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## A Quiet Exit from Fair Value Accounting?

Why is it government bureaucrats and politicians seem to find it much easier to sign checks for trillions of dollars than changing a few accountancy regulations? This mystery has puzzled us ever since the start of the financial crisis. The obvious answer is that signing trillion-dollar checks involves other people's money, while reversing regulatory decisions impinges on the policymakers' own professional pride. But now that they've watched the lynching of bankers and politicians, the bureaucrats in Washington seem suddenly to have changed their minds. If Paris was worth a Mass for Henry IV, who had to display his Catholicism to become King of France, then maybe avoiding another trillion-dollar bailout request from Congress was worth a little embarrassment for the regulators and accountants.

Whatever the reason, something potentially very important happened last week which almost nobody seemed to notice—in the financial media or the markets. The members of the US Financial Accounting Standards Board decided to swallow their professional pride, quietly announcing a reform that banking lobbyists, along with many financial economists (ourselves included) have been suggesting since the crisis started and which the accountancy profession has been fiercely resisting: an almost complete suspension of mark-to-market accounting for assets in “distressed” markets. For good measure, the FASB also radically widened the definition of “temporary” impairment of troubled assets, thereby allowing banks to write up the value of some troubled assets if these have been hit by falling markets without (yet) suffering any significant credit loss. These two reforms were specifically designed, according to the FASB's chairman, to “encourage” banks to “use more judgment” in valuing distressed assets on the basis of long-term cash-flows, rather than volatile market prices. Another board member was even blunter about the purpose of the new standard; telling Bloomberg: “Hopefully [this change will] elevate fair values to a reasonable point, so investors are more interested in investing in the banking system.”

Amazingly, little was reported about this U-turn in US financial policy in the Wall Street Journal, the FT or New York Times—even though it was extensively covered by Reuters and Bloomberg. Did the media and the financial community ignore this story because it was unimportant? Or was this announcement missed simply because everyone's attention was distracted by the lynch-mobs at AIG?

In our view, this announcement's importance was emphasized by the timing. The FASB decided to make the new accounting standard effective immediately (from March 15), even though a formal vote will not be held on it until April 2. US banks can therefore use the new approach in calculating their first-quarter results—a change which may help to explain the bullish noises about a return to profitability at Citibank and Bank of America last week. Moreover, the new standard coincides with the launch of Geithner's plan for buying up and valuing toxic assets next week and with the capitalisation “stress tests” to be completed by the end of April.

Another way of gauging the significance of what happened last week is to look at the reactions from strong advocates of mark-to-market. Within hours of the FASB announcement, the International Accounting Standards Board in London, which has been even more zealous in promoting and defending mark-to-market, said that it would “*seek views on the new US guidance before deciding on whether to publish*

Mark-to-market accounting is still a very hotly debated topic.

It appears the FASB is now prepared to ease on mark-to-market accounting.

*its own proposals*”, adding with evident irritation that this process would “*take several months with no guarantee that any change will be made*”. According to Lynn Turner, the SEC’s former chief accountant and another leading advocate of mark-to-market, “*with this proposal the FASB is really suspending fair value accounting and taking accounting standard-setting back four decades.*” The Bloomberg accounting columnist Jonathan Weil was more outspoken. In an article entitled [Accounting Brothel Opens Doors for Banker Fiesta](#) he described the FASB draft as “*the dumbest, most bankrupt in its 36-year history... If it stands, the FASB ought to change its name to the Fraudulent Accounting Standards Board.*”

On the other side of the debate, the American Bankers Association, told Reuters: “*Policymakers are slowly realizing that it does not make any sense to mark assets to the values in a dysfunctional market. It is causing billions of dollars of capital to be needlessly erased.*” And Ed Yardeni, the prominent Wall Street economist, added on Bloomberg: “*I’ve been wondering for about two years why they haven’t done it already ... to me it seems to be the simplest, fastest, cheapest way to deal with the heart of the problem, which is the negative feedback loop between the economy and marking asset values in illiquid markets.*”

Rather than reopening the debate about the pros and cons of mark-to-market—on which our clients, like the rest of the financial community, are deeply divided with strong views on both sides—all we want to point out in this article is that something important is happening and investors should be aware. The one point that we cannot resist making on the merits of this issue is that the world financial system managed quite well before the introduction of mark to market in 2007—and has not done so brilliantly since then. Thus, the burden of proof should be on those who insist that financial capitalism would collapse with the abolition of mark-to-market, rather than on those who merely suggest that accounting and regulation should return to the standards that worked well enough in resolving financial crises until 2007. What, then, are the FASB plans?

Two important FASB Board Decisions were announced on March 16 (see [link](#)), followed by the release of detailed guidelines, known as FASB Staff Positions (FSPs) on March 17 (see [link](#)).

The first of these FSB Staff Positions, known as FSPs (FAS 157-e, “*Determining Whether a Market Is Not Active and a Transaction Is Not Distressed*”) provides guidelines for making fair value measurements when a market for an asset or a liability “is not active” and determining whether previous transactions in such assets were distressed or not. FASB Chairman Robert Herz explained to Reuters that “*there is currently a presumption that if a company cannot prove a market is distressed, it has to use the price from a recent transaction, which, more often than not, has been depressed. The guidance would flip that presumption, and let companies value an asset by using more information than just the price at which a similar asset was sold in a distressed or forced transaction*”.

The second group of FSPs (FAS 115-a, FAS 124-a, and EITF 99-20-b) deals with the “Other-Than-Temporary Impairments”, providing guidance on how to analyze distressed securities which are not likely to be sold prior to recovery. The deterioration in such securities is to be split between genuine impairments in credit and the non-credit components caused by fluctuating market prices. The proposed FSP would require separate display of losses related to credit deterioration and losses related to other market factors on the income statement. “*If an entity does not intend to sell the security and it is not likely that the entity will be required to sell the security before recovering its cost basis, only the portion of the impairment loss representing credit losses would be recognized in earnings as an other-than-temporary impairment. The balance of the impairment loss would be recognized as a charge to other comprehensive income. Market-related losses would be recorded in ‘other comprehensive income’.*”

The impairment recognized in other comprehensive income would be amortized over the remaining life of the debt security in a prospective manner based on the

Under the proposal, changes in valuations would not be dragged through the P&L.

As a result, bank shareholders could start to see a way out of their present morass, provided the institutions they owned showed evidence of strong operating income on their new business.

amount and timing of future estimated cash flows unless there is an indication of additional credit losses. That amortization would be recognized in other comprehensive income with an offset to the asset and would not affect earnings.

Between them, these two proposals would, if adopted, transform the reported financial positions of many US banks and other financial institutions. They would allow banks to start reporting substantial operating profits, maybe as soon as the first quarter. **Credit losses would materialise when borrowers actually defaulted and not in response to erratic shifts in the market moods.** Under the FASB proposals, there would be no loss of the information currently provided by mark-to-market accounting. Impairments due to falling market prices would still be recorded, provided these falling prices were set by liquid markets with genuine willing buyers and not in distressed fire-sales. But, crucially, the balance sheet changes resulting from these shifts in market value would be treated in the same way as changes in pension fund deficits, property valuations and other unrealised capital transactions. They would not appear in the profit and loss account.

As a result, bank shareholders could start to see a way out of their present morass, provided the institutions they owned showed evidence of strong operating income on their new business. **Regulators could commit themselves to judging capital adequacy by official Tier One capital ratios and long-term cash flow projections, instead of lurching from one emergency recapitalisation to another on the basis of the wildly fluctuating values set for toxic assets by illiquid markets.**

This dilution of mark-to-market accounting would therefore be an obvious and cost-free way of easing the effects of the credit crunch. In saying this, we do not go as far as Steve Forbes, who wrote in the Wall Street Journal recently that *“mark-to-market accounting is the principal reason why our financial system is in a meltdown”*. All we suggest is that allowing banks to value their assets on a hold-to-maturity basis, especially for purposes of regulation, as proposed by Warren Buffett, would ease the banking system’s return to profitability and make financial balance sheets look much stronger and less volatile. Rolling back mark-to-market accounting would thus reduce the up-front price tags of government guarantees and stabilise the global financial system, while leaving the ultimate costs of bank bailouts to be determined as the assets are realised, liquidated or amortised in the long-term.

Sir David Tweedie, the chairman of the International Accounting Standards Board, who is perhaps the world’s most zealous advocate of mark-to-market accounting, noted last week that *“there has always been a battle between the prudential regulators and the securities regulators over stability versus transparency.”* To Tweedie’s chagrin, the prudential regulators and stability are finally starting to win.