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Mark-to-market's Liability Lag

A new study of the S&P 500 finds a whopping mismatch between assets and liabilities subject to fair value.

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The scramble to implement fair value accounting rules has launched a thousand companies in as many directions, subjecting assets and liabilities to market valuations whether or not markets exist. The ramifications resemble guideposts to some observers, futile and dangerous exercises to others. But in an era of proliferating derivative and asset-backed securities, special purpose investments and other financial instruments subject to volatile global forces, both sides agree that the reliability of U.S. financial reporting hangs in the balance.

Even post adoption, mark-to-market rules under FAS 157 provoke profound disagreement in upper echelons. Panelists at a roundtable on fair value accounting standards (http://www.cfo.com/article.cfm/11706229?f=related), hosted by the SEC yesterday, sparred over implications. "If you are holding a position, you should know its value and how to apply that information," said Goldman Sachs managing director Matthew L. Schroeder, who said illiquid markets just require harder work to discern fair value. "We don't subscribe to the notion that there are no prices out there."

With elusive insurance company assets and liabilities under a microscope, Loew's Corp. CEO James Tisch said he understood the principle but mainly saw confusion in adjustments to income spawned by fair value accounting. "In a philosophical sense that may make sense," he said, "but to me it undermines income statements and has no real practical use."

The fair value dustup even made national television on July 7. It surfaced during the *Charlie Rose* program, when JPMorgan Chase CEO Jamie Dimon summarily rebuffed prominent critics who attribute much of the recent market upheaval to needless mark-to-market accounting. Said Dimon, "It was not an accounting issue, okay? Most of the loss that people have taken will be realized."

An exhaustive new research report by Credit Suisse attempts to get to the bottom of the debate now swirling around fair value accounting. It claims that evidence gleaned from 380 companies in the S&P 500 that have adopted fair value measurement per FAS 157 supports a clear verdict: marking assets and liabilities to market value clarifies economic reality for all stakeholders.

"We can hear the complaints already, you're crazy, that would make earnings too volatile," say authors David Zion, Amit Varshney and Christopher Cornette. "Too bad, that volatility is real, even if the company has no control over it; we would prefer to see the financial statements reflect real economic volatility rather than a false sense of stability."

Do not blame the dizzying rigors of fair value on zealous accountants, write Zion and his colleagues. Instead, an ugly combination of factors have steadily pushed matters to the brink — and over it, in the case of subprime loans. "The real problem was overexposure to certain assets, poor risk management, misunderstood mispriced risks and lots of leverage."

Familiar causes have fueled surging momentum for fair value accounting that companies used to apply at managers' discretion. The Credit Suisse report concentrates instead on consequences of calculating exit values for assets and liabilities — that is, prices they would fetch in an orderly market or the closest possible proxy for one. The new rule applies regardless of good health or impairment, even when no current or foreseeable need exists to find buyers.

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