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June 19, 2002

MP&T Director, File Reference 1100-163 Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

Re: FAS 133 Exposure draft comments

To the Director of Technical Projects and Technical Activities:

I am the principal of Kawaller & Company, LLC, which is a private consulting company that specializes in assisting commercial enterprises in their use of derivative instruments.

This letter is my second comment pertaining to this paragraph 6.b, which states, "If it is an option-based contract, it has an initial net investment equal to the fair value of the option component." In this letter, I would like to (a) elaborate on my earlier submission pertaining to "initial net investment" and (b) offer a second suggestion that relates to "fair value."

Initial Net Investment

In discussions with the FASB staff since my original submission, I have learned that the Board intends for such a contract to be covered by FAS 133 – not as a stand-alone derivative, but as an embedded derivative. In this case, the reporting entity would have to realize that the reporting entity would be expected to consider the present value of any deferred payment to be an amount that (a) equals the fair value of the option component; and, in addition, this present value would have to be considered to be an initial net investment

If this description appropriately captures the thinking of the Board, I would urge the FASB include clarifying language along the lines of the above paragraph in the final FAS 133 amendment. Such a clarification would be useful for the reader (like me) who might think of an initial net payment as something that must be paid at the inception of the trade – i.e., a payment that may not be deferred. (To me, the use of the word "initial" seems problematic, without further clarification.)

Fair Value

In addition to the above suggestion, I would also like to urge the Board to reconsider the proposed requirement that the initial net investment for an option component must be equal to the *fair value* of this component. The proposed language seems to provide an open invitation for entities to argue that their option contracts should not be covered under FAS 133 because they were entered into at prices *other than* fair value.

The commonly accepted definition of fair value is that it is the price at which the good or security *should* trade – not necessarily the price at which it *does* trade. Thus, fair value is in the mind of each market participant. Put another way, any assessment of fair value is simply one person's opinion. If a widget producer sells widgets for \$1, but he/she would have been willing to sell at a cheaper price, say \$.90, the sales price could be deemed to be expensive relative to fair value. Similarly, if the buyer bought at \$1 but would have been willing to pay \$1.10, the buyer would say that the \$1 price was cheaper than fair value. Particularly for options, fair value cannot be objectively determined in a way that has universal acceptance. Fair value is found with the aid of an options model, reflecting the analyst's judgment about the "correct" estimated volatility to use as an input. Different analysts, however, will make different judgments; and the determination of who is correct, or which fair value estimate is "right" can only be discerned *ex post*, by the time the option expires.

In contrast to fair value, the *market value* is observable -- assuming a trade takes place. Market value is simply the price at which buyers and sellers actually make a trade. A given market price might be construed to be above fair value by one party and below fair value by the other.

Respectfully, I fear that the FASB has misunderstood the concept of "fair value" and confused it with the concept of "market value." I believe Paragraph 6.b should reference "market value", rather than "fair value," and I would urge the FASB to make the substitution

If you would care to contact me to discuss these comments, I would be most happy to hear from you. Thank you for your consideration.

Sincerely,

Lutkurll