

COMMENT

Don't like the score? Change the rules

Decision to let firms postpone asset impairments wraps the market in fantasy

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We live in unprecedented times ... supposedly. Taking a backwards view, numerous pundits argue that current market conditions constitute a rarity. Looking forward, of course, nobody can say for sure — except the accountants, that is.

When the European Union and Canada adopted changes last month to fair-value accounting rules, they

allowed certain asset impairments to be delayed in so-called “rare” circumstances. Many companies have conveniently assumed, with support from their accountants, that the present market conditions are indeed rare.

The impact of the accounting change, almost invariably, makes the financial statements of companies look much better. “Look” being the operative word, because there is no change in actual substance. But we’ll return to that point in a moment.

First, let’s deal with the timing and wording of the accounting change. It’s easy to call something rare in retrospect, but when setting rules that can only be applied to the future, history is irrelevant. Put another way, things have undoubtedly changed for good. All sorts of historical norms

have been blown away, and deemed unreliable for predicting the future.

But for argument’s sake, let’s pretend for now that history still has some predictive power. How much history are we really talking about here? As far as the accounting rules go, it has been less than two years since Canada adopted the framework to fairly value financial assets — and we are already changing them mid-game because of supposedly unforeseen events.

Had the rules been in place during the tech wreck, we would have witnessed a similar uproar from companies having to fairly value assets in a plunging market. We are basically setting ourselves up to say that cyclical, and rather predictable, market downturns are somehow “rare” enough to change the accounting rules each time around.

But you won’t get any hint of this from the companies that are postponing losses courtesy of the accounting change. **Deutsche Bank** (DB/NYSE) recently reported third-quarter income before taxes of €93-million (\$143-million), because the accounting change allowed the deferral of €845-million in unrealized losses that otherwise would have hit the income statement.

Deutsche Bank offers no explanation for why it chose to suspend fairly valuing its assets. But, essentially, the bank is saying that it would never dispose of these assets at fire-sale prices, so why should it recognize losses unless they are realized? The rule change allows companies to recast history to say that they never intended to sell such assets, precluding them from participating in either the accounting upside or downside (now that it’s clear that there’s only downside).

The problem with allowing companies to reclassify assets mid-game is that it practically invites accounting manipulation. Deutsche Bank and others were more than happy to boost reported net income as the value of assets rose with markets awash in unsustainable levels of liquidity.

Now that the tide has turned, and the markets have naturally delevered from their precarious heights, we are swift to label the downturn as so extra-

Deutsche Bank deferred losses of €845-million

ordinary it defies explanation and requires a suspension of the ground rules. Allowing companies to defer losses in this way assumes that the market will quickly and easily bounce back. But, it’s a far cry to say this is a view held by any majority (save the accounting soothsayers, of course).

Which brings us back to the first point — not only was the accounting change very convenient, it was all too easily accepted by companies on behalf of investors. Corporate financials look better under the new rules and, by extension, capital adequacy in many financial institutions appears to improve. Suddenly, investors gain more confidence based on mere appearances, and soon we are back to where we started: with a market more than happy to cloak itself in fantasy.

Several market watchers have claimed that the old accounting rules worsened the credit crisis, when in fact all they did was reflect unvarnished reality. Left alone, the old rules would have produced better financial results as soon as market liquidity improved.

But instead of waiting for a substantive change in economic reality, we have decided to shoot the accounting messenger, which will only end up delaying a recovery of the markets by continuing to produce unreliable and capricious financial reporting.

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