

March 20th, 2008

Attention: Technical Director
International Accounting Standards Board
30 Cannon Street, 1st Flr.
London, EC4M 6XH
United Kingdom
Phone: +44 (0)20 7246 6410
Email: iasb@iasb.org

RE: INVITATION TO COMMENT ON IASB “DISCUSSION PAPER FEBRUARY 2008” REGARDING FASB FILE REFERENCE NO. 1550-100 – “PRELIMINARY VIEWS – FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF EQUITY”

Dear IASB Director:

I respond to your request for comments on the IASB’s February 2008 “Discussion Paper” pertaining to FASB File 1550-100, “Financial Instruments with Characteristics of Equity” and specifically your question B1. 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 IASB’s “Discussion Paper” paragraph 42 states the FASB put forward the “claims” approach in its Appendix E in a form that is “[not] fully developed”. Importantly, the IASB summary fails to mention that the FASB indicates it will reopen consideration of the “claims” approach in the event it receives adequate favorable comment.

I strongly recommend the IASB and FASB consider the advantages of the “claims” approach. In support, I have attached 2 comment letters submitted to the FASB. The first comment letter argues the three alternatives proposed by the FASB will not correct the underlying problem (the distinctive treatment accorded to equity transactions) but rather result in ongoing complexity and opportunity for earnings manipulation. The second comment letter presents a letter from the CFO of a U.K. corporation that argues in favor of the “claims” approach.

Regards,

Michael A. Gumport, CFA
Founding Partner

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IASB Attachment 1

Open Letter to FASB Published as

“GAAP’s Gap Part II”

Posted at

<http://ssrn.com/article=1069423>

GAAP's Gap – Part II

Accounting for Equity Transactions

Open Letter Comment on:

FASB Preliminary Views Financial Instruments with Characteristics of Equity (11/30/07 – File Reference No. 1550-100)

Abstract

The Financial Accounting Standards Board (FASB) has long recognized shortcomings in fundamental accounting principles that are exacerbated by the proliferation of increasingly complex financial instruments. The FASB has been engaged since 1986 in a project to align financial reporting with economic substance and improve consistency.

The FASB recently issued its *Preliminary Views*. Key points are:

- After a 22 year effort, the result should be good. It is not.
- A carve out is provided to allow separate consideration “at a future date” for the treatment of compensation options. Until then, option compensation accounting (SFAS 123R), though flawed, is exempted. Hot potato!

The FASB *Preliminary Views* lists two fundamental premises of accounting that contribute to engineered earnings and inconsistent reporting: 1) The definition of equity, and 2) The exclusion of equity items from the income statement. The FASB's proposed solution is to redefine “equity” and deals with only the first premise while ignoring the second. If adopted, the result will be a tedious, case by case dispute on whether an instrument qualifies to be treated as equity, and a crop of new securities will surely arise to skirt the revised rules. Meanwhile, a simple, comprehensive opportunity (the “claims approach”, part of a 1990 FASB Discussion Memorandum) to modernize accounting by marking equity to market within the income statement has been scrapped.

**The “Comment Letter” that follows refers to
The FASB’s 11/30/07**

***Preliminary Views
Financial Instruments with Characteristics of Equity***

Available at http://www.fasb.org/draft/pv_liab_and_equity.pdf

Opinions expressed rely heavily on the author’s

***GAAP’s Gap:
Pacioli after the Dutch East India Company***

<http://ssrn.com/article=1062201>

December 10th, 2007

Attention: Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116
Tel. - 203 847-0700
Email - director@fasb.org

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 comments¹ 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 so³.

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.”

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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 effort⁶, 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 liability¹⁰ ... [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 Examples¹³ 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 instruments¹⁵ and treatment upon instrument reclassification¹⁶ 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.]

Michael A. Gumport, CFA
Founding Partner
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.

IASB Attachment 2

M. Gumport Email to FASB in Support of “Claims” Approach Including Forwarded Comments of U.K. Corporation CFO

Posted at

<http://www.fasb.org/ocl/1550-100/51749.pdf>

-----Original Message-----

From: M. A. Gumport [mailto:magumport@att.net]

Sent: Tuesday, December 11, 2007 2:58 PM

To: 'director@fasb.org'

Subject: CFO Comment on "Equity Mark to Market Accounting" (RE: FASB Preliminary Views 1550-100)

FASB Directors:

The excerpted message below is from a CFO and is relevant to the Liability and Equity project's *Preliminary Views*. I submit it in addition to my formal *Comment* which urged the Board to reopen consideration of the "claims" approach (<http://www.ssrn.com/article=1069423>).

The CFO's note describes how current accounting rules produce two entirely different reporting results for economically identical transactions, in this case, an IPO. He discusses his actual IPO experience and how it would apply to an example in which IPOCO with 100 million shares outstanding and \$10.00 book value executes an IPO of 10 million shares at \$30.00 apiece (example from "Marking Equity to Market", 12/5/07, <http://www.ssrn.com/article=1062201>, pages 10-17).

The solution proposed by *Preliminary Views* will do nothing to address the conflicts cited by the CFO. However, the "claims" approach (synonymous with marking equity to market and recognizing it in income) eliminates the disparate treatment in the CFO's IPO case and most other cases, too, plus has the virtue of extreme simplicity.

Regards,

Mike

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(cont'd)

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-----Original Message-----

From: [a CFO]

Sent: Thursday, December 06, 2007 5:35 AM

To: M. A. Gumport

Subject: RE: *Marking Equity to Market: 400 Years Overdue? (Pacioli in Light of the Dutch East India Company)*

Mike,

[Regarding your report "GAAP's Gap"], it's not often that I have found such materials interesting - thanks.

[In the example case from your paper "Marking Equity to Market", 12/5/07, <http://www.ssrn.com/article=1062201>, pages 10-17, in which IPOCO with 100 million shares outstanding and \$10.00 book value executes an IPO of 10 million shares at \$30.00 apiece], IPOCO could have recognized the hidden asset in its balance sheet by deal structuring. All it would need to do is to set up IPOCO Holdings Inc. with a contract to purchase IPOCO for \$3 billion stock plus \$0.3 billion cash immediately after its IPO. Then IPOCO Holdings would IPO and raise the \$0.3 billion cash and immediately purchase IPOCO. Purchase accounting would then kick in and the new IPOCO group would have to recognize around \$2.0 billion goodwill on its balance sheet.

So, two transactions which are substantially the same, can result in massively different accounting. This happened to my company - in 1999 we were acquired and, because the acquirers chose to set up and capitalize a holding company as an acquisition vehicle, \$58 million of goodwill was created. If they had simply bought the shares directly there would have been no goodwill.

So, right now GAAP allows your hidden assets to be recognized, but only if there has been an acquisition. To me this is completely illogical because it means the net asset value on the balance sheet can be radically different due to structural deal considerations.

Your proposal would eliminate this discrepancy. Your hidden asset is similar to goodwill, effectively you are wanting goodwill to be continually revalued based on market stock value, rather than only being created when there is an acquisition. This is a logical progression given the current tend to "fair value" accounting (though what is "fair" about paying valuation specialists big fees to make up phony valuation numbers which bear little real relation to future cash flows is beyond me).

Regards,

[Name Removed, CFO, UK Corporation]

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