September 27, 2004

Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Letter of Comment No: 30
File Reference: EITF03-1
Date Received: 09/29/2004

Re: Comments on FSP EITF Issue 03-1-b

Who we are:

Farmers and Merchants Trust Company of Chambersburg (F&M) is a community bank based in Chambersburg, Pennsylvania. F&M has assets of approximately $580 million, of which $160 million is held in its available-for-sale investment portfolio. F&M is dependent upon its ability to manage its investment portfolio so that it strengthens its balance sheet. Specifically, we use the investment portfolio in order to balance earnings, interest-rate risk and liquidity needs. Thus, our perspective focuses on how this ruling will impact F&M.

Our thoughts on FSP EITF Issue 03-1:

While we applaud the FASB for its efforts to tighten its guidance on the realization of impairments of investments, we think that there must be a clear distinction between what constitutes true impairment versus a temporary fluctuation in the value of a security. We would assert that a downward shift in credit quality or a significant change in prepayment speeds may result in a permanent reduction in value. Therefore, in these cases, it would be appropriate to label an investment as "impaired." In contrast, securities that have fluctuations in fair market values resulting solely from interest rates/credit spread movements should be excluded, for the reasons which are discussed herein.

The business of banking revolves around the ability to manage net interest spread (which accounts for 80% or more of community banks' revenues). We believe that FSP EITF 03-1 (Issue 03-1), in its current form, will have a profound and potentially catastrophic effect on a bank's ability to manage spread, leading to unneeded (and artificial) fluctuations in earnings during times when

interest rates are rising. This ruling will place unneeded regulation on an industry that is already highly regulated in the area of interest-rate risk. We believe this ruling could result in "unsound" decisions in the management of investment portfolios, and within their balance sheets in general.

Due to the ever increasing complexity of balance sheets, community banks must be able to "manage" their interest-rate risk. For the most part, the investment portfolio is the primary tool which is used to accomplish this. In fact, Owen Carney, formerly the OCC's capital markets specialist, stated:

> *If the bank holds a significant level of volatile securities but management represents they will not actively manage the held-to-maturity by selling in response to anticipated interest rate or prepayment changes, [the OCC may] criticize bank management for limiting their options by locking themselves into an inflexible management strategy. (Talking Points—FAS115)*

Furthermore, Mr. Carney continued by stating that:

> *FAS 115 is not an excuse for bad management...we do not accept accounting rules as the basis for uneconomic decisions. (Talking Points—FAS 115)*

This ruling will effectively eliminate this management of risk, potentially with catastrophic effects. Any accounting change that would deem the trading account as a more conservative classification than A.F.S., would, in our view, be irresponsible and dangerous.

Because banks' assets and liability terms are usually matched, the net effect to the fair value of a balance sheet due to an interest rate movement is usually insignificant, especially for those transactions that do not have prepayment risk. Furthermore, there is very little change in net interest income when rates move. However, if Issue 03-1 goes into effect, the bank will have to realize a loss because of the lower fair market value of the asset in the transaction; ignoring the advantage of the below-market funding. As a result, shareholders will receive very misleading impressions of the true profile of an institution.

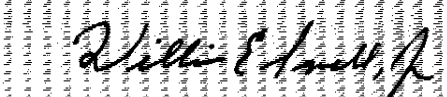
Furthermore, if the impairment is reflected in earnings, the bank's yield on the investment portfolio will then be artificially high, because of the reduced cost basis then used to determine the yield. This could also be misleading to stockholders, as the perception will be that the bank's investment portfolio is producing exceptional yields. Then, if rates decline and the bank sells the now

"impaired" security, the bank will realize a gain on the sale, again suggesting that the bank has done a good job of managing its investment portfolio. Thus, Issue 03-1 will make analyzing institutions more difficult, because it will create misleading information.

Finally, if this ruling is implemented, companies will be forced to manage their security portfolios on a security-by-security basis, while not being allowed to take a holistic management approach. The former is based on the old "Prudent Man Rule," from which the finance industry has been moving away from. Instead, the industry has moved toward the new "Prudent Investor Rule," which allows the fiduciary to take a holistic view of the portfolio. A holistic view enables a portfolio manager to recognize the fact the diversification within a portfolio will help minimize risks to both fair value and income.

For these reasons we are taking the stance that companies should not be required to classify investments as impaired that have fair values below its cost basis if the decline in value is solely the result of changes in the level of market interest rates. **Thus, in response to FSP EITF Issue 03-1-b we believe the effective date for the "application of paragraph 16 of Issue 03-1 debt securities that are impaired solely because of interest rate and/or sector spread increases" should be eliminated.**

Cordially,



William E. Snell, Jr.
President & CEO