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Thursday, September 11th, 2008

[Inside Wall Street: The Hocus-Pocus Accounting Tricks That Will Perpetuate the Capital Markets Credit Crisis](#)

[The second installment of a two-part story detailing how accounting machinations have fueled the capital markets credit crisis. [Part I](#) appeared yesterday (Wednesday).]

By Shah Gilani
Contributing Editor

Who says accounting can't be fun? When it comes to determining capital adequacy and the solvency of banks and investment banks gutted by this historic capital markets credit crisis, accounting cards are magically being shuffled to manifest the illusion of repaired balance sheets - and sometimes even profits.

On the dark side, these few seemingly simple tricks are actually masking the thick red ink of buried losses.

The props in this "hocus-pocus accounting show" determine how assets are accounted for. In fact, there are three "accounting boxes" into which assets are placed. Let's take a close look at each of the three:

- **The first accounting box is labeled "Held-to-Maturity:"** Assets that are [held-to-maturity](#) are accounted for on the balance sheet at cost. That's good and bad, but at least it's transparent. If an asset has appreciated, it doesn't show, nor does its depreciation change the balance sheet or hit the [profit-and-loss \(P&L\) statement](#). The generally good news is that longer-term, fixed-type assets appreciate over time. The caveat to continuing to hold an asset at cost is that it should be

accounted for differently if changes in value are considered either "[more permanent](#)" or "[other than temporary](#)." Hocus-pocus accounting is possible here simply by virtue of manipulation of the definition of the terms *more permanent* and *other than temporary*.

- **The second accounting box is labeled "Held-for-Trading."** In this box, assets are [marked-to-market](#) on a quarterly basis (quarterly for reporting purposes, however, they are usually marked internally on a daily, if not hourly, basis). And their fair value - relative to the last time they were marked-to-market - reflects a profit or loss that is accounted for on the institution's balance sheet and in its quarterly earnings. Marked-to-market means that the asset is priced based on the last sale price on the day it is being accounted for. For example, if you wanted to mark-to-market the shares of International Business Machines Corp. ([IBM](#)), you would use the closing price for the stock on the day you want to value it. [The difficulty](#), which includes transparency issues and the potential for manipulation, is valuing assets that do not trade frequently, or may be priced based on internal mathematical models. These hard-to-value assets are classified as Level 3 assets. There's plenty of room here for hocus-pocus accounting. [Valuing Level 3 assets](#) is a magic act all by itself.
- **The third accounting box is labeled "Available-for-Sale."** This box is the magician's version of a "[black hole](#)." In here assets *could* be sold, but are likely to be held. Gains and losses on assets in this box are not accounted for on the balance sheet in terms of profit or loss, and instead are accounted for under *equity*. And they don't show up on the P&L (corporate income statement) - unless, of course, any change in value is determined to be *not temporary*. I'll come back to "not temporary" value changes shortly, but please realize it's important to know where these gains and losses are floating, and to understand the circumstances under which they'll affect earnings.

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Instead of hitting earnings when changes occur in the value of assets in the *available-for-sale* box, the changes are parked on the balance sheet under [shareholders' equity](#), and from there, under *accumulated other comprehensive income* (AOCI). It is in this floating netherworld that gains or losses are neatly stashed, potentially for years, until they are released into net income when desirable. Another term for active use of this trick is "managed earnings."

The hocus-pocus accounting is in the determination of *temporary*, or when these losses should be extracted from the darkness of the netherworld and accounted for in the light of day. Generally, they should be accounted for in earnings when they are *impaired*, as defined under International Accounting Standard (IAS) 39, paragraph 58.

The important exposure of this trick is in understanding that losses held under AOCI do not

count in calculating either Tier1 capital or capital ratios. If these rules were to be changed, only God could help the banks meet capital adequacy and solvency tests.

All this prestidigitation, or sleight-of-hand, is revealed by understanding what you can't see. The problem is "intent-based" accounting. If assets can be accounted for in multiple ways - and the determining factor is the intent of management - there isn't much room for transparency, and there's even less for the comparative analysis of balance sheets, earnings, capital and capital ratios.

According to [Stephen Ryan](#), an accounting professor with New York University's [Stern School of Business](#), "all forms of intent-based accounting are problematic, as intent does not change the risk or value of a position while you hold it." Add to that insight the comments of *Bloomberg Markets* columnist [Jonathan Weil](#), who recently noted that the [Financial Accounting Standards Board](#)'s recently issued Statement 159 further obfuscates appropriate comparisons and transparency. [FASB Statement 159](#) allows companies to pick and choose when to apply recurring fair-value reporting - as well as which assets to apply it to.

While the illusion that banks and investment banks are nearly finished writing off their accumulated losses suggests the potential for bottom-fishing, there's a key point to understand: Without the appropriate transparency, the actual critical measures of capital and solvency will remain cloaked in secrecy.

The U.S. Federal Reserve, the U.S. Treasury Department and federal regulators are in no mood, and in no position, to tighten up accounting rules at this stage of the game. Any further deterioration in capital measures will only force the Fed to keep its liquidity window open indefinitely - and rates artificially low. The Treasury will continue to backstop the [Federal Deposit Insurance Corp.](#) (FDIC), while the FDIC continues to bulk up reserves for the inevitable cascade of failing commercial banks.

Unfortunately, the only magic that will settle the capital markets credit crisis is the bottoming out of home prices and the de-leveraging of inflated balance sheets. Once that's done, the accounting tricks that mask transparent comparisons need to be eliminated.

The next trick will be to pull the U.S. consumer out of the deep debt hat in an ugly environment of skittish banks whose cost of capital will crimp margins and profits for years to come.

In finance - as in life - perhaps it's sometimes just better to believe in magic and not ask how the trick is done.

[Editor's Note: Contributing Editor R. Shah Gilani has toiled in the trading pits in Chicago, run trading desks in New York, operated as a broker/dealer and managed everything from hedge funds to currency accounts. In his new column, "[Inside Wall Street](#)," Gilani promises to take readers on a journey through the "shadowy back alleys" of the U.S. capital markets - and to conduct us past the "velvet rope" that guards Wall Street's most-valuable secrets - in an ongoing search for the investment ideas with the biggest profit potential. In [Part I of his commentary](#) on "hocus-pocus accounting," which ran yesterday (Wednesday), Gilani detailed just how these accounting maneuvers created the foundation for the capital markets credit crisis.]

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6. Comment by Stan Watts on [16 October 2008](#):

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 A great service with excellent material.
 And, how I have enjoyed Mr. Shah Gilani's writings.
 His writing is clean, clear and to the point. They have been immensely enlightening to me in understanding what is going on.
 Please pass on my appreciation to all for an excellent publication. Thank you.

Stan Watts
 BC Canada

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