Pursuit of convergence is coming at too high a cost

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There are a variety of problems behind the present market turmoil – chiefly reckless lending and inaccurate credit ratings of securitised debt. But one has so far had little attention – the role played by so-called "fair" value accounting.

The gold standard in financial reporting has long been "lower of cost or market", meaning an asset is on the books at either its purchase cost or its current valuation – whichever was lower. This conservativsm counterbalances the inherent tendency of managers to overstate performance by preventing them from reporting profits before cash is in hand.

But this year, US firms have been encouraged to adopt early SFAS 157 and SFAS 159, new accounting standards. Under these rules, financial instruments (including mortgage-backed securities) are stated on balance sheets at their "fair" values, which are taken from markets where possible, or for more complex securities are estimated from valuation models.

The problem is that this assumes markets have good information from inputs such as financial reports and credit ratings. But there is a circularity built in: if credit raters and investors get their information from accounting numbers, which are themselves based on prices inflated by a market bubble, the accounting numbers support the bubble.

So instead of informing markets through prudent valuation and controlling management excess, "fair" values feed the prices back to the market. For example, a drop in the market value of the borrowings of a troubled company is reported as an increase in its income because the reduced liability flows through the income statement, thus obscuring the problem.

Investment banks, early adopters of SFAS 157, have shown improved performance from the changeover. JP Morgan Chase reported that SFAS 157 increased its first-quarter earnings by $391m (£196m, €289m) – 8.2 per cent of its earnings – and Goldman Sachs reported an even larger increase of $500m – 11.5 per cent of net income. Share prices rose despite the incipient problems in mortgage-backed securities.

There were warnings. In 2006 the US Federal Reserve warned that fair value accounting could make an insolvent company look solvent. The UK's Financial Services Authority expressed concerns this year that fair value might not fully represent the economic reality of a business. Four months after some banks reported high first-quarter profits using fair value accounting, the Fed has cut interest rates to stabilise markets and keep some highly leveraged investment banks and hedge funds afloat.

The "fair" value accounting edifice is built on sand. Some banks sold subprime loans to reduce risk exposure but reacquired the risk by lending to parties holding the overvalued instruments. Bank directors certified their balance sheets. Did they ask the awkward questions about the real risk, credit controls and security in their loan books? Did the buyers of these derivatives, who packaged them up and sold them on, know how dodgy they were? Someone knew.

This is the second time in seven years that widespread problems have arisen in US accounting, securities' ratings and governance. Despite the onerous and costly requirements of Sarbanes-Oxley, and stringent audit controls, the system was unable to fix something as basic as the existence and collectibility of loans.

Meanwhile, US and international accounting standard setters are pressing ahead with a global framework which would embed this aggressive accounting. They seek one global system, however defective. They want verifiability, via a market price or a management estimate, rather than reliability of the underlying substance.

Warren Buffett has warned that mark-to-market accounting turns to mark-to-model in illiquid markets and risks becoming "mark-to-myth". Auditors sign off that accounts comply with the accounting standards. What use is that to investors when it means complying with a bubble-blowing accounting model? The pursuit of convergence in accounting standards needs a radical rethink if this is what it leads to.

Most losses from the subprime debacle may fall to knowledgeable investors but our savings and pensions will not escape entirely.

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