



# COLORADO REAL ESTATE JOURNAL

THE COMMUNICATION CHANNEL OF THE COMMERCIAL REAL ESTATE COMMUNITY

APRIL 1, 2009 – APRIL 14, 2009

## FAS 157: from riches to rags

According to recently released data from the Federal Reserve Board, the net worth of United States households has declined by almost \$13 trillion since June 2007. The mind, of course, boggles when trying to understand a trillion of anything. A trillion seconds is 32,000 years; a trillion dollar bills placed end to end would circle the globe an ungodly number of times; and a trillion dollar bills stacked one on top of the other would reach an incomprehensible height. While the enormity of \$13 trillion might be beyond the grasp of most Americans, the sense of a large loss that accompanies such a statistic is not.

While everyone has suffered, not everyone has suffered equally, and the truly wealthy have incurred losses against which those of most Americans pale. Forbes magazine, for example, recently reported that the world's billionaires collectively lost \$2 trillion in 2008. Forbes also reported that there are now 300 ex-billionaires who have been reduced to mere multimillionaire status by the financial disasters of 2008.

More than 4,000 investors who believed on Dec. 10, 2008, in the accuracy of the financial information provided by Bernie Madoff discovered on Dec. 11, 2008, that their belief was ill-founded and their trust in him misplaced. Individuals, charities, foundations, hedge funds and trusts all learned to their ruin that the collective \$64 billion notional value reflected on their monthly statements was a fictional one and that what they had



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believed a good investment was a disastrous one.

After Madoff's confession that his well-respected investment fund was an elaborate Ponzi scheme, numerous experts and pundits called attention

to the numerous red flags that should have alerted the ruined investors of his massive fraud. While these signs seem obvious now, trusting investors were blinded to them by the outright lies on their monthly statements that confirmed what they wanted to believe.

That \$64 billion – however large it may seem and however devastating its loss was to Madoff's investors – is but a fraction of Americans' lost \$13 trillion. It only follows that someone must be to blame for the financial debacle causing a loss of such magnitude, and there are many candidates ranging from greedy financiers to somnolent bureaucrats. Some unlikely candidates now emerging for this blame are government regulators whose strict application of mark-to-market accounting rules are being criticized by financial institutions for their having to take artificial and premature losses.

Mark-to-market rules require that the value of assets on a financial institution's

books must be revised from time to time to reflect their actual value. The logic of these rules seems compelling, for what values should be reflected on financial statements other than accurate ones? The rub, of course, lies in defining "accurate," and the Financial Accounting Standards Board adopted FAS 157 to increase consistency and comparability when measuring value. The intended result was that those relying on financial statements would have better and more accurate information about the financial condition of the institution issuing the information.

Application of FAS 157 requires businesses to carry assets on their books at prices that a party would be willing to pay. When the economy was booming and values were increasing, the harsher effects of FAS 157 were not felt; in the current liquidity crisis, however, the wisdom of FAS 157 is being questioned. There are no buyers and there is no market for the mortgage-backed securities and collateralized debt obligations held by such national banks or commercial and residential real estate securing repayment of loans held by regional lenders. National and regional lenders alike are being forced by FAS 157 to write these assets down, recognize immediate losses and further weaken already tenuous financial conditions.

Holders of these now illiquid investments believe that government regulators should not force recognition of losses that would not exist in normal credit markets. Relief from rules like FAS 157, they argue,

will stabilize the financial condition of institutions that will not have to recognize losses on assets whose value will be restored by the passage of time and the return of normalcy to the credit markets. Relaxation of FAS 157, moreover, would help avoid a similar liquidity crisis and deterioration of institutions holding securities backed by automobile, credit card and student loans.

Many American businesses would, of course, welcome the application of such leniency to their own finances. By measuring worth by what was paid for a bad investment and allowing time to restore the asset's value, a business's financial condition could be immediately improved and, by being able to borrow funds to finance its business, it could add to the nation's general economic recovery. Indeed, the financial institutions that invested with Bernie Madoff could improve their financial health by hoping for a government bailout and reporting their investment at its book value rather than its actual worth.

While such accounting *léger de main* and oversimplification may be absurd, they do highlight one of the surprising lessons to be learned from the Madoff scandal: Investors, even sophisticated ones, rely on information supplied by financial institutions as being accurate and trustworthy. If anything, the recently discovered frauds and reckless financial practices that led to the current economic debacle argue for greater economic regulation and financial transparency, not less.▲