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Technical Director
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856-5116

File Reference No. 2020-500
Re: The Proposed Statement of Financial Accounting Concepts - Concepts Statement 8—Conceptual Framework for Financial Reporting—Chapter 4: Elements of Financial Statements

Dear Technical Director:

Thank you for this opportunity to comment on *The Proposed Statement of Financial Accounting Concepts - Concepts Statement 8—Conceptual Framework for Financial Reporting—Chapter 4: Elements of Financial Statements* (File Reference No. 2020-500 and hereafter the "Exposure Draft"). We summarize below what we believe is a fundamental weakness in the proposed definitions of liabilities and equity, and we discuss an alternative approach to distinguishing between liabilities and equity. This alternative approach is based on our academic article, *An Alternative Approach to Distinguishing Liabilities from Equity*, which was recently accepted for publication in *Accounting Horizons*.

The Fundamental Weakness

In our view, the effectiveness of any definition for liabilities rests on its ability to distinguish liabilities from equity. Given the longstanding debate within the accounting profession over distinguishing liabilities from equity, it would appear that the existing definition of liabilities in Statement of Financial Accounting Concepts No. 6 ("CON 6") is ineffective at defining liabilities. Unfortunately, we believe that the definition proposed in the Exposure Draft does little to remedy the ineffectiveness of the CON 6 definition. The fundamental weakness of the current and proposed definitions for liabilities is that they attempt to distinguish liabilities from equity by distinguishing a firm's creditors from its owners. At its core, this approach to distinguishing liabilities from equity is subjective, arbitrary and subject to financial statement manipulation.

To illustrate our view, consider two common types of financial securities a firm can issue to finance its business activities: (1) traditional debt instruments (e.g., bonds) and (2) shares of common stock. Conventional wisdom within the field of financial accounting asserts that claimants holding bonds are among the firm's creditors, whereas claimants holding shares of common stock are among the firm's owners. One reason for this characterization is perhaps that common stockholders are exposed to economic fluctuations of the business, whereas bondholders are generally insulated from these economic fluctuations. Consequently, financial reporting standards essentially use these types of financial securities as benchmarks for determining whether a claimant is a creditor or an owner, and in turn, whether the underlying claim is classified as liabilities or equity.

However, consider that there are countless ways in which a firm can contractually structure financial securities to impose on the security holder varying degrees of exposure to the economic fluctuations of the business. For example, there are various classes of preferred stock that specify, to varying degrees, the amount to be paid as dividends or the timing with which the shares are to be settled (i.e., redeemed), thus limiting exposure to economic fluctuations relative to common stock. Conversely, there are debt instruments that present the security holder with options to convert the instruments to common stock, thus increasing the exposure to economic fluctuations relative to traditional debt instruments. However, at what level of exposure to economic fluctuations of the firm's business does the economic substance of a share of stock become that of a debt instrument, and perhaps require classification as liabilities, or does the economic substance of a debt instrument become that of a share of stock, and perhaps require classification as equity? These types of financial securities illustrate the problem with distinguishing a firm's creditors from its owners, and in turn, developing an effective definition of liabilities.

In our view, the point at which a bright line is drawn between declaring that one security holder is a creditor and another is an owner is subjective and inherently arbitrary. In the proposed definition of equity, the FASB clearly states that common and preferred stockholders are the owners. While this definition is certainly understandable, it does not solve the fundamental weakness of trying to draw a bright line along a continuum of complex financial instruments. We further contend that relying on the approach of distinguishing creditors from owners to distinguish liabilities from equity produces a definition for liabilities that is form based, rather than substance based, and is vulnerable to contract structuring to achieve desired liability or equity classifications.

An Alternative Approach

In our academic article, *An Alternative Approach to Distinguishing Liabilities from Equity*, we propose that liabilities can be distinguished from equity on the basis of a fundamental distinction between the capital a firm acquires from issuing claims on its assets ("external capital") and the capital it earns from selling goods and services ("earned capital") – hereafter the "Earned Capital Approach." Earned capital consists of retained earnings and accumulated other comprehensive income and external capital consists of all else, including claims currently classified as liabilities and contributed shareholder capital. Under the Earned Capital Approach, external capital is classified as liabilities and earned capital is classified as equity. This approach notably departs from current financial reporting standards in that contributed shareholder capital is classified as liabilities rather than equity.

We classify external capital as liabilities and earned capital as equity because the acquisition of external capital is accompanied by the issuance of claims on the firm's assets (e.g., bonds, shares of stock), whereas the acquisition of earned capital is accompanied by the delivery of goods and services. This distinction is important because while the delivery of goods and services represents a sacrifice of economic benefits, the issuance of a claim on the firm's assets, including a shareholder claim, represents only an expectation of a sacrifice of economic benefits in the future. In other words, external capital represents capital received for which the firm is expected to make sacrifices in the future, whereas earned capital represents capital received for which the firm has already made a sacrifice, and in turn, has earned the right to use the capital for whatever purpose it sees fit.

In our view, the Earned Capital Approach can be used to develop a clear and consistent definition for liabilities. Under the Earned Capital Approach, the feature that distinguishes liabilities from equity is the existence of a claim on the firm's assets. That is, liabilities are simply outstanding claims on the firm's assets, including the outstanding claims of common stockholders. The primary advantage to defining liabilities in this way is that it *does not* rest on arbitrary distinctions between different types of claims.

We recognize that a definition for liabilities that conforms to the Earned Capital Approach would differ significantly from the current CON 6 definition and the proposed definition in the Exposure Draft. Accordingly, we discuss three alternative ways in which these definitions could be modified to conform to the Earned Capital Approach:

(1) Revise the concept of "present obligation" to include shareholder claims.

Perhaps the simplest modification to the current and proposed definitions for liabilities is to expand the concept of "present obligation" to include obligations a firm has to its shareholders. To illustrate the logic behind this modification, consider the arrangement between the firm and a shareholder. The shareholder has supplied capital to the firm in exchange for a share of stock. This share of stock grants the shareholder the right to receive an economic benefit in the future as compensation for providing use of capital. The existence of this right is recognized under current financial reporting standards in that the shareholder would record the share of stock as an asset (i.e., a present *right* to an economic benefit) on its financial statements. If one accepts that the holder of a share of stock has a present *right* is to an economic benefit, one must accept that the issuer of the share of stock, conversely, has a present *obligation* to transfer that economic benefit.

(2) Replace the concept of "obligation" with that of "expectation."

We recognize that, to many accountants, the notion that a firm has a *present obligation* to its shareholders may be difficult to accept. Therefore, our second alternative for modifying the current and proposed definitions for liabilities, for which we express support in our paper, is to replace the concept of *obligation* with that of *expectation*. Specifically, we note that all types of claims on a firm's assets represent, at the very least, *expectations* of the firm to transfer economic benefits in the future. That is, an outstanding claim arises when the firm engages in an economic transaction with another entity in which that other entity willingly agrees to transfer an economic benefit to the firm in exchange for a claim on the assets of the firm. A claim on the assets of the firm represents the prospect of receiving an economic benefit from the firm in the future. Note that the other entity would not willingly accept a claim on the assets of the firm if it did not at least have an *expectation*, however probable, of receiving an economic benefit in the future.

We recognize that it may appear, at first glance, that a shift from *obligation* to *expectation* is merely an issue of semantics. This raises the question as to how the existence of an *expectation* is any easier to observe than the existence of an *obligation*. The simple answer is that a related past transaction or event serves as objective and observable evidence than an expectation exists. For example, consider the case of a bond issuance. To the issuing firm, the bond represents an expectation to transfer of an economic benefit not simply because there is an explicit legally enforceable requirement that it make such a transfer, but on a deeper level, because the bondholder would not have willingly paid for the bond had it not expected to receive an economic benefit in the future. We can apply this same logic to the case of a share of common stock. That is, a share of common stock represents an expectation for the issuing firm to transfer an economic benefit because the shareholder would not have paid for the share had it not expected to receive an economic benefit in the future. In other words, the issuances of the bond and share of common stock in these examples serve as the objective and observable evidence that they represent expectations to transfer economic benefits.

It is important to note that the use of *expectation* in the definition for liabilities does not in any way open to door to the recognition of any and all expected future transactions. We are not suggesting, for example, that firms recognize liabilities for the wages they expect to pay in future years. Rather a past transaction or event is required for an expectation to exist, as described herein. In an exchange with another entity, the firm can only have an *expectation* to transfer an economic benefit to the other entity if the other entity has already performed its end of the exchange. In the case of wages, the firm only has an expectation to pay wages to an employee if the employee has performed the work for which the wages are earned.

(3) Replace "liabilities" and "equity" with "external capital" and "earned capital."

Finally, the third alternative for modifying the current and proposed definitions for liabilities is not really a modification at all, but rather an elimination of the definitions from Conceptual Framework altogether. More specifically, the terms *liabilities* and *equity* could be replaced as financial statement elements by *external capital* and *earned capital*. The fact that the profession has wrestled with how to distinguish liabilities from equity, and in turn, developing effective definitions for liabilities and equity for roughly the past three decades may indicate that these terms are inherently complex and confusing. The primary advantage of this alternative is that it does not require the dramatic changes to the definition for liabilities discussed with the other two alternatives. Rather, it simply replaces *liabilities* and *equity* with financial statement elements that are easier to distinguish from one another, and in turn, easier to define.

Financial reporting benefits of the Earned Capital Approach

In addition to providing an effective definition for liabilities, we discuss in our paper four ways in which financial reporting would benefit from the implementation of the Earned Capital approach. Below we present a brief summary of those benefits.

Benefit #1: A Conceptual Definition for Equity

As noted by Ms. Botosan in the alternative view section of the Exposure Draft, the proposed Concept Statement falls short of providing a definition for equity. We believe that modifying the definition of liabilities in one of the ways we suggest above gives rise to a conceptual definition for equity independent of the definitions for assets and liabilities. While equity can be defined under both the Earned Capital Approach and current financial reporting standards as "assets minus liabilities," the difference lies in how much easier it is to ascribe meaning to "assets minus liabilities" under the Earned Capital Approach than it is under current financial reporting standards. Specifically, "assets minus liabilities" under the Earned Capital Approach represents the accumulation of amounts earned from selling goods and services (net of the value of goods and services consumed and any incidental gains and losses). In contrast, "assets minus liabilities" under current financial reporting standards represents both the accumulation of amounts earned from selling goods and services and amounts acquired from issuing claims to various classes of shareholders, which represent two fundamentally distinct activities. In our view, the reason that equity lacks a conceptual definition under current financial reporting standards is because it is a combination of these two fundamentally distinct activities. The Earned Capital Approach remedies this problem by excluding from equity amounts acquired from issuing claims to shareholders.

Benefit #2: An Improved Concept of Net Income

As part of the Earned Capital Approach, we propose that the cost of shareholder capital be recorded as an expense when the firm declares cash dividends and/or executes stock repurchases. Specifically, we propose that cash dividends be recognized as expenses when declared, whereas stock repurchases result in the recognition of losses (gains) if the amount paid to reacquire the shares is greater than (less than) the book value of the shareholder claim. Consequently, net income under the Earned Capital Approach represents a measure of the *firm's income* rather than a measure of the *owners' income*. While cash dividends and stock repurchases represent increases to the owners' net worth, they represent decreases to the firm's net worth. The Earned Capital Approach reflects this reduction in net worth as an economic cost to the firm.

Benefit #3: Improved Financial Statement Articulation

Third, financial statement articulation is easier to observe between the balance sheet and statement of comprehensive income under the Earned Capital Approach. More specifically, under the Earned Capital Approach, comprehensive income is simply the net change in equity during the period. (i.e, the change in the net economic resources available to the firm). In contrast, under current GAAP as well as under the proposed Concept Statement, observing the relation between comprehensive income and changes in stockholders' equity requires adjustments for stock issuances, repurchases, and dividends. In our view, simplifying this articulation allows users to more clearly observe the relationship between a firm's comprehensive income and its financial position.

Benefit #4: Alignment of Balance Sheet with other Financial Statements

The format of the balance sheet under the Earned Capital Approach is conceptually consistent with the formats of the income statement and statement of cash flows. That is, the balance sheet presents accumulations of capital earned from selling goods and services in a separate category (i.e., equity) from accumulations of capital received from the issuance of claims (i.e., liabilities). Similarly, the income statement presents amounts earned from selling goods and services and excludes amounts received from issuing claims, and the statement of cash flows presents cash received from selling goods and services in a separate category (i.e., operating activities) from cash received from issuing claims (i.e., financing activities). In our view, this alignment of financial statement presentation allows users to more clearly understand the relationships between the financial statements.

Subclassifications of Liabilities

Finally, we discuss what we anticipate to be a common objection to the Earned Capital Approach: heterogeneity within the liabilities classification. Specifically, the Earned Capital Approach creates a substantial amount of heterogeneity by similarly including shareholder claims and creditor claims in the liabilities classification. To some, it may appear as though important distinctions between significantly different types of claims (e.g., debt versus common stock) are ignored. On the contrary, we suggest that many of these distinctions could be emphasized by organizing the liabilities section on the balance sheet into a hierarchical system of subclassifications. We relegate a detailed discussion of this subclassification system to our academic article.

Conclusion

To summarize, it is our view that the fundamental weakness of the proposed definition for liabilities in the Exposure Draft is in the attempt to delineate between a firm's creditors and its owners. As a solution to this problem, we propose distinguishing liabilities from equity on the basis of two fundamentally distinct methods of acquiring capital: (1) issuing claims against the firm's assets, and (2) selling goods and services. This approach is discussed at length in our academic article, *An Alternative Approach to Distinguishing Liabilities from Equity.* A pre-acceptance draft of the article is available at: https://papers.ssrn.com/abstract=3086824.

We thank you for the opportunity to comment on the Exposure Draft. We would be happy to answer any questions you might have or discuss these matters further at any time.

Sincerely,

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