1550-100

LETTER OF COMMENT NO. 1

From: M. A. Gumport [mailto:magumport@att.net]
Sent: Monday, December 10, 2007 5:17 PM
To: Director - FASB
Subject: FASB File Reference No. 1550-100 - Comment on Preliminary Views

Dear Director:

Attached is a comment on the 11/30/07 *Preliminary Views - Financial Instruments with Characteristics of Equity.*

While the attached comment is my principal focus, I would like to express my surprise that paragraph 28 (p. 7) of the *Preliminary Views* indicates the application to FASB 123R will be considered separately.

Regards,

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December 10th, 2007

Attention: Technical Director
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RE: FASB FILE REFERENCE NO. 1550-100 – PRELIMINARY VIEWS – FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF EQUITY

Dear Director:

I respond to the request for comments on File 1550-100. As background, I am engaged in a corporate finance advisory start-up. Previously, I served as CFO and/or director of three semiconductor ventures, two of which went public and were acquired. I began my career as an economist and securities analyst, my occupation for over 20 years. I have been involved in the design, trading, and issuance of complex equity securities and options for investment banks, corporate issuers, and personal investment.

The FASB Board solicited comments[1] on variations and alternative approaches and indicated it had "briefly discussed"[2] the "claims approach" in which the distinction between liabilities and equity is eliminated, that the claims approach was an alternative in the 1990 Discussion Memorandum, and that the claims approach will be reconsidered only if the FASB Board is persuaded to do so[3].

[1] *Preliminary Views*, p. 65, question 1, "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?"

[2] *Preliminary Views*, p. 63 "Other Approaches Briefly Discussed but Not Fully Developed".

[3] *Preliminary Views*, p. 64, E9, "The Board probably will not discuss the claims approach again unless comments on the proposed approaches in the Preliminary Views persuade it otherwise. Respondents who favor eliminating the distinction between liabilities and equity are urged to provide details on how different types of instruments would be measured, whether change in carrying value would affect net income, and how they would be presented in the financial statements."

REASONS TO RECONSIDER "CLAIMS" APPROACH

Accounting standards face a dilemma in the application of fundamental premises.

- *Premise 1* - Equity is defined as a residual of assets minus liabilities.[4]

- *Premise 2* -Changes in the value of assets and liabilities are reported in income but changes in the value of equity are never reported in income.[5]

Complex financial instruments complicate application of these premises. The FASB's broad project on financial instruments in 1986 resulted in a Discussion Memorandum in 1990. After public comment, the effort was suspended in 1991, then reactivated in 1996. Two Exposure Drafts were issued in 2000. Statement 150 in 2003 tried to implement conclusions of limited scope but was put on hold.

After 22 years of effort[6], any adopted recommendation of the Liabilities and Equities Project should meet the FASB's stated goals:

> "...[In 2003, the FASB] Board changed its plan. The new plan was to start over and attempt to develop a convergent set of classification principles...as well as resolve the remaining issues."[7]...
>
> "[in summary, the new plan was] to 1) improve accounting and reporting by issuers of financial instruments that contain characteristics of equity and liabilities, assets or both and 2) amend and improve the definitions of liability, equity, and perhaps assets...such that decisions...are consistent..."[8]

The FASB's goals, if achieved, are anticipated to:

1) Align financial reporting with economic substance.

   "In some ways, the current standards depend more on legal form than on economic characteristics...In some cases, an issuer [today] can effectively choose how to report an instrument or instruments by altering their form without changing the substance..."[9]

2) Provide principles that can be practically and consistently applied.

[4] From *Concepts Statement 6*, Paragraph 49 as stated in *Preliminary Views*, p. 58, paragraph D9.
[5] *Preliminary Views*, p. 1, paragraph 3.
[6] *Preliminary Views*, p. 62, paragraph E1.
[7] *Preliminary Views*, p. 63, paragraph E6.
[8] *The FASB Report*, 2/27/04, "Evolution of the Liabilities and Equity Project".
[9] *Preliminary Views*, p. 2, paragraphs 5-6.

> "Strict application of [the current definition of a liability] would lead to the conclusion that any obligation that requires an entity to issue shares of its own stock is not a liability[10]...[Consequently], GAAP has not always literally applied [its own] definition."[11]

Adoption of *Preliminary Views* Will *Not* Meet the FASB's Goals

The Preliminary Views release offers one solution in three sizes ("narrow", "wide", and "wider"): All amount to "solution by proclamation / decision by opinion". Instead of defining equity as a residual (assets minus liabilities), all versions of the proposed solution define equity and then proclaim which instruments meet the definition. The only difference between the three solutions ("basic ownership", "ownership-settlement", and "reassessed expected outcomes") is the breadth of the definition.

> "Basic ownership instruments are fundamental to all three approaches...The definition of a basic ownership instrument can stand alone as a reasonable starting point for the definitions of liabilities and equity. In contrast, the current definition of equity cannot stand alone because it depends entirely on the definitions of assets and liabilities. The three [proposed] approaches [are the same except] use the concept of a basic ownership instrument [differently]..."[12]

Nailing down comprehensive and definitive treatment of complex instruments under any version of the Preliminary Views' approach will prove an exercise in futility. The *Preliminary Views'* Classification Examples[13] table lists 25 types of financial instruments with varying purported treatment under the "narrow", "wide", and "widest" versions. Disputes on the theoretical and economic justification for various classifications of the 25 identified financial instruments are inevitable.[14] Moreover, new instruments will evolve to take advantage of the new rules, and each new instrument (and all its special cases) will need to be added to the 25 examples before an authoritative opinion on "correct" treatment can emerge. The special treatment accorded redeemable instruments[15] and treatment upon instrument reclassification[16] are just two among many practical problems in implementation that will give leeway for income management.

[10] *Preliminary Views*, p. 2, paragraph 7.

[11] *Preliminary Views*, p. 19, footnote 5.

[12] *Preliminary Views*, p. 58, paragraphs D8-10.

[13] *Preliminary Views*, Table 2, p. 46.

[14] *Preliminary Views* (p. 15, paragraph 46) discusses the treatment of a warrant with a $0.01 strike price for a stock trading at $100.00 and also discusses the treatment if the strike were $0.01 and the stock price were $0.02. But what if the strike price were $0.50 and the stock price $10.00? Or a strike of $1.00 and stock price of $2.50? At what point is an alternative treatment required (at what point does the possibility of exercise become significant)? This example is among the simplest, yet it clearly will raise issues of interpretation. Similarly, all 25 examples are subject to special cases, exceptions, and various "shades of gray".

[15] *Preliminary Views*, p. 8, paragraph 32.

[16] *Preliminary Views*, p. 12, paragraph 40.

All the proposed solutions treat symptoms, not the underlying disease, and application will be a complex, tedious, confrontational operation. The FASB Board supports the "narrow" Basic Ownership approach because:

> "...[it] is simpler and easier to apply than the other two approaches [...and...] provides fewer opportunities...to structure instruments...to achieve a desired accounting treatment."[17]

Yet, the *Preliminary Views*' Qualitative Comparison[18] table underscores that the advantages of the "narrow" approach are strictly *relative*. All three approaches share a common starting point and differ only in degree. None can claim the virtue of absolute simplicity in application nor assure accounting more naturally hews to economic substance. All will demand reexaminations of special cases and special instruments one by one, a thankless task bound to be marked by conflicting opinions.

Importantly, if the problem is that financial statements diverge from economic substance and lack consistency, arguably, a chief cause is the distinctive treatment accorded to equity claims. The Preliminary Views report addresses only Premise 1, the definition of equity, which it proposes to resolve by proclamation and opinion, and entirely ignores Premise 2, the appropriateness of excluding from income and/or the balance sheet transactions and value changes in instruments deemed to be equity.

Equity Mark to Market ("Claims Approach") Will Meet All FASB Goals

"Equity mark to market" is synonymous with the "claims" approach. In its "brief"[2] consideration of the claims alternative, the FASB Board rejected it because:

> "Unless all claims are measured the same way, and the changes in their value are reported the same way, the distinction between liabilities and equity is necessary."[19]

[17] *Preliminary Views*, p. iii.

[18] *Preliminary Views*, Table 1, p. 45.

[19] *Preliminary Views*, p. 63, paragraph E7. *Preliminary Views* states a claims approach fails to indicate which items should be reported in income, but, to the contrary, a claims approach starts with the notion that *all* items should be reported in income, and that starting point is an advantage, not a shortcoming. *Preliminary Views* (in all three flavors) is flawed by allowing some transactions ("equity adjustments") to escape being reported in income and then arguing over which items qualify. In the claims approach, all financial instrument transactions (other than issuances at a market price or retirement at recognized cost) and value fluctuations are recognized as income (profit, loss, interest or dividends) regardless of the label (equity, debt), and controversy over classification, separation, and combination disappears.

But, that is exactly the point. Under the claims approach, all claims *are* measured and reported the same way. While *Preliminary Views* addresses solely Premise 1 (definitions), the claims approach addresses Premise 2 (actions).

Adoption of the claims approach would represent a long overdue modernization of accounting. The exclusion of "equity" items from the income statement (and/or the failure to mark equity to market on the balance sheet) serves no useful purpose and is the chief cause of the current dilemma. When Pacioli codified accounting in 1494, public stock exchanges did not exist. That changed subsequent to the founding of the Dutch East India Company in 1602, but accounting did not. Public stock exchanges accord "market equity value" *distinct* from "accounting equity value"[20], but rules of accounting act as if stock exchanges were never invented. Today, companies routinely trade at 2x-3x accounting book value and often far more. Companies like Microsoft and Coke, among many others, have substantial "hidden assets", and often these will be the majority of a firm's assets. Imagine if personal brokerage statements came in the form of corporate financial reports: Investors would know their exact, cumulated, proportionate interests in the accounts (income, assets, liabilities, equity, etc.) of the companies in which they were invested yet find hardly a clue as to what their holdings were actually worth.

The accounting implementation of marking equity to market ("claims" approach) is straightforward and entirely objective. While the Preliminary Views' approach will end up addressing symptoms instrument by instrument, the claims approach remedies the root problem and will fully meet the FASB's goals. The claims approach eliminates labels ("liability", "equity") as a path to allow form to take precedence over substance since, whatever the label, the treatment is the same: All instruments are marked to market and recognized in income. Assets show an "equity value added" account, liabilities show an equal and offsetting "equity adjustment" account. It would be reasonable to separate reported income into income from operations and financing (with further subdivision for discontinued operations and mark to market adjustments).

An example transaction including balance sheet, income statement, and equity account reconciliation is provided in "Accounting for Equity Transactions", pages 10-17 (http://www.ssrn.com/article=1062201).

Regards,

[sig.]
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cc. Ann Sulzberg, Special Counsel, SEC

[20] Lenders recognized the collateral value of the Dutch East India Company's "hidden assets" (and "hidden equity"). Access to credit far in excess of what accounting book value would have allowed facilitated the Dutch East India Company's rise to become the world's largest commercial enterprise in the 17th century.