Mark-to-Market Accounting and the Financial Crisis

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Do Accounting Standards Matter?

- FASB adopted No. 157 requiring mark-market-accounting on Nov. 15, 2007, while the subprime crisis was in process
- Cacophony of public and academic criticism blames the new standard for exacerbating the crisis
- Position of an amateur, but reasonably sophisticated observer of accounting:
  - It can’t possibly matter
- My goal tonight: Have the professionals explain what I am missing
My (Apparently Confused) Framework

- Markets are efficient with respect to accounting methods
- Accounting standards therefore do not influence securities prices so long as market participants can rearrange the numbers
- Bill Beaver’s influence on a young law professor at Stanford
Problem: Business People Act Like Accounting Standards Matter

- Back to the 80s debate over pooling versus purchase
  - “Often, an acquiring corporation has foregone a tax basis step-up in the target corporation’s assets where to do so would have had an adverse impact on its earnings for financial reporting purposes.” Head of Arthur Anderson corporate reorganization team, 1982
  
- Acquiring companies abandoning sound acquisitions because pooling wasn’t available “isn’t atypical.” Arthur Wyatt (1983)
Economic Consequences Literature

- Conflict between logic and smart people’s behavior led to “economic consequences” literature: an effort to explain why accounting mattered even with efficient markets
  - E.g., regulation, bond covenants, incentive compensation schemes (Holthausen & Leftwich (1983); Gilson (1985))
Puzzle Remains

- Expensing stock options and the politicization of Silicon Valley
- Fight over adoption of FASB 141 and 142
- Why do smart people fight over what can’t matter?
The Controversy over Mark to Market Accounting

- Current value versus historical cost
  - Assume that can also report historical cost
  - Why would additional information matter?

- Public debate
  - Mark to market forces companies to sell into a short term crisis
  - Companies selling at the same time causes asset prices to drop
  - Further drop in prices causes more selling, making the crisis worse
    - If could report a different, or additional number, what would change?
Allen & Carletti (2006):
“When liquidity plays an important role as in times of financial crisis, asset prices in some markets may reflect the amount of liquidity available to the market rather than the future earning power of the asset. Mark-to-market accounting is not a desirable way to assess the solvency of a financial institution in such circumstances.”

Plantin, Sapras & Shin (2007):
M to M “leads to the emergence of an additional endogenous source of volatility that is purely a consequence of the accounting norms, rather than something that reflects the underlying fundamentals.”
My Tentative Conclusion

• Gorton (2008) gets it right:
  • “Mark-to-market, however implemented, during a panic, has very real effects because regulatory capital and capital for rating agency purposes is based on GAPP.”

• Problem isn’t the FASB 157 – it’s the regulators, stupid!
  • Regulators seem to be substituting an accounting standard for a regulatory judgment
My Puzzle Remains

- Why do smart people care about 157, instead of asking why the regulators do not exercise judgment in the face of changed conditions?
- More generally, why do smart business people care about accounting standards?