Question 2 under the basic ownership approach are equally applicable to the REO approach.

Q2: Do the separation and measurement requirements provide meaningful results for the users of financial statements?

We are concerned that the REO approach may not yield information that is understandable to users of financial statements.

Q3. The Board has not discussed the implications of the REO approach for the EPS calculation in detail; however, it acknowledges that the approach will have a significant effect on the calculation. How should equity instruments with redemption requirements be treated for EPS purposes? What EPS implications related to this approach, if any, should the Board be aware of or consider?

Please refer to the discussion of EPS in Question 11 of the basic ownership approach.

Other Alternatives

Q1. Some other approaches the Board has considered but rejected are described in Appendix E. Is there a variation of any of the approaches described in this Preliminary Views or an alternative approach that the Board should consider? How would the approach classify and measure instruments? Why would the variation or alternative approach be superior to any of the approaches the Board has already developed?

As noted in our comment letter and in our responses above to the questions about the basic ownership approach, we believe that the basic ownership approach would be significantly improved by making certain fundamental modifications to the definition of a basic ownership interest.