Technical Director File Reference No. 1550-100

LETTER OF COMMENT NO. | 2_

I am responding to the Preliminary Views document from the perspective of the following quote from Concept Statement 1, "Objective's of Financial Reporting by Business Enterprises (from paragraph 32):

The objectives begin with a broad focus on information that is useful in investment and credit decisions; then narrow that focus to investors' and creditors' primary interest in the prospects of receiving cash from their investments in or loans to business enterprises and the relation of those prospects to the enterprises prospects; and finally focus on information about an enterprise's economic resources, the claims to those resources, and changes in them, including measures of the enterprise's performance, that is useful in assessing the enterprise's cash flow prospects.

I believe the Ownership-Settlement Approach (O-S) would result in better financial reporting than the Basic Ownership Approach (B-O) for the following reasons:

- O-S takes an enterprise perspective and provides information useful in assessing the
 enterprise's cash flow prospects and provides information on the face of the financial
 statements about the enterprise's liquidity and solvency. B-O takes the perspective of
 the enterprise's existing basic ownership interest holders and treats dilution to the
 existing holders interest as if it has liquidity and solvency implications to the
 enterprise.
- 2. Both O-S and B-O have complexity. The simplicity of B-O is overstated.
- 3. An operational definition of a liability is needed. B-O creates more of a challenge to creating such a definition that covers both instruments and non-instruments.

Meeting the Objectives of Financial Reporting From an Enterprise Perspective

To demonstrate why I believe O-S takes the enterprise perspective and results in better financial reporting, I will use the following simple (and unrealistic) example. The enterprise's common stock is the basic ownership interest. The enterprise also has perpetual preferred stock outstanding. Dividends on both the common stock and preferred are not required.

Balance Sheet #1

O-S				<u>B-O</u>				
<u>Assets</u>		Liabilities		Assets		<u>Liabilities</u>		
Cash Inventory	100 200	Accounts Payable <u>Equity</u> Common Stock	200 75	Cash Inventory	100 200	Accounts Payable Preferred Stock	$\frac{200}{25}$	
	300	Preferred Stock	$\frac{25}{100}$ $\frac{300}{300}$		300	<u>Equity</u> Common Stock		

The enterprise issues 50 common stock warrants that are equity under O-S at \$5 per warrant. The warrant allows the holder to buy previously unissued common stock for \$25 per share.

Balance Sheet # 2

O-S				<u>B-O</u>				
<u>Assets</u> <u>Liabilities</u>			<u>Assets</u>		<u>Liabilities</u>			
Cash Inventory	350 200	Accounts Payable <u>Equity</u> Common Stock Preferred Stock Warrants	200 75 25 250	Cash Inventory	350 200	Accounts Payable Preferred Stock Warrants	200 25 250 475 Equity	
	<u>550</u>		350 550		Commo <u>550</u>	on Stock	7 <u>5</u> 55 <u>0</u>	

The enterprise's common stock price increases to \$32 per share. Thus, the warrants are in-the-money and the existing common stockholders are subject to dilution of \$7 per share. For simplicity, the warrant's fair value is equal to the \$7 per warrant.

Income Statement for Balance Sheet #3

<u> </u>	<u>B-O</u>				
Nothing reported	Remeasurement loss on warrants	<u>350</u>			
	Net loss	<u>350</u>			

Balance Sheet #3

<u>O-S</u>				B-O			
Assets		<u>Liabilities</u>		<u>Assets</u>		<u>Liabilitie</u>	<u>s</u>
Cash Inventory	350 200	Accounts Payable <u>Equity</u> Common Stock Preferred Stock Warrants	200 75 25 250 350	Cash Inventory	350 200	Accounts Payable Preferred Stock Warrants Equity Common Stock Retained deficit	200 25 600 825 75 <350> <275>
	<u>550</u>		<u>550</u>		<u>550</u>		<275> 550

The common stock price stays at \$32 per share and the warrants are exercised.

Balance Sheet #4

O-S				B-O				
<u>Assets</u> <u>Liabilities</u>			<u>Assets</u>		<u>Liabilities</u>			
Cash Inventory	1,600 200	Accounts Payable Equity	<u>200</u>	Cash Inventory	1,600 200	Accounts Payable Preferred Stock	$\frac{200}{25}$	
		Common Stock Preferred Stock	$ \begin{array}{r} 1,575 \\ \underline{25} \\ 1,600 \end{array} $			Equity Common Stock Retained deficit	1,925 <350> 1,575	
	<u>1,800</u>		<u>1,800</u>		1,800		$\frac{1,375}{1,800}$	

In each of the 4 balance sheets, which approach gives the more useful information about the enterprise's liquidity and solvency? Although, each balance sheet would require footnotes to disclose attributes of the common stock warrants and the preferred stock, I believe O-S provides clearer information on liquidity and solvency. B-O would need additional subtotals and schedules to provide the same information or the user would need to determine which instruments have settlement obligations to restructure the information.

Although the liquidity and solvency information under O-S is very basic, it is useful to users to screen enterprises for further evaluation. This basic information is used by governmental bodies for licensing and bidding purposes, suppliers and lenders. As we have seen in the current credit situation, the amount of "cushion" an enterprise has in the form of capital without settlement obligations is an important signal for users in making decisions about whether to do business with an enterprise.

Does reporting the dilution to existing common shareholders of \$350 in the financial statements provide meaningful information about the operations of the enterprise? I believe dilution to the existing common stockholder can better be displayed in footnotes or as part of a statement of changes in stockholders equity.

Dilution to the existing basic ownership's interest holder does not reflect meaningful information about the enterprise's performance with respect to future cash flows or changes in the enterprise's liquidity or solvency. As shown in the changes in balance sheet #3 to balance sheet #4, the inflow of capital from the issuance and exercise of the common stock warrants ends up to be the same in terms of net equity. However the display under B-O of a larger number for common stock and a deficit in retained earnings does not give a clear picture of what happened to the enterprise.

I believe including consideration about whether and how an instrument is required to be settled in the classification effort result in improved financial reporting and simplicity for users. Although, cash = stock for widely-held, actively traded stock, I believe you can see different valuations for instruments with PIK and non-PIK features. These differences result from forms of settlement.

Part of the simplicity appeal for preparers and auditors results from shifting complexity to users.

Complexity Concerns

Both O-S and B-O have complexity. Some of the complexity will be the same under either approach and some will be unique to an approach. For example as a common complexity, determining the substance of an instrument will be difficult under either approach. An example is whether a dividend is required or not (especially for cumulative dividends). Will the decision be based on a legal determination or the expectations of the issuer and investor? I believe some stocks have an implicit dividend requirement.

For B-O the determination of subordination features will be critical in determining the basic ownership interest. This can be more difficult than it sounds like. Using legal determinations has not proven helpful for other accounting treatments.

Another area that I would expect to exist in practice is expected or automatic conversions on a net basis of indirect ownership interests upon liquidation. Under B-O, would such interests be considered basic ownership? Is this a structuring concern?

Finally, the provisions in paragraphs 20 and 21 are complex. For example, why an **Active** market in 21b? Who decides and how whether the redemption formula is designed to approximate fair value in 21a? I am unsure whether these provisions will work in practice.

I believe the B-O claims of simplicity are overstated as well as its anti-structuring claim.

Operational Definition of a Liability

Both approaches will need a definition of both equity and a liability. I hope the definition of a liability will be the same for instruments and non-instruments. I believe it will be much more difficult to develop an operational definition of a liability under B-O since a liability instrument under B-O does not require an obligation to settle.

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Sincerely
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