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January 9, 2009



LETTER OF COMMENT NO. 7

File Ref: Proposed FSP FAS 107-a

Dear Sir:

I do not believe the Proposed FSP will achieve its goal as stated in Paragraph 7 to provide "additional disclosures (that) would result in greater understandability and comparability of certain financial assets."

Lack of Comparability in Theory

Paragraph 15F states that the "incurred loss amount" is to represent the following:

- For loans and receivables, the reported carrying amount based on Statements 114 and 5.
- For debt securities covered by the FSP, the present value of expected future cash flows discounted at the security's effective interest rate (consistent with Statement 114). Also, there is to be no pool allowance under Statement 5.

An incurred loss under statements 114 and 5 means that it is "probable" that the holder will be unable to collect all amounts due according to the terms of the instrument. "Probable" having the meaning as defined in Statement 5 of "the future event or events (not collecting the amount) are likely to occur." This likelihood is much more certain to occur than "more likely than not." In practice, many use a likelihood of not collecting at 80% or higher as being the criteria for a loss to have been incurred. Thus a financial asset where it is 60-80% likely that all amounts will NOT be collected will be reported as if all amounts will be collected in the "incurred loss" column. Effectively no incurred loss has been incurred even though it is 60-80% likely that not all amounts will be collected.

A measurement based on "expected future cash flows" (regardless of the discount rate used to calculate the present value amount) does NOT have a likelihood requirement (or screen) that amounts will not be collected. These "an expected future cash flow" reflects what is expected to occur in the future. An asset for which it is 60% likely or 20% likely that all amounts will not be collected will have "expected future cash flows" less than the amount specified by the terms of the asset. An "expected future cash flow" amount without a probability requirement of $\geq 80\%$ is a key part of a fair value measurement.

The "incurred loss amount" for loans and receivables and debt securities are NOT comparable. As explained above an "expected future cash flow" does not have the probability screen. If the Board means to include the "probable" screen for debt securities, it should be stated explicitly. I read the reference to Statement 114 to refer to the interest rate. If such a screen is intended, why not have the statement 5 allowance for similar securities as allowed for loans and receivables?

Lack of Comparability in Practice

Determining when a debt instrument has experienced a loss event (met the probability requirement as required under Statements 114 and 5) is done in practice with little or no comparability between instruments or holders (Preparers). The FASB, AICPA, SEC and Bank Regulators have tried to develop guidance to obtain comparability — without success.

The concept of an Other Than Temporary Impairment is not applied in practice in comparable ways. Again the FASB, EITF, AICPA, SEC and Bank Regulators have tried to develop guidance to obtain comparability — without success.

Lack of Comparability

In theory and in practice the amounts under the "incurred loss" column will not start from a comparable basis. Any claim that the amounts required by the FSP will be comparable or "more comparable" is false.

Lack of Understandability

After 40+ years as an auditor and standard-setter I am convinced that most users and many preparers do not understand or accept as good financial reporting the "incurred loss" model that presently exists in GAAP. I believe most users believe the allowance for loan losses or bad debts covers all amounts not expected to be collected from the existing assets.

As I have discussed fair value with many persons since leaving the Board, I have found the following helpful.

An Exit Price = ~~a current~~ estimate of future cash flows discounted at a ~~current~~ rate that includes:

- Time Value of money, and
- Risk/Uncertainty premium.

For a fair value measurement, the cash flows and rates are those of market participants.

Changes in fair value for debt instruments are caused by changes in either or both the cash flows and the discount rate.

to make the difference between the "fair value" and "incurred loss" columns understandable, only the discount rate should be different or the cash flows used to determine the amounts in the two columns should be disclosed.

I believe persons requesting additional disclosures expect to have the fair value estimated future cash flows discounted at current rates for the "fair value" column and the same cash flows discounted at historical rates for the "incurred loss" column.

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Please contact me at 203-358-8274 if you would like to discuss.

Sincerely,
Edward W. Trotter