



LETTER OF COMMENT NO. 276

Sent: Tuesday, March 31, 2009 5:13 PM
To: Adrian Mills; Diane Inzano; Joseph Vernuccio; Kristofer Anderson; Mark Trench; Meghan Clark; Peter Proestakes; Russell Golden; Vita Martin; Wade Fanning
Subject: FW: Proposed Fair Value FSPs

From: David Merkel [mailto:david.merkel@gmail.com]
Sent: Tuesday, March 31, 2009 5:00 PM
To: Director - FASB
Subject: Proposed Fair Value FSPs

Sir,

My name is David Merkel. I am the Chief Economist and Director of Research for Financorp Securities. I am against the proposed changes to mark-to market accounting. I would urge that you consider my arguments in favor of SFAS 157 as currently understood, as well as the arguments of two stellar accountants, Jack Cieselski (<http://www.accountingobserver.com/PublicBlog/tabid/54/EntryId/12565/A-Few-Comments-On-FASBs-OTTI-Proposal.aspx>) and Tom Selling (<http://www.accountingonion.com/theaccountingonion/2009/03/mark-to-market-accounting-scapegoat-for-the-failure-to-properly-regulate-banks.html>).

I attach my most recent piece on mark-to-market accounting below. More of my thoughts can be found here: (<http://www.google.com/custom?domains=alephblog.com&q=157&site=alephblog.com&sa=Google+Search&client=pub-2776072933217634&forid=1&channel=6372747699&ie=ISO-8859-1&oe=ISO-8859-1&safe=active&cof=GALT%3A%23008000%3BGL%3A1%3BDIV%3A%23336699%3BVLC%3A663399%3BAH%3Acenter%3BBGC%3AFFFFF%3BLBGC%3A336699%3BALC%3A0000FF%3BLC%3A0000FF%3BT%3A000000%3BGFNT%3A0000FF%3BGIMP%3A0000FF%3BFORID%3A1&hl=en>)

Sincerely,

David J. Merkel, CFA, FSA

PS -- my thoughts are my own, and do not reflect the views of the firm that I work for.

Of Course not at Par; That's Par for the Course

There are several truths well-known to educated investors that have been glossed over in all of the discussions of mark-to-market accounting, or SFAS 157. (Really SFAS 133, but SFAS 157 clarified it.)

- Accounting rules have little impact on stock prices. Almost every academic study on accounting rules supports that idea. Why? Investors attempt to estimate the stream of free cash flows that an asset will throw off. Accounting rules can help or hinder that. Because SFAS 157 attempts to calculate a present value of cash flows for level 2 and 3 assets, it aids in that estimation.

- Parties involved confuse regulatory with financial accounting. Mainly due to the laziness of financial corporations in the boom phase of our markets, they looked to minimize effort, and make the accounting the same for regulatory and financial purposes. This was foolish, because there is no one accounting method that is ultimate. Every financial statement answers one main question. For GAAP, the balance sheet asks “What is the net worth?” Regulatory accounting would ask “Is net worth positive under conditions of moderate stress, including the possibility that markets go illiquid, and we have to rely on cash flows to pay off the liabilities?”
- There are always two ways to do accounting. You can do mark-to-market, or you can do book value accounting with impairment. Darkness encourages skepticism. In a period where there are few credit risks, book value accounting will be well-received. In an era where credit risks are significant, book value accounting will be no help, investors will distrust book value, and the effect might be less than where fair value estimates are provided. Regardless, the cash flows will still flow.
- Equity-like investments deserve equity-like accounting. They should be market to market, as equities are. With derivatives, this is the reason that we mark them to market, their values are so variable. So we should mark speculative mortgage investments: estimate the future cash flows, and discount them at a high, but not equity-like interest rate.
- But what of assets that are seemingly money good, but the few trades that have happened indicate a value at 60% of par, possibly because of The Bane of Broken Balance Sheets, or Time Horizon Compression. Here’s the problem: we have a lot of people alleging that those values can’t be right. Let them stand up and start buying to prove it all wrong. Part with precious liquidity to gain uncertain yield. It is quite possible that we are in a depression, and as such, there are too many assets relative to the ability to fund them — asset values must fall. Don’t immediately assume that the few trades in the market are ridiculous because they are lower than your current marks.
- Some argue that there is an inconsistency between loans and bonds. Bonds get marked to market, while loans are marked at book. There is no inconsistency. The loans are held to maturity, unless sold. The bonds could be held to maturity as well, in which case they are at book value, and only changed if there is a need for a writedown, the same as the loans. Most companies have not chosen that option, largely because they want the right to sell assets if they want to. But that locks in their accounting; if they want the ability to sell, they must accept balance sheet volatility.
- We have to differentiate SFAS 157 from misapplications of SFAS 157, which might be driven by the auditors. SFAS 157 does not mean last trade. In thin markets, companies are free to use discounted cash flow and other analyses to estimate fair value.
- Now all of this said, practically, SFAS 157 leads to overestimating the value of assets. In the consulting work I have done, companies are not willing to mark their volatile assets down to levels near their fair value, much less last trade, which is worse. They are hoping for some huge return of risk-taking to appear, and revalue their assets. What if present conditions persist for five to ten years, where there are too many debts relative to the willingness to fund them, as in the Great Depression? In that situation, SFAS 157 would prove to be too flexible, with banks marking assets higher than warranted.

The anti-SFAS 157 arguments rely on an assumption that things aren’t so bad — that mean-reversion is right around the corner. We are in a situation where marginal cash flows to purchase dud assets aren’t there. Mean reversion is a long way off, and the valuations of financial assets reflect that consistently. Try selling a bunch of whole loans held at par. See what the offers are. Why aren’t banks doing that to raise liquidity? Because the prices don’t justify it.

You can’t fight cash flows. Accounting exists to partition cash flows into periods, so that analysis of businesses can be done, and debt financing can be secured. In the end, cash flows win out, regardless of the accounting methods.

Thus my opinion: SFAS 157 is a good standard, and I am no fan of the FASB generally. There are

misapplications of SFAS 157, forced by auditors, I believe. SFAS 157 already offers decent flexibility to management teams — let them use that flexibility, but no more. After that, let the regulators set their own solvency rules.