

## **Commentary: Shoots With Green Paint on Them**

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On Friday, American International Group (AIG) reported a profit. This is good news for several reasons.

Since the federal government owns 80% of AIG, profits suggest that the US taxpayer might actually see a return on this \$200 billion investment. Even better, AIG's report, along with a report indicating that fewer jobs were lost in July than expected, provides one more indication that the longest recession in post-World War II history is finally finding a bottom. Market prices soared like a hawk on this news.

Like just about everyone else, I would like to see the Second Great Depression consigned to the great dustbin of history. But, there are parts of this positive news report that are troubling.

It turns out that, notwithstanding its reported profits, AIG suffered an operating loss of \$1 billion last quarter. This means that the profits had to come from somewhere other than its operations. Edward M. Liddy, the government's pick for chairman and CEO, tells us that the primary reasons for the reported profits were a favorable accounting change and general improvement in market conditions.

Mr. Liddy didn't provide any further details, and AIG's published report doesn't identify how much of the \$311 million profit, which had to overcome the \$1 billion operating loss, consisted of a favorable accounting change, as compared to improved market conditions. Mr. Liddy also failed to explain the nature of this "favorable accounting change."

So, let me speculate.

There is no "truth in labeling" law in the disclosure rules, where the largest ingredient is placed first on the label. But lawyers spent a lot of time on Mr. Liddy's statement, and lawyers are predictable creatures. My guess is that the "favorable accounting change" explains most of AIG's second quarter profit.

In March of this year, under great pressure from Congress, the Financial Accounting Standards Board (FASB) issued proposed staff position (FSP) Financial Accounting Standard (FAS) 157-e, entitled "Determining Whether a Market is Not Active and a

Transaction is Not Distressed.” This FSP permits issuers to assume that indebtedness represented by a security will be timely repaid, even though market prices would tend to suggest that potential purchasers are less optimistic. My guess is that the FSP that “clarified” FAS 157-e is the favorable accounting change that compensated for AIG’s \$1 billion operating loss and provided an additional \$331 million of profit.

Much of the recent market buoyancy is attributable to the rising market prices of stocks issued by technology companies and financial services firms. As it happens, financial services firms are the primary beneficiaries of FASB’s “clarification.”

The purpose of accounting is to enable the managers of a business and its investors to understand whether or not they are truly profitable. The banks that lobbied Congress to change the mark to market rules argued forcefully that the rules forced them to write assets down that were more valuable than the rules allowed. If they were right, then current rules provide more accurate information to the investing public. If they were wrong, financial institutions that appear healthy for now are doomed to crash and burn, contrary to all expectations.

I would like to think that the people who pushed the accounting industry to abandon its principles and go along with all of this are motivated by the public interest. There has been a lot of talk during this harsh recession about the role of confidence in creating and prolonging recessions. There are those who believe that if people only have confidence, consumer spending will rise, investors will liberate the money hidden in their mattresses, and the economic engine will start to crank full bore. On this theory, bending a few accounting rules to quick start the economic engine is worth the injury done to public disclosure.

Brings to mind the faith healer, who tells us that faith can move mountains. For my money, if it’s mountains you wish to move, buy a bulldozer.

Personally, I don’t think confidence is a matter of psychology. Confidence mirrors economic realities. I am a lot more willing to spend money when some coins are rattling around in my jeans and more coins are expected. I am unlikely to buy a new car when it is difficult to put food on the table. No amount of clever accounting can compensate for falling profits for very long. If the revalued debt securities on AIG’s books end up in default, its profits will evaporate like dew drops in the Sahara.

Accounting tricks will not keep a business afloat forever. Every business must at some point have operating profits to survive.

We have seen this sort of thing before. The experience of Enron, Worldcom, HealthSouth and, most recently, General Electric all lead to the same conclusion.

Painting the grass green will not bring it back to life. For that, you need water and fertilizer. An economy cannot be resurrected with accounting clarifications.