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LETTER OF COMMENT NO. 2

To the Technical Director

File Reference No. 1550-100

Comments on Preliminary Views, Financial Instruments with Characteristics of Equity, dated November 2007

Dear Technical Director:

I am very pleased to have this opportunity to comment on this most important Preliminary Views related to financial instruments with characteristics of equity. I believe that the importance of this topic cannot be overstated since it affects so many areas in accounting and finance. I tried to group my comments into homogenous groupings by relevance. I hope the comments are easy to read for that was my goal in writing them.

The first thing I would like to address is the use of the "Basic Ownership" approach to classify liability and equity instruments. I concur that the basic ownership approach is the desirable method. The basic ownership approach agrees with the conceptual framework project as specified in SFAC No. 6, paragraph 49 which considers "equity or net assets" to be the residual interest in the assets after liabilities are deducted. I feel so strongly about the residual concept that I believe that the title of the equity section of the balance sheet should be changed to the "Net Assets" section. I also agree that the basic ownership approach is easier to work with than the other two methods and I'm a proponent of simplified accounting principles.

I would like to take the opportunity at this time to address the decision in paragraph no. 12 of the Preliminary Views regarding the restructuring of the financial statements. I believe that a restructuring of the balance sheet into three new categories (the business section, the financing section and the equity section) would be very expensive and thoroughly confusing for several reasons. First, the covenants in almost every loan agreement would have to be rewritten to account for the new structure. This would include perhaps millions of agreements. And second, the earnings per share section would have to be restructured in a way that would render the comparability of EPS rather impossible to achieve. SFAS No. 128 on Earnings per Share would also have to be

replaced. And third, the financial statements would not be comparable over several years and the comparable balance sheets presented with the current year would have to be restated under SFAS No. 154. In any case, if the balance sheet is restructured, I believe that those financial instruments that bear characteristics of both equity and liabilities should be classified in the financing section of the balance sheet, or that a new section should be presented for those instruments that do not easily fit into either the financing section or the equity section. I next consider the issue of "Separation."

I believe rather strongly that the separation of financial instruments should not be done unless the instruments meet three conditions:

- 1. The financial instruments must be physically separable so that each can be traded on an exchange or otherwise bought and sold separately,
- 2. Markets for the separate instruments must exist so that fair value can be reasonably determined, and
- 3. The value of each instrument must not be dependent upon each other.

I have the same philosophy, but in reverse, when dealing with the concept of linkage. In this case I believe that linkage should be achieved only when three conditions are met. They are:

- 1. The financial instrument must be physically attached so that they must be traded on an exchange or otherwise traded together,
- 2. Markets for the combined instruments must exist so that their values can be reasonably determined, and
- 3. The values of each linked instrument must be dependent upon each other.

The next area I address is one that was given scant attention in the Preliminary Views. That area relates to the characteristics of an equity instruments which should be stated so that one can properly classify a financial instrument in the balance sheet. I compiled a brief list of characteristics which I believe define equity investments or at least allow a subjective determination that an instrument is an equity instrument. They are:

- 1. A risk of loss,
- 2. The residual interests after liabilities are paid (the Preliminary Views addresses this feature but takes a hypothetical liquidation approach to determine residual interests),
- 3. Participation in management. While those creditors who provide financing to an entity (especially a small entity) do in fact have input into the management of the entity, their input is more indirect and is usually limited to ascertaining that the management in place has the expertise and ability to properly manage the entity. Management control for an equity instrument is usually more direct and more active on a day to day basis,
- 4. Equity investment holders expect a greater return on investment to compensate them for the greater risk they take,

5. And finally, equity investment holders are not guaranteed a dividend or other direct return on investment.

I believe rather strongly that equity instruments should be recorded in the financial statements at fair value with a debit or credit to "Unrealized Gains and Losses." This would give stakeholders a better idea, without the need for burdensome research, of the value of their securities in the marketplace. Another approach would be to value assets and liabilities at fair value so that the residual interest (equity) would then be valued at fair value by default.

The Preliminary Views does not address some important areas which I believe the FASB should consider if this project goes forward. The first area is in the proper accounting treatment of dividends and a determination of the value of securities as they move from the dividend declaration stage to the "ex-dividend" date. Since I believe that equity securities should be restated from time-to-time to properly reflect the fair value of the securities, I also believe that the change of value of the instrument caused by the declaration of a dividend should be a recordable event. The second area not addressed in the Preliminary Views is that of loans from owners to include officers. Some loans from owners are more like equities than financing (or liability) instruments. They usually have no repayment schedule and are repaid when the entity is able to do so. In some cases the loans from owners are never repaid. These loans from owners might best be classified as paid-in capital. A third area not addressed is how best to define assets and liabilities in order to determine the residual "Net Assets" section in the balance sheet. A fourth area not completely addressed is the definition of the term "probable outcome" in paragraph 44 of the Preliminary Views. What is an outcome? Can the Board provide examples to help CPAs gain a better understanding of the term "outcome" and what it means? A fifth area to consider is how to value instruments held by subsidiaries and how the value of those instruments affect affiliated entities.

In reading paragraph 18 of the Preliminary Views I am a bit troubled by the use of a hypothetical liquidation approach to characterize a basic ownership instrument. My concern lies in the brief but decisive abandonment of the going concern concept of accounting. Yet, as a valuation technique I have no trouble with using this liquidation methodology. As a result, I believe that the Board should look at this and make a determination based on the risks and merits of using this measurement technique.

I believe that the Board should take a second look at the proposal to classify preferred stock as a liability. Are dividends guaranteed? Do they have to be declared? I thought they were the first dividends paid when dividends are declared which means that they could go without dividends from time to time. This would render the preferred shares to be equity, not a liability.

The Preliminary Views states that dividends should be recorded when declared or at regular intervals based on a company history of consistently declaring dividends. I do not concur with this approach and I believe that a company history of declaring dividends

is not determinative when deciding the likelihood that a dividend will be declared in the year in question.

In paragraph 49.a. of the Preliminary Views the term "derecognized" is used to explain the treatment of an instrument that would cease to exist. This term "derecognized" is not further explained and in all my years in accounting, I have never seen a case where an instrument is "derecognized." So how does one go about derecognizing an instrument? And what does it mean to "completely derecognize" an instrument? Is it possible then to partially derecognize an instrument? I think the Preliminary Views needs to better define this term.

In regards to paragraph 55 of the Preliminary Views, the statement is made that basic ownership instruments are the "one class of claimants without which the entity could not exist or operate." I don't know what the impact of this statement is across the document, but I disagree with the statement. An entity cannot exist or operate without creditors too. In fact, creditors may have a greater claim to the statement that the entity cannot exist or operate without them.

Again, I am grateful for this opportunity to comment on this Preliminary Views. I am also grateful for the speed at which the document was provided to me. It was very impressive.

Anthony DeStefano, CPA