

Consulting Corner – Jan 05

Bad Accounting: Don't just get mad, get even

by Andrew Davidson

The current accounting paradigm has given importance to certain measures of economic value such as Fair Value, retained earnings and comprehensive income. As a consequence, companies are incented to generate good results measured in these accounting terms. This issue of Pipeline presents a hedging technique that financial institutions can use to help manage their key reporting results.

The primary accounting measure of value is the economic Fair Value of the firm. In general, firms seek to stabilize and increase the Fair Value of the firm in order to maximize the value of the company and to ensure that the company is fit to survive various economic shocks. Firms also seek to maintain the stability of retained earnings and accumulated other comprehensive income (AOCI). Good management of these metrics indicates that the company can control its risks, and limits the potential that the market will interpret adverse accounting results as real economic instability.

For a firm that applies cost based accounting and holds par priced loans that are match funded with its own debt, changes in the economic value of assets and liabilities will not have any impact on Retained Earnings or AOCI. Retained Earnings will change by the amount of net interest income, less expenses. Consequently, companies using cost based accounting for par loans should be concerned primarily with stabilizing their economic value and maintaining stable net interest income. The chart that follows summarizes the reported risk exposure under cost based accounting for a hypothetical firm having \$100mm of par loans with a duration of 3 years, that are match funded with debt. The results assume an instantaneous change in rates.

Rates fall 100bp:
(\$millions)

Position	Fair Value	AOCI	Retained Earnings
Loans	\$3.0	-	-
Debt	-\$3.0	-	-
Net	0	-	-

For purposes of illustrating how accounting results can vary, suppose now that the firm utilizes derivatives in addition to debt to hedge itself. The company expects it will get hedge accounting treatment on its derivatives. Its reporting position is now represented by the following chart.

(\$millions)

Position	Fair Value	AOCI	Retained
----------	------------	------	----------

			Earnings
Loans	\$3.0	-	-
Debt	-\$2.0	-	-
Derivatives	-\$1.0	-\$1.0	-
Net	0	-\$1.0	-

Although the firm is hedged, it looks like it is taking risk due to the fluctuation in AOCI. To better manage the risk of adverse changes in reported AOCI, the firm could designate some of its assets as Available for Sale (AFS). AFS assets are recorded at Fair Value, and changes in the Fair Value are reflected in AOCI.

With this change, the firm's position is reflected as follows:

(\$millions)

Position	Fair Value	AOCI	Retained Earnings
Loans--HTM	\$2.0	-	-
Loans--AFS	\$1.0	\$1.0	
Debt	-\$2.0	-	-
Derivatives	-\$1.0	-\$1.0	-
Net	0	0	-

Note that by way of the change in accounting designation, the firm has kept its Fair Value stabilized against changes in interest rates for all of these changes. The only thing that has changed is how the accounting measures reflect the value of these positions.

Suppose now that the firm has premium loans in its held to maturity portfolio. These loans are subject to FAS-91, so that changes in the amortization of premium are reflected directly in retained earnings. Falling rates will cause a loss in premium as prepayment forecasts increase. The position of the firm is as follows:

(\$millions)

Position	Fair Value	AOCI	Retained Earnings
Loans--HTM	\$2.0	-	-\$0.3
Loans--AFS	\$1.0	\$1.0	
Debt	-\$2.0	-	-
Derivatives	-\$1.0	-\$1.0	-
Net	0	0	-

The fluctuation in FAS-91 premium amortization can create significant volatility in the net income of the firm. To offset this risk, the firm can replace some of its assets with

TBA mortgages. The firm would not seek hedge accounting on these assets so that changes in their value would be reflected directly in net income and retained earnings. At this point the firm could be represented as follows:

(\$millions)

Position	Fair Value	AOCI	Retained Earnings
Loans--HTM	\$1.7	-	-\$0.3
Loans--AFS	\$1.0	\$1.0	
TBAs--trading	\$0.3		\$0.3
Debt	-\$2.0	-	-
Derivatives	-\$1.0	-\$1.0	-
Net	0	0	0

The firm has succeeded in maintaining control of its economic risk on a Fair Value basis. By utilizing the differing treatments of assets, debt and derivatives, the firm has been able to stabilize the accounting measures as well. Somewhat surprisingly, the firm does not need to match the assets and liabilities falling into each bucket; in some cases it may be impossible to do so. For example, loans which create the FAS-91 amortization can not be used to hedge the risk they create without taking on a greater degree of mark-to-market risk.

While the market is waiting for the accounting bodies to face the reality that the current accounting framework creates misleading financial statements and encourages firms to act against their economic interest, firms can use these methods to even out their accounting exposures, without compromising economic management of their assets and liabilities.

Disclaimer: Nothing in this piece should be construed as accounting advice. Each firm must utilize the approaches and methods allowed by its advisors.