

From: [Director - FASB](#)
To: [Joe Damico](#)
Subject: FW: File Reference No. 1810-100 Financial Instruments, Derivatives and Hedging
Date: Monday, July 12, 2010 10:06:20 AM

From: Ron DiMattia [mailto:ron@corporatevaluepartners.com]
Sent: Monday, July 12, 2010 9:56 AM
To: Director - FASB
Subject: File Reference No. 1810-100 Financial Instruments, Derivatives and Hedging

Thank you for the opportunity to comment on the Exposure Draft issued May 26, 2010 regarding the FASB's proposal: [Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities](#). I have included my comments in the following paragraphs.

- 1) The proposal is based on a faulty premise. In the second paragraph of the Summary the proposal notes, "... (GAAP) permit different accounting treatments for similar (emphasis added) financial instruments. For example, under existing U.S. GAAP, debt instruments may be measured at amortized cost (for example, loans held for investment or held-to-maturity debt securities), at lower of cost or fair value (for example, loans held for sale), or at fair value (for example trading securities)."
 - a) These financial instruments are not at all similar and vary significantly regarding the contractual rights of the owners and marketability of the instrument. To say that \$1 million of IBM stock is similar to a \$1 million loan to a privately-held company reflects a fundamental disconnect with the real world. If an owner doesn't like how IBM is being run, she can call the CEO but the owner would have no contractual rights to bring IBM to the table to discuss her concerns and act. On the other hand, the owner of a commercial loan to a privately-held company often has significant rights to negotiate with the borrower and effect change in the relationship.
- 2) Good bankers in the US are quick to point out that they are relationship bankers, meaning that they tailor their products to the needs of their customers as they change over time. As market conditions change, or as customers change and grow, a good banker will adjust their product to fit their customer's needs. Waivers, amendments and additional services change the nature of the loan as time goes by. The difficulty is that fair value mathematics treat the instrument as being fixed in place through the term of the loan based on "market participants" expectations at a particular time. I think everyone in business would expect the owner of a loan to take some action if the perceived value of the loan is declining. Does this mean that we should be handicapping "market participant's" likelihood of making some positive change in the loan agreement in the valuation process? How can we predict how well the borrower will react and improve the situation? Hard won experience has shown me that different "market participants" will react differently to the same situation, but it is the relationship itself that dictates how well the lender and borrower react and adapt to changing circumstances. By removing the element of a specific relationship, the FASB demonstrates a complete disconnect with the business of banking. Relationships are not theoretical. Nearly all my clients have stories of going to several lenders and being turned away, and then finding the one banker that understood their situation and stood by them. There were no other "market participants" that would make a market for the loan. It was one banker and one relationship that made the difference.
 - a) Also, because "market participants" expectations change over time for a variety of reasons, this means necessarily that the value of a loan will go up or down at each measurement period, introducing an element of volatility in results that is purely theoretical. It seems to me that the FASB has become enamored with the culture of trading that captures our country at various times. Every company's balance sheet will become a portfolio of assets that day-traders can swap and bargain. Forget about any company's particular skills or resources that they have developed; forget about any employee's particular skills at developing customer relationships. Everything has become interchangeable and generalized based on the concept of "market

participants.”

- 3) The proposal signals a great deal of complexity about how to assess the effect of other elements of the banking relationship beyond the loan itself. Other services such as 401K plans, checking accounts, payroll services, treasury management services and other services all play into the value proposition when a bank extends credit to a customer. The FASB acknowledges this fact in paragraph 14 noting “... the financial instrument and the other element(s) in the transaction shall be measured separately” if the difference in fair value and transaction price is, “... at least partially due to the existence of other elements in the transaction.” As an example, let’s say a bank offers an interest rate that is 1% less than “market participants” would offer on the same loan. But the bank offered a lower rate to ensure a relationship with a customer that has significant needs for other services, such as 401K plans and payroll services. Overall the bank could have significantly improved its shareholder value, but would be required to record a loss on the loan at some point because it is priced less than the “market.” Are we supposed to recognize an offsetting gain in connection with the other services the bank provides the customer? If not, then how does this accounting treatment reflect economic reality?
 - a) Again, the FASB demonstrates a fundamental disconnect with the real world and how loans are priced and how customer relationships are managed.
- 4) The proposal is built on a weak foundation and likely presents an incomplete picture because it continues with fair value accounting for financial liabilities. The proposal notes, “Many have said that there should be symmetry between the accounting for financial assets and the financial liabilities funding those assets.” I have written before on the fundamental conflict between the concept of going concern and measuring liabilities at fair value (included as an appendix to this letter). I can only suspect that this conflict is the reason that the update to the Going Concern Exposure Draft is so long delayed. The FASB would do well to deal with the issue of going concern relative to fair value measurements of liabilities (and other issues) first before embarking on a new project such as the one at hand. Sir David Tweedie (Chairman of the IASB) has acknowledged that the revaluation of liabilities is “hard to defend” (Reuters press release, [Accounting Board Proposes Change to Liability Rule](#), May 11, 2010). Given that the FASB is supposed to be undertaking its recent projects with an eye toward converging U.S. GAAP with IFRS, doesn’t it seem odd to be continuing with fair value for liabilities while its partner in convergence discredits the idea? (Please note – Mr. Tweedie made his comment before the FASB released this current exposure draft). If fair value measurement of liabilities is not likely to remain in effect, isn’t the current proposal presented with incomplete information? Won’t investors and preparers of financial statements view the current proposal differently if they knew that measuring liabilities at fair value was not going to remain in effect?
 - a) It seems to me the FASB is rushing forward with changes before it resolves more fundamental issues about fair value accounting. Also, exposure drafts are becoming compartmentalized and I do not believe that investors and practitioners have a complete picture of how the fair value standards are taking shape in total (as an example – see file reference 1830-100 issued on June 29, 2010 which also deals with fair value accounting or the previously-mentioned exposure draft on going concern which remains incomplete). This causes me great concern.

As a result the current proposal should not be adopted. The FASB should reconsider its efforts in connection with fair value accounting and issue comprehensive guidance if fundamental issues can be resolved.

Thank you for considering my comments.

Sincerely,

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APPENDIX – Comment Letter dated December 7, 2008: Going Concern Exposure Draft File Reference Number 1650-100

I appreciate the opportunity to comment on the Exposure Draft of the Proposed Statement of Financial Accounting Standards – Going Concern; File reference No. 1650-100. My comments are included in the following paragraphs.

I am troubled with the relationship between any definition of going concern and the provisions of SFAS 157 and SFAS 159 which allow for the revaluation of a firm's liabilities. Under these pronouncements, a company may re-value its liabilities to market value – below book value – and recognize a gain and a resulting increase in shareholders' equity.

If the FASB is moving toward financial statements that are strictly a theoretical construct, then the ability to re-value liabilities could make sense. But the concept of going concern is important because it removes financial statements from the theoretical realm and places them in the context of a real firm with real creditors and addresses a firm's ability to continue to function; an important part of that being the ability to repay its debts. At one level the FASB has created a contradiction within the standards themselves – management may re-value liabilities and imply a loss to creditors, yet not be required to disclose doubts about the company's ability to continue as a going concern. Outside of a purely theoretical framework, how could management not make a going concern disclosure if it recognizes that the value of its liabilities are worth less than what the firm is obligated to pay? When issuing financial statements without a going concern disclosure, are not management and the auditors making a statement that all liabilities are expected to be satisfied in full in the ordinary course of business? We may assume that "market participants" would buy and sell a company's debt obligations in a hypothetical secondary market at something other than face value. But the going concern concept places the responsibility squarely on management's shoulders to state their expectation whether these debts will be paid in full. If so the financial statements should reflect management's expectation, not the theoretical expectation of "market participants" in a hypothetical secondary market.

More damaging, in my view, is the contradiction that the FASB has created between accounting standards and long-established legal precedent. The idea of "absolute priority" is firmly established in bankruptcy law, which is properly considered in connection with the Going Concern exposure draft. According to Black's Law Dictionary, the absolute priority rule is:

"The rule that a confirmable reorganization plan must provide for full payment to a class of dissenting unsecured creditors before a junior class of claimants will be allowed to receive or retain anything under the plan."

So while legal precedent would dictate that debt-holders be made whole before equity-holders receive anything, SFAS 157 & 159 allow a loss to creditors with the result being a gain to equity. This could only happen in a theoretical sense. Long-standing legal precedent would preclude such a result in the real world.

At a minimum, the ability to revalue liabilities and recognize a gain should be precluded within the context of a firm that is expected to continue as a going concern. Real world experience would dictate that this cannot happen. Perhaps it would be useful to allow management to revalue liabilities when there is a doubt that the firm can continue as a going concern, but it should not under any circumstance result in a gain to equity holders. An offsetting reduction in the value of assets would seem to be most appropriate in that circumstance.

Thank you for the opportunity to comment. Feel free to contact me if you have any questions about my comment letter.

