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SFAS 115 was a significant evolutionary improvement in financial reporting when it was issued in 1993. The major part of the evolutionary aspect of SFAS 115 was the use of OCI as the place for the unrealized holding gains and losses for available-for-sale securities to be recorded (outside earnings). Another part of the evolutionary aspect was that when a holding gain or loss was realized, the realized gain or loss would be reported in earnings and removed from OCI (this is called recycling). Allowing recycling has the benefit of having holding gains and losses ultimately affect earnings. The negative is that the recycling reports the gains and losses that occurred in prior reporting periods to be reported in the current reporting period—an earnings management facilitator.

As a means of damping the earnings management aspect of recycling, SFAS 115 requires that Other Than Temporary Impairments (OTTI) of individual securities be recycled to earnings even if the loss is not realized by a disposal transaction.

The idea of OTTI recognition is fine. It does reduce the ability to manage earnings. However OTTI recognition is not neutral. Recognition of holding gains reflecting prior reporting period changes in the current reporting period is unrestrained.

As the writer of a firm's comment letter on the ED that led to SFAS 115, I agreed with the evolutionary improvement to financial reporting caused by SFAS 115 and felt “good” about the OTTI requirement. As an EITF member and FASB Board member subsequent to the issuance of SFAS 115, I was happy that the OTTI requirement continued to be used in the literature.

The problem with an OTTI requirement is that it is not operational and not neutral. The “good” feeling about having this conservative, earnings management dampener disappears when you see the inconsistency of its application over time and between entities.

As both and as EITF member and FASB Board member, I worked with others, including the financial institution regulators and the SEC, to try to create guidance to make OTTI operational. These efforts included one-on-one meeting with the regulators and SEC and

drafting of EDs. The reasons these efforts to provide guidance failed is that OTTI requires both a determination of what an entity's actions will be in the future and a determination of how a securities fair value (exit price) will change in the future. Preparers and Auditors cannot predict the future. The financial statements User receives information that is subject to Preparer, Auditor and SEC staff bias. The bias in applying OTTI are constantly changing and thus the information provided by OTTI is of little value.

One of the reasons for the current ED is the calls by the SEC staff and others to use consistent impairment guidance throughout GAAP—especially for financial assets. The ED does the opposite. It introduces a second type of impairment recognition for credit concerns (incurred losses for debt instrument assets that are not securities and a type of expected loss for debt instruments that are securities) and a second type of OCI. The “Subsequent Measurement” guidance in the ED sounds “good” but I don't know what the financial statement User will do with the resulting information and it would appear to add significant complexity to the accounting.

If the FASB seeks to issue guidance based on the ED, I believe they will be required to expand on its complexity by answers questions like:

What will be the tainting rules if the Preparer's assertions about holding the asset prove to be contradicted by sales?

What is the accounting if the assertions change?

Isn't the information needed to apply the guidance the information that a number of financial institutions who commented on in response to the first 107 FSP ED said was not available.

Finally, will the PCAOB and ASB be asked to provide more auditing guidance to audit current and future Preparer's intentions and future exit prices?

Overall Comment

Although I do not agree that the proposed guidance on making fair value estimates in inactive markets will solve the concerns sited in the Alternative View, I do agree with the other parts of the Alternative View.

Also, I believe that the idea of OTTI should be replaced with more comprehensive guidance on accounting for all financial instruments held as assets. But until that is done, modifying OTTI guidance as proposed in this ED will add confusion, not improve the financial statement. User's confidence in the financial reporting will not improve. It will be hard to create the needed improved comprehensive guidance.

If the majority of the FASB Board believes for political reasons that they must issue something on OTTI at this time, I would like to meet with the Board and staff to propose an approach that would change the accounting for OTTI that would move towards a more

comprehensive solution. Please contact me at 203-358-8274 or email at [HYPERLINK "mailto:ewtrott@aol.com"](mailto:ewtrott@aol.com) ewtrott@aol.com.

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File Reference: Proposed FSP FAS 157-e

Overall Comment

The guidance in the ED negatively amends SFAS 157. It effectively makes prices observed in non-active markets assumed to be not “orderly transactions” and thus not information to be used in making fair value estimates.

There are many reasons for assets [this would also apply to liabilities] to be exchanged in other than active markets. Examples include:

the asset may be useful to a limited number of potential buyers,
the asset by tradition may be exchanged on a principal-to-principal basis rather than on regulated markets or through a broad set of brokers and dealers,
but most likely with respect to financial assets, the potential sellers have not priced the assets to attract potential buyers.

As we are seeing in some housing markets, once potential sellers have lowered their prices, buyers emerge and transaction volume increases. I believe the proposed guidance will lead Preparers and Auditors to ignore information being given by the marketplace. An action that is directly opposite what is required by SFAS 157.

In many cases, I believe the information from the marketplace is that the infrequent number of transactions and few potential buyers for some financial assets is a signal that the potential sellers are seeking too high a price—not that the few observable transaction prices are not orderly transactions.

As a participant in creating SFAS 157, I believe it was fully discussed and decided that an active market was not required for observable prices to be key information in making fair value estimates. That is why level 2 inputs do not require active markets. Also see paragraph C81. I also believe it was fully discussed and decided that there was no need to fully defined active and non-active markets because both markets have “orderly transactions” that provide appropriate information to be used in making fair value

estimates.

What is a “Liquidity risk Premium”?

I don't believe you will find the phrase “liquidity risk premium” in SFAS 157. You will find the term “risk premium” in Appendix B. As pointed out in Appendix B, fair value estimates made using estimates of expected future cash flows *must* incorporate an appropriate risk premium and the Appendix displays a number of ways it can be incorporated.

As I have thought more about fair value measurements since retiring from the Board, I have become convinced that the guidance in Appendix B should have been made more prominent. I believe the discussion in Appendix B provides the basis on which almost all prices used in exchanges are based. Thus an understanding of the discussion in Appendix B would help in making all fair value estimates. It would explain why prices in active markets are constantly changing.

Prices, and fair value measurements, include three components:

an estimate of expected future cash flows-probability weighted for both amounts and timing,

an estimate of the time value of money, and
a risk premium for the specific asset.

Prices and fair value estimates require that all three of these components be market-based and current as of the transaction or measurement date.

The risk premium covers a number of risks or uncertainties. These include:

the risk related to the dispersion of possible future cash flows,
the risk of making poor probability estimates,
the risk of a black swan event occurring, and
the risk that the information needed to make estimates of future cash flows, etc. is not available or that the provided information is not accurate.

I believe the *risk premium* has been the major cause for many of the “lower” fair values for financial assets. I also believe the risk premium was the cause for the “higher” fair values for financial assets that were observed in the past. Even in active markets the changes in risk premium significantly affects the observed prices.

One of the benefits of fair value measurements is that the measurements use information at a point in time that is the present (for transactions) or that is past (as of a reporting date). By information I mean the three components noted above that are included in prices and fair value measurements. A fair value measurement does not try to predict the future.

How do you determine when a risk premium is abnormal? Can a risk premium be abnormally low (and thus higher values) as well as high (and thus low values)? Even if there is a liquidity risk premium, why should it be ignored? If you try to make a normal/abnormal risk premium cut or exclude a factor considered by the marketplace, are you not saying to ignore the marketplace—for active and non-active markets! That is not what SFAS 157 currently says and it should not be amended to say that.

Step 2

I believe the ED proposes a “presumption” that is opposite the presumption that should be made in considering observable prices in a non-active market. If the Board that created SFAS 157 had thought it was necessary to explicitly state a presumption, I believe it would have been that observed transactions are “orderly transactions” unless clear evidence is available to say the transactions were not orderly. I do not believe an assertion that the lack of many completed transactions or the low prices currently being observed is evidence that the transactions are not orderly.

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I would be happy to discuss my comments with you. My telephone # is 203-358-8274 and my e-mail address is [HYPERLINK "mailto:ewtrott@aol.com" ewtrott@aol.com](mailto:ewtrott@aol.com).