The University of Texas at Austin
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International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

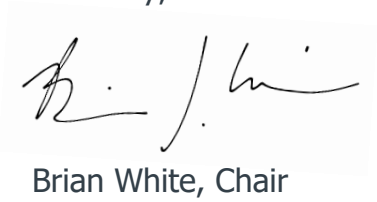
Dear Board Members,

The charge of the Financial Reporting Policy Committee of the American Accounting Association is to evaluate selected official standard-setting releases (e.g., invitations to comment, discussion memoranda and exposure drafts) related to financial accounting and reporting, and to provide timely, substantive, and constructive written feedback that is grounded in relevant academic research.

Thank you for the opportunity to comment on the Discussion Paper *Financial Instruments with Characteristics of Equity*. We are pleased to attach our comments.

Please do not hesitate to contact me if you require any clarification.

Sincerely,



Brian White, Chair
Financial Reporting Policy Committee
American Accounting Association

Committee Members, 2018-19:

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Prefatory Note

The Discussion Paper sets out eleven questions for respondents. Our goal in providing comments is to do so on the basis of relevant academic literature. Thus, we have limited our comments to those questions for which there is relevant research. In our view, these are Question 1, Question 2 and Question 9. We were unable to identify research that was directly relevant to the other questions in the Discussion Paper.

We note that prior FRPC comment letters (see Weygandt et al. 1993, Wahlen et al. 1999, Ryan et al. 2001, Botosan et al. 2005 and Hopkins et al. 2009) and a recently published review of the relevant accounting literature by Fargher at al. (2018) were very helpful in preparing these comments.

Questions and Comments

1. Question 1 (p. 26)

   Paragraphs 1.23 – 1.37 describe the challenges identified and provide an explanation of their causes.

   a. Do you agree with this description of the challenges and their causes? Why or why not? Do you think there are other factors contributing to the challenges?
   b. Do you agree that the challenges identified are important to users of financial statements and are pervasive enough to require standard-setting activity? Why or why not?

Comment:

(a) We agree with the description of the challenges and their causes, and we commend the Board for identifying and clearly articulating these difficult issues. These challenges and their causes are consistent with research and previous commentaries.

(b) We agree that the challenges identified are important to users of financial statements and are pervasive enough to require standard-setting activity. Research indicates that both classification and characteristics of financial instruments are relevant to the decision-making of financial statement users.

In particular, with respect to classification:

- Hopkins (1996) finds that buy-side analysts' valuation judgments differ in a predictable way when mandatorily redeemable preferred stock (MRPS) is classified as a liability or as equity.

- Engel et al. (1999, 250) find that firms are willing to "incur substantial costs to achieve reclassification of a tax-equivalent capital source on the balance sheet;" specifically, to reclassify claims out of liabilities and into equity. Thus, these firms appear to believe that classification matters to financial statement users.

With respect to characteristics:

- A number of archival studies, including Kimmel and Warfield (1995), Cheng et al. (2003), and Terando et al. (2007) examine market reactions to specific hybrid securities. These studies support the conclusion that market participants condition their assessments of hybrid financial instruments on certain characteristics.

- Clor-Proell et al. (2016) conduct an experiment with experienced finance professionals. They find that these experienced users rely primarily on disclosed features of a hybrid financial instrument in making credit-related judgments, even when the instrument is classified as a liability or as equity.

2. Question 2 (p. 40)

The Board's preferred approach to classification would classify a claim as a liability if it contains:

a. an unavoidable obligation to transfer economic resources at a specified time other than at liquidation; and/or
b. an unavoidable obligation for an amount independent of the entity's available economic resources.

This is because, in the Board's view, information about both of these features is relevant to assessments of the entity's financial position and financial performance, as summarized in paragraph 2.50.

The Board's preliminary view is that information about other features of claims should be provided through presentation and disclosure.

Do you agree? Why, or why not?

Comment:

We view this question as having three distinct parts. First, do the two criteria identified as the basis for distinguishing liabilities and equity represent an appropriate basis on which to base classification? Second, does the way in which these criteria are applied (i.e., liability classification if either criterion is satisfied) make sense? Third, are presentation and disclosure reasonable methods for presenting information about relevant features other than those identified as the basis for classification?

Are the two criteria an appropriate basis for classification?

The Board's preferred approach bases the liability/equity classification on two criteria. The first criterion is whether a claim contains an unavoidable obligation to transfer economic resources at a specified time other than liquidation. The second is whether a claim contains an unavoidable obligation for an amount independent of the entity's available economic resources. The Committee believes that these criteria are very closely related to what has been previously referred to as the *solvency* perspective (criterion (a)) and the *valuation* perspective (criterion (b)) in previous commentaries (e.g., Wahlen at al. 1999, Ryan et al. 2001). Ryan et al. (2001, 390) define a solvency perspective as

"reflecting the presence or absence of contractually specified claims on assets," and a valuation perspective as "reflecting the presence or absence of an ownership relationship/residual claim." In other words, the solvency perspective looks to whether a claim is an obligation to pay cash or another financial asset (yes: liability; no: equity). The valuation perspective looks to whether a claim is a residual claim or will be valued like a residual claim (yes: equity; no: liability). Under the Board's preferred approach, criterion (a) is similar to the solvency perspective, because "contractually specified claim on assets" is very similar to "unavoidable obligation to transfer economic resources." Criterion (b) is similar to the valuation perspective because "independent of the entity's available economic resources" means that a claim is classified as equity if it is dependent on a company's performance, and so ends up being valued like a residual claim.

The Committee agrees that these features are relevant to financial statement users. There are of course other features of financial instruments that are likely to be relevant—including voting rights, form of settlement (e.g., cash or share-settled), and priority in liquidation. Further, there is considerable variation in the feature or features that users consider to be most important in distinguishing between liabilities and equity, suggesting that there may be no binary classification on which all users would agree (Clor-Proell et al. 2016). In addition, a working paper by Linsmeier et al. (2018) finds that investors consider an entity's economic health in determining whether a claim should be considered a liability or equity, suggesting that users form their own beliefs about liability or equity status based on criteria that would be difficult to codify in standards.[1] As a result, whatever features or other determinants the Board chooses as classification criteria will be incomplete and in some sense arbitrary. However, the solvency and valuation perspectives have long been considered fundamental in discussions regarding classifying equities and liabilities (Wahlen et al. 1999, Ryan et al. 2001). As such, the Committee agrees that the Board's preferred approach constitutes a reasonable basis for classification, so long as other relevant information is provided in a way that can be easily accessed and understood by users.

Application of the criteria under the Board's preferred approach

As illustrated in the table in paragraph 2.36 of the Discussion Paper, the Board's preferred approach defines equity narrowly (although not as narrowly as restricting equity to only common stock, as some commentators have advocated). Further, the Board's preferred approach maintains a strict dichotomous classification: a financial instrument must be classified as ether a liability or as equity; no other classification (e.g., mezzanine) is permitted. It thus follows that the Board's preferred approach defines liabilities relatively broadly: indeed, a financial instrument will be classified as a liability unless it satisfies the "nonobligation" test under both the solvency and valuation perspectives.

The Committee notes that there are advantages and disadvantages to this approach, which we highlight below. However, we do not opine on the relative importance of these advantages and disadvantages. One advantage of the Board's preferred approach is that maintaining a strict dichotomy between liabilities and equity—without a mezzanine—avoids the need to determine (and the potential for a lack of clarity about) how to account for changes in the value of items classified in the mezzanine; i.e., should these be included in net income, other comprehensive income, or not accounted for at all?

We note that a previous commentary (Ryan et al. 2001) advocated for a mezzanine approach, primarily based on research by Hopkins (1996). Hopkins tested the effect of liability, equity, and mezzanine classification of mandatorily redeemable preferred stock (MRPS) on the valuation judgments of experienced buy-side analysts. As Ryan et al. (2001, 391) explain, "Hopkins' (1996) conclusion is that

[1] Specifically, Linsmeier et al. (2018, 7) find that investors "price preferred stock of low (high) default risk firms like liabilities (equity) consistent with an emphasis on dilution (solvency)."

the analysts more carefully examined the attributes of the MRPS when it was classified in the mezzanine, but the analysts took certain attributes for granted when the MRPS was classified as either debt or equity." This argument was persuasive in light of Hopkins' (1996) evidence. However, Clor-Proell et al. (2016) find that experienced financial statement users rely primarily on the features of a similar instrument in judging the issuer's creditworthiness, and this is true even when the instrument is classified as a liability or as equity. There are multiple possibilities for the apparent differences between the conclusions reached by Hopkins (1996) and Clor-Proell et al. (2016), including both the passage of time and the different nature of the dependent measures in the two studies (valuation in Hopkins (1996) versus creditworthiness in Clor-Proell et al. (2016)). Nevertheless, the Committee considers it likely that experienced users understand the significant variation in the features of financial instruments. Hybrid and compound financial instruments may not have been well-understood in the mid-1990s, even by experienced users. However, the subsequent proliferation of such instruments, paired with a lack of clarity about classification, has surely made experienced users aware of the need to examine the features of financial instruments.

Another advantage of the Board's preferred approach is that the narrow definition of equity has the advantage of what might be called categorical diagnosticity. Equity is a well-defined category under the Board's preferred approach, so that users know what it means for a claim to be classified as equity, at least as regards the two criteria specified. As discussed by Botosan et al. (2005, 168), and based on Scott (1979), a good classification system "uses the attributes of an object that are of central importance to the classification system's primary users to unite similar objects and distinguish them from fundamentally different objects." The Board's preferred approach seems to meet this criterion for equity classification, at least for many users. However, the dichotomous nature of the liability/equity distinction means that the advantages of defining equity narrowly are offset by disadvantages of a correspondingly broad definition of liabilities. In other words, the liabilities category is not well-defined, and the Board's preferred approach will result in a broad range of claims with very different characteristics being classified as liabilities.

Other features – presentation and disclosure

A consistent theme in the research on financial instruments with characteristics of equity is that standard setters should consider presentation and disclosure to be as important as classification, or perhaps even more important. This is evident in the studies noted in our comment on Question 1 above. However, as noted by Fargher et al. (2018), academic research generally does speak to the cost-benefit tradeoff of providing information about features, and we do not offer a comment about the costs of disclosure. Nevertheless, the Committee commends the Board's emphasis on presentation and disclosure.

We offer two additional comments on this issue. First, a large body of research on footnote disclosure versus recognition suggests that footnote disclosure is unlikely to be a complete substitute for clear presentation on the balance sheet (e.g., Aboody 1996, Barth et al. 2003, Ahmed et al. 2006, Frederickson et al. 2006). Thus, the Committee concurs with the assessment of Ryan et al. (2001), who note that, when practical, presentation on the face of the balance sheet is preferable to footnote disclosure as a means for communicating effectively to users. Presentation could include, for example, disaggregation of various types of financial instruments classified as liabilities and equity, listing of such instruments in order of priority in liquidation, and parenthetical disclosure of other features, including voting rights and form of settlement. Such information, clearly presented on the face of the balance sheet, would benefit many users, including those who base their analysis of financial instruments on criteria other than those in the Board's preferred approach. Second, we note the importance of disclosing the effects of remeasurement subsequent to initial classification.

3. Question 9 (p. 123)

The Board's preliminary view is that providing the following information in the notes to the financial statements would be useful to users of financial instruments:

a. information about the priority of financial liabilities and equity instruments on liquidation (see paragraphs 7.7-7.8). Entities could choose to present financial liabilities and equity instruments in order of priority, either on the statement of financial position, or in the notes (see paragraphs 6.8-6.9).
b. information about the potential dilution of ordinary shares. These disclosures would include potential dilution for all potential issuance of ordinary shares (see paragraphs 7.21-7.22).
c. information about terms and conditions should be provided for both financial liabilities and equity instruments in the notes to the financial statements (see paragraphs 7.26-7.29).

Do you agree with the Board's preliminary view? Why, or why not?

How would you improve the Board's suggestions in order to provide useful information to users of financial statements that will overcome the challenges identified in paragraphs 7.10 and 7.29.

Are there other challenges that you think the Board should consider when developing its preliminary views on disclosures?

Comment:

(a) The Committee agrees that information about the priority of financial instruments on liquidation is useful to financial statement users. As noted in our reply to Question 2 above, the Committee believes that, where practical, presentation on the face of the balance sheet is preferable to footnote disclosure.

(b) The Committee agrees that information about the potential dilution of ordinary shares is useful to financial statement users. Information about dilution is essential for users who are primarily interested in valuation.

(c) The Committee believes that it is essential that information about financial liabilities and equity instruments be provided. Experienced users hold a variety of opinions about the characteristics that are most important in determining liabilities and equity (Clor-Proell et al. 2016). Thus, it is desirable to disclose sufficient information that users are able to form their own opinions about classification, and to conduct pro forma analyses on that basis.

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