**GAAP IS CRAP: THE CASE OF JP MORGAN**

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Abraham Briloff complained that sometimes the accounting standard setters do a pathetic job by creating rules that enhance the ability of managers to manage earnings. At those times, he indicated that [GAAP becomes cleverly rigged accounting ploys](http://www.uic.edu/classes/actg/actg593/Readings/Investments/Life%20and%20career%20of%20Abe%20Briloff.pdf). The CRAP acronym is tart, but precise.

David Reilly has written an excellent example of this proposition in his Wall Street Journal article, “[Heard on the Street: J.P. Morgan, Hedges and ‘Asymmetric Accounting](http://online.wsj.com/article/SB10001424052702304065704577422422211831822.html).’” The issue pivots on the use of portfolio hedging and the “asymmetric accounting” that arises when the portfolio hedge is accounted for by mark-to-mark accounting, and at least some of the hedged items are treated as available for sale securities. This situation creates a mismatch in the accounting for these items, thereby potentially subjecting an entity to large gains or losses in the derivative, while gains or losses of the hedged items bypass the income statement, and going directly into stockholders’ equity.

David Henry also has a nice essay about this chain of events, entitled “[JPMorgan Chase Sells $25 Billion in Securities To Offset ‘London Whale’ Losses](http://www.huffingtonpost.com/2012/05/29/jpmorgan-chase-securities-london-whale_n_1552037.html?view=print&comm_ref=false).” He quotes former SEC Chief Accountant Lynn Turner who said JP Morgan made two stupid mistakes. They did not comprehend the risks they took with these complex derivatives and they covered half the losses with gains from high income assets that they no longer enjoy.

Jamie Dimon addressed these issues in a corporate conference call on May 10, 2012. From an edited transcript of this conference call by Thomson Reuters StreetEvents, we read these comments by Mr. Dimon:

“I want to update you on a few items that we have in our just filed 10-Q. Specifically, we've given prior guidance that Corporate -- that net income in the Corporate segment, remember it's not the corporation, it's just one of the segments, excl.-Private Equity and litigation, would be approximately plus or minus $200 million. This includes CIO's overall performance.

We would currently estimate this number to be minus $800 million after-tax. This change is due to two items, both in CIO this quarter. I'm about to give you pretax numbers now. **Slightly more than $2 billion trading loss under synthetic credit positions and $1 billion of securities gains, largely on the sale of credit exposures (emphasis added).** I want to remind you the CIO has over $300 billion in its investment portfolio and unrealized gains as of March 30 of $8 billion.

The CIO manages all the exposures in total as a whole and it does it in light of the firm's total requirements. We are also amending a disclosure in the first quarter press release about CIO's VAR, Value at Risk. We had shown average VAR at 67. It will now be 129. In the first quarter, we implemented a new VAR model, which we now deemed inadequate and we went back to the old one, which had been used for the prior several years, which we deemed to be more adequate. The numbers I just gave are effective March 30, the first quarter.

We don’t care for this at all, even though JP Morgan complied with GAAP. Our first problem is with the accounting used for portfolio hedges. Specifically, FASB No. 133 requires a company to record both the derivative and the hedged item at fair value. However, for some reason, the FASB does NOT require this “symmetric accounting” for portfolio hedging. The result? Changes in the value of the derivative hedge are run through the income statement, while fair value changes associated with the hedged asset potentially can bypass the income statement, going directly to balance sheet equity (i.e., via accumulated other comprehensive income or loss). Why is this the case?

A related matter leads to our second concern: the “special accounting” permitted for available-for-sale (AFS) securities, an accounting rule which appears to have played a role in the JP Morgan “loss” story. This accounting option essentially allows managers to decide when they want to record market value changes associated with marketable debt and equity securities. Essentially, managers can “cherry pick” the timing of market value gains and losses in their security portfolios. In JP Morgan’s case, the company had $8 billion of unrealized AFS gains at March 30, 2012, $1 billion of which they subsequently decided to record from actual security sales to partially offset the negative effects of the $2 billion trading loss. What is our objection? ***Such “cherry picking distorts the quality of earnings!***  Investors and creditors would be much better served if accounting standard-setters eliminated available-for-sale accounting, and put an end to at least one of the games managers play.

And as Jon Weil points out in [JPMorgan Makes Groupon’s Disclosures Look Good](http://www.bloomberg.com/news/print/2012-05-24/jpmorgan-makes-groupon-s-disclosures-look-good.html), the story is not just about GAAP compliance. It’s also about the transparency of all of the Company’s financial disclosures including those related to risk and controls.

Clearly, JP Morgan found a clever way to reduce the overall impact of the $2 billion loss from synthetic credit positions on equity by generating $1 billion of realized gains from its AFS securities. JP Morgan followed GAAP’s prescriptions throughout. Unfortunately for the investment community, in this case GAAP is CRAP.

*This essay reflects the opinion of the authors and not necessarily the opinions of The Pennsylvania State University, The American College, or Villanova University.*