

VALUE IN NORTHEAST OHIO

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FASB Liberalizes Mark to Market

On April 2 the Financial Accounting Standards Board (FASB) voted to relax fair value accounting standards for debt securities.

Debt securities are classified in three groups. Held to Maturity are carried at amortized cost, Trading Securities, which will be sold within a year, are valued at the fair value. Everything not in the first two groups is also carried at fair value but unlike Trading Securities, the unrealized gains and losses are not included in the Income Statement.

FASB changed the standard for Held to Maturity debt securities from the owner having both the "intent" and "ability" to hold to maturity to into "intent" and "more likely than not have to sell before recovery of its cost basis".

Disclosures of those assets grouped by major security type and segregated by Available for Sale and Held to Maturity will include the cost, methodology of valuation, key inputs in deriving a value including loan to collateral ratios, third party guarantees, and performance indicators of the underlying assets.

Another change FASB made was to allow assets traded in a market that is not active to be valued using other methods than the market bid price. This pronouncement also requires disclosure of the impact of the change in valuation techniques.

The new rules have a soft and squishy feel to them. First a very simple hypothetical: A company owns 10 bonds with fair value \$10 each. It will need to sell four of them. It can be argued that any individual security is more likely than not to be held to maturity. While I believe the auditors may successfully navigate this scenario, there are an infinite number of more complicated ones where the securities aren't homogenous and the probability of selling is not clear. This will increase the use of and reliance on the judgment of management and their auditors.

It will be interesting to see how the disclosures work as well. It could end up looking like a table with several variables and stretch a page or more. Or it may end up being more summarized and of limited usefulness to the investors.

Why is Wall Street Thrilled?

The Dow Jones Industrials rose 216 points on April 2. During that trading day FASB released its rule changes. The rule change does not directly create any extra cash for the banks, its only on paper so the rally seems irrational at first blush.

It is impossible to speak for the millions of people that trade stock each day, but I have some explanations that may resonate. First, the markets have been rallying since early March so any piece of good news will push it up in the same way that two months ago the negativity pushed the markets to decade lows.

Second, the markets had been agonizing over the potential nationalization of banks. The perception of strength, even if its only paper will improve banks ability to operate and raise capital. There will be fewer short-selling bear raids, fewer depositor runs, and more operating room for regulators to allow banks to work out their own problems.

On the other hand Wall Street was very enthusiastic about subprime lending, and over leveraged financial institutions until the system broke. Just because the market rallies doesn't make it good.



Why I am not Thrilled

The FASB moves do little to instill confidence in the financial statements produced by some of the banks in the United States. The pronouncements do not affect private companies. They principally impact debt securities, not inventory, not fixed assets, cash good-will accounts receivable, etc.

There are a few problems with the changes. First, there is a consistency problem. Two companies can own the same security and yet value it differently based on their assumptions and judgment. One can decide the market is active and another can say it is not. Another may discount cash flows at 6% and another at 10%.

A second problem has to do with the financial reporting at weak financial institutions. The quality of financial reporting is an inverse function of the

financial strength of an institution.

More plainly, sick institutions frequently use less conservative assumptions than other financial institutions in order to post better results, maintain investor confidence, and hold regulators at bay, even if only temporarily.

How often have we seen CEO's tout the strength and liquidity of their institutions to the point of being indignant only to see them collapse weeks later? When was the last time you saw a banker say "We have some big problems in our portfolio?"

Let's take two banks, one called AAA, named after its bond rating, and a similarly named Bank B. Bank AAA generally does not want surprises for its investors. The reporting decisions are generally conservative. In that way once a problem occurs it does not continue



Why I am not Thrilled, Continued

to recur in the future, giving investors that bottomless feeling and losing faith in management. So they are more likely to use the 10% discount rate or continue to use the market price, even if it isn't as high as they would like.

Bank B has lots of problems. The stock price is sinking on rumors of its weakness. Regulators are uneasy as the stock price declines their ability to raise capital to work themselves out declines with it. Large depositors pull funds rather than risk exposure to balances above the FDIC limit so Bank B's liquidity is suffering. Of course Bank B's CEO is trumpeting their strength and liquidity and treating the rumors with disdain. He wants his financial statements to look strong by any means available. As many of the securities he can avoid impairing he will. "Those markets are all distressed." He will instruct his ac-

countants to maximize the values they present.

Now the third problem is magnified by the change in the definition of "Held to Maturity." Bank AAA has the desire and ability to hold securities to maturity so the change has no impact on their reporting.

Bank B wants to hold the securities to maturity but can they? What are the odds? 33% 51% Who can honestly say? (Maybe Bank B's CEO, but he doesn't want to.)

Unfortunate paradox results. Bank B carries the bonds at a higher value than Bank AAA even though the probability of a distress sale is greater for Bank B. In reality the value of the bonds in B's hands may be lower than in A's. So the ability to compare the financials of the two companies is greatly impaired.

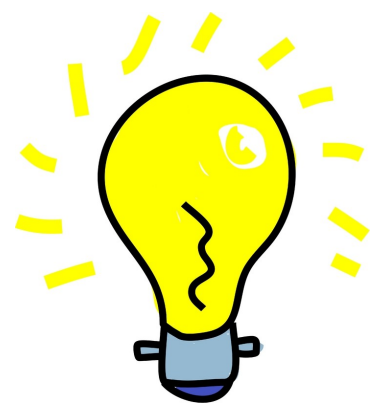
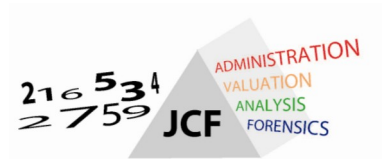
My Proposal

The insurance industry is required to submit their investments to the Securities Valuation Office of the National Association of Insurance Commissioners. They categorize the bonds by grade and let the companies know if they can carry them at amortized cost or at a particular value.

I think the banking industry needs a similar body under the control of the Controller of the Currency, the Fed, Office of Thrift Supervision (do we need all these different regulators?) By doing this we accomplish the goal of consistency in reporting. Investors will

not need to decipher the set of assumptions used in valuing particular bonds or classes of bonds. A simple disclosure of the cost of the bonds, the carried value of the bonds, and the fair market value (even if they are distressed) will provide investors with more objective information on the financial condition of the bank and will put them in a better position to assess the risk exposure that each institution presents.

Just as SVO is funded by the insurance industry this office can be funded by the banking industry.



Poker?

The same group of people that induced Fannie Mae and Freddie Mac to guarantee and purchase subprime mortgages is at it again. FASB was under pressure by members of Congress to relax the mark to market standards because that was what is ailing the banks. It had little to do with lack of oversight by Congress, regulators, boards of directors, rating agencies, and whoever else had a hand in the largest financial debacle of our lifetime.

So some (but not all) of the FASB

board have caved into the pressure from our politicians even though the result goes against what they are in place to do: creating uniform accounting standards to enhance the quality and trustworthiness of the financial reporting in the United States.

I don't expect many of these people to appear in the World Series of Poker given the way that they folded under pressure. But to show there are no hard feelings they are invited to my weekly poker game.



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