

COMMENT

Collective delusion about true value of ABCP holdings

Writedowns of subprime losses vary widely

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Many eyes in the market will be on Dundee's quarterly results today. A wide swath of investors and companies alike will be watching to see what the company reports as an impairment loss on its roughly \$387-million of asset-backed commercial paper (ABCP). Dundee could recognize an impairment loss of anywhere between zero and \$100-million, perhaps the largest so far, hence the heightened intrigue.

In a report to clients this week, we detailed the 33 companies that have reported on their ABCP holdings so far, and which ones will probably have to report additional losses as part of their fourth-quarter results. Another 18 companies, representing the majority of the \$4.2-billion in ABCP held by public companies, still have to report their third-quarter writedowns.

Since mid-August, the market for Canadian non-bank ABCP has been frozen and untradeable by design through an agreement of the very holders of a majority of the paper. These previously liquid investments have been in stasis for three months now, the delay a testament in part to the nebulous and opaque nature of the underlying assets.

After speaking with several holders of the investments, it's clear that few know what they own, much less what it might be worth. While all the companies are operating under the same restrictions and market conditions, and often use the same descriptive verbiage in their financial state-

ments, there are nevertheless widely divergent estimates of impairment writedowns.

One company that took a significant writedown noted, "There is no assurance that 100% of the principal will be repaid."

Another company that took no writedown said there was "no reason to believe at this stage that 100% of the initial investment will not be recovered." Yet another company that also took no writedown is nevertheless suing its bank for damages for advising it to buy the ABCP. What damages are those again?

So far, companies have decided to recognize losses ranging from nil to 15% of the value. But frankly, there are many reasons why 15% should be the bottom of the range, not the top.

Overall, there's a collective delusion when it comes to the

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current market value of these investments. To be clear, accounting rules require companies to report investments at their fair value. But, with no current market for non-bank ABCP, companies are free to estimate the values on their own.

In fact, one of the major attractions of having paper frozen by the Montreal Accord is that companies don't have to come to terms with the significant impairment losses and potential reversals of accrued interest income.

It is a myth, of course, that the paper is somehow not impaired if it does not trade.

Likewise, it's difficult to believe that even an orderly restructuring will not result in marked-to-market losses once the paper starts trading again.

Nevertheless, that may all change very soon. Perimeter Financial has announced it will attempt to open a market today to trade the illiquid paper. Some holders of ABCP are not part of the Montreal Accord standstill and are in need of cash for operations. Given the intentions of some of the sellers, initial trades could result in discounts of 20% to 40%, effectively throwing down the gauntlet at companies that have reported insufficient writedowns.

Accounting rules require companies to consider open-market trades in determining fair-market values, and marking-to-market their own holdings. Recent accounting literature confirms that illiquid market transactions simply cannot be ignored at will when determining financial statement fair values.

In an initial report to clients in October, we said the essential valuation question should be, "What would a third party pay for the ABCP today given the excessive lack of information that exists?" It is not "How much less do we think this is worth given that we already hold it?"

So far, we have seen some anecdotal indication of third-party assessments of value. One company has been able to secure a \$12.6-million line of credit from its bank using \$17-million face value of its ABCP (the only collateral offered up). This translates to a discount of roughly 26%, a far cry from what some companies have reported as impairment writedowns so far.

So, it's worth looking closely at what companies are reporting. It's likely that many will need to report additional losses as part of their fourth-quarter results in order to top up their current impairment estimates. As for the next few weeks, there's still that \$4.2-billion hanging out there.

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