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Feb 12, 2009 Economic Commentary

Untouchable Accounting Rules; Really?

For some reason our elected leaders and a significant, although shrinking, number of financial market professionals have fought strenuously against any alteration of mark-to-market accounting rules. These people have been supported by a vast majority (also shrinking) of the financial market media in their stubbornness about this topic.

The untouchable nature of these accounting rules may have been most clearly stated by Congressman Barney Frank on CNBC the morning of February 11th. "You certainly don't want Congress legislating accounting [rules]," he argued. Amazingly, no one asked: Why? Congress passes laws all the time: gas mileage in our cars, where we can drill for oil, Sarbanes-Oxley, etc., etc., etc. Why are these accounting rules suddenly untouchable?

Don't get us wrong, we don't think Congress should legislate nearly as much as it does. But how and when did the accounting profession become so infallible? After all, despite the cold accuracy of numbers, most accounting rules are only an estimate of reality.

If the computer on your desk is more than three years old, accounting rules for depreciation says it is worth nothing whether or not it still works. Depreciation provides only an estimate of true value. If fuel prices fall, and an airline may save billions in fuel costs over the next few months, current accounting rules do not allow it book those lower costs as savings today – but, if it has hedged at higher prices it would be forced to book those losses right away even if the hedge has months to run.

Fair value accounting is also just one way to keep the books. This rule forces financial institutions to "mark" the value of assets to the "market" and then take any gain or loss through the income statement and onto the balance sheet. There is no allowance made in this process for whether markets are liquid or not, whether prices reflect true underlying cash flows, or whether panic is in the air and the prices available are fire-sale prices.

This does not mean that fair value accounting is 100% wrong. It's not. But it is extremely pro-cyclical. When the market is going up, bank capital is boosted and banks lend more. And when the market is going down, fair value accounting rules cause bank capital to shrink, which causes banks to pull back from taking risk. In other words, the rule helped create our housing bubble in the first place, and in this past year, by hampering lending activities has made the economy worse.

Nonetheless, some observers – who believe fair value accounting should be retained – think that the prices of so-called toxic assets in the market (no matter how low) are reflective of "real" value. They argue that home prices will fall significantly further and that more foreclosures will occur. Therefore, market prices for toxic assets (no matter how low) reflect reality.

The problem is that this is a ***forecast***. Those who believe it think that current market prices are correct and that anyone who wants to price them higher is "marking-to-myth." But, in reality, these pessimists are the ones who want to mark-to-model. It's their model, of course, the one that says the world will get much worse. No matter how low the price for any security is, they believe that it is probably justified.

And this is where a bigger more systemic error is created. Because mark-to-market accounting reduces the capital position of our banking system, it impacts the economy. The accounting rule itself creates a self-fulfilling prophecy because it sets off a vicious and circular economic cycle. Capital contraction harms lending, which in turn hurts the economy, which in turn lowers the

prices for assets, which reduces capital further, starting the whole cycle all over again.

This cycle must be ended before the economy recovers. As a result, one of three things must happen.

1) Every asset has to be written down to a rock-bottom level, where the odds of further mark-downs are near zero.
2) The government must buy all the bad assets, or flood the system with so much money, that it takes away the risk of further markdowns.
3) Or, Congress, the SEC, the Treasury, or the Financial Accounting Standards Board (FASB) must alter or suspend mark-to-market accounting.

The first option is the nuclear option. If mark-to-market accounting is not altered, the downward spiral will continue and capital will remain frozen, making things much worse. The second option is taking an awfully long time to come to fruition, it is very expensive, and there is no guarantee that Treasury will ever get it right.

This leaves option three. But, don't count on FASB to support any change in rules. The accounting profession likes fair value accounting because it protects it from making any decisions that might put it in jeopardy. As long as auditors can point to "market" pricing, they can avoid any responsibility for making judgment calls. As a result, no matter what Barney Frank argues, Congress (or government) must make this call.

The good news is that there finally seems to be some movement on this issue. It came up in questions during hearings in both the House and Senate in recent days. After twelve months of avoiding the issue entirely, and deriding anyone who brought it up, even CNBC is giving airtime to discussions of the topic. Congressman Frank and Senator Dodd have both discussed it with reporters.

We still hold out hope that sanity will prevail and that the untouchable nature of this topic, and the nearly religious fervor that some seem to have about this issue will lead to some sanity on the topic. We are hopeful that members of Congress, who see the harm that fair value accounting has done, will pick up the banner and start pressuring the Treasury Department and the Securities and Exchange Commission to push changes on FASB. This is the quickest and cheapest way to help stop financial market problems and their impact on the economy.

Up to this point, we have avoided calling for a complete suspension of fair value accounting because it makes sense in most scenarios. It's when markets get illiquid or bubbly, that fair value becomes a problem. What we have hoped for is a "targeted and temporary" alteration to accounting rules for the assets (probably issued between 2003 and 2007) that are very illiquid. Cash flows should be used to value assets, not market prices.

However, the longer this crisis lasts, the more we think fair value accounting should be suspended altogether. If it takes this long for the government to realize the damage it has done, then it should never be in place at all. Fair value accounting existed in the 1930s and we had the Great Depression. President Roosevelt suspended it in 1938 and between then and 2007 the economy had no panics or depressions. Now that the rule is back, so are the major economic problems. So, maybe we would be better off just putting it through the shredder once again.

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