

LETTER OF COMMENT NO. 139

To:

Adrian Mills; Diane Inzano; Joseph Vernuccio; Kevin Stoklosa; Kristofer Anderson; Mark Trench;

Meghan Clark; Peter Proestakes; Russell Golden; Vita Martin; Wade Fanning

Subject: FW: FSP FAS 157-e

From: Mark Hughes [mailto:MarkH@cnbankpa.com]

Sent: Friday, March 27, 2009 1:07 PM

To: Director - FASB

Cc: Charles Updegraff; Craig Litchfield

Subject: FSP FAS 157-e

March 27, 2009

Re: FAS 157-e

Dear Chairman Herz:

I am the Chief Financial Officer for Citizens & Northern Corporation, a relatively small banking corporation. The views expressed below are mine and not necessarily those of my employer.

I appreciate the FASB's recent efforts regarding other-than-temporary impairment issues (and have sent a separate comment letter on the related FSP); however, I am disappointed in FAS 157-e. The fair value accounting model is not effective – at least for the banking industry – and needs to be re-examined by individuals who are willing to be objective about the underlying theoretical and practical issues. My sense is Congress is looking for a more robust evaluation of the situation, as opposed to the "tweaking" that is provided in this FSP.

I disagree with the fundamental premise of fair value accounting proponents that fair value is the most "transparent" system. In my experience, most investors have more desire to understand a company's future earnings prospects than to know the fair values of financial instruments, which are often highly subjective and fluctuate continually based on changes in market psychology, interest rates and many other factors. Further, if you consider the "Qualitative Characteristics of Accounting Information," as described in the FASB's Statements of Financial Accounting Concepts, fair value accounting fails in comparison to an historical cost-based model in several important ways - Timeliness (a component of Relevance); Reliability; Comparability and Consistency; and Cost vs. Benefits.

Notwithstanding my overall feeling that FSP 157-e is inadequate and inappropriate, my thoughts on the specific questions raised by the Board are as follows:

- 1. The proposed effective date is <u>not</u> operational, because the entire FSP is not operational.
- 2. I do not believe the proposed FSP meets the objective to improve financial reporting. My comments and suggestions are provided in response to question 3.
- 3. I do not believe the proposed 2-step model is understandable and operational. My objections are as follows:
 - a. Although the basic premise is that a market is to be considered inactive unless proved otherwise (which I think is good), I fear the detailed considerations provided in the "2-step process" will result in auditing firms requiring time-consuming investigation for entities to document the basis for the conclusion that a market is inactive. The FSP is not clear on whether the entity would be expected to conduct such an investigation. Further, some of the "evidence" that would be required to prepare such documentation is not readily available to entities that do not make markets in or trade securities for their clients, which will make it difficult to obtain and subject to an indeterminate amount of further scrutiny and verification requirements.
 - b. Paragraph 13 is particularly troubling. Unless you are a market maker in a particular security, how can you reasonably evaluate whether there was "... sufficient time before the measurement date to allow for usual and customary marketing activities for the asset..."? Also, paragraph 13 suggests that if there are "multiple bidders," then (along with "customary marketing activities") a transaction is considered <u>not</u> to be distressed. That point of view is truly detached from the current reality. The only entities buying many types of debt securities today are the ones fortunate enough not to be required to prepare financial statements in accordance with U.S. Generally Accepted Accounting Principles. Put another way, I reject the notion that 2 or 3 "vultures" constitutes a market.
 - c. Paragraph 14 is unclear in that it does not indicate whether "... an insignificant volume relative to the total market..." is supposed to be determined based on the size of the total market under "normal" conditions. I hope that is the intent, but I am not sure that would be easy to evaluate and document.
 - d. The example transaction in paragraphs A32A through A32G raises more questions than answers. The basic premise, described in paragraph A32E, is that Entity A's approach to valuation hinges on its ability to consider inputs that market participants would consider in estimating a rate of return in an orderly transaction. If Entity A has concluded that the current market is primarily not orderly, why give such a high priority (or even consider) credit spreads for <u>current</u> issuances? Similarly, in paragraph A32F, why is the 7% discount rate rejected because a "willing buyer" (perhaps one of the "vultures" I referred to above) would not agree to that rate of return in the current market? I believe that, if you reasonably conclude the market is not active, it would be more appropriate to <u>completely discard current</u>

- transactions in determining non-distressed fair values. If Entity A did a good job in estimating cash flows (as suggested in paragraph A32D), with reasonable assumptions as to defaults, I think the example should have concluded that <u>7%</u> would be the appropriate discount rate to select under the circumstances described.
- 4. The factors provided in paragraph 11 are appropriate; however, for the reasons cited above, I do not believe it to be a good idea to go down the path of requiring an onerous, if not impossible, mountain of documentation to establish whether or not a market is active.
- 5. I expect the costs associated with addressing this FSP to be substantial. My first choice for reducing the costs would be to eliminate fair value accounting. Absent that change, my next request would be for FASB to clarify that an entity may consider the market for a security to be inactive, without conducting a "formal" or "documented" investigation to prove that to be the case. Like many other banking companies and their auditors, we spent ridiculous, inordinate amounts of time in 2008 on fair value and other-than-temporary impairment issues, and expect to do the same in 2009. We incurred a moderate amount of direct external costs associated with fair value issues, and I would expect that to be the case again in 2009 as a direct result of the FSP. The larger costs are: (1) the impact of the broken securities market, to which fair value accounting rules have contributed, and which make it very difficult for us to purchase securities for fear of write-downs or risk-based regulatory capital adjustments that happen "automatically" if a rating agency downgrades a security, and (2) the opportunity cost of spending a large percentage of our time - including Board, management and accounting staff time - on these issues, when the time could be spent on activities that might be positive for our employees, shareholders, customers and communities.

Thank you for your consideration.

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