



Fair Value Accounting and Measures of Corporate Profits in the U.S. National Accounts

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International Guidelines on National Accounts

- *System of National Accounts 2008 (SNA)*
 - Production account
 - Income accounts
 - Revaluation account

- Corporate Profits in the *SNA*
 - Component of operating surplus
 - Part of entrepreneurial income

- Holding Gains and Losses in the *SNA*
 - Reflect changes in prices but do not arise from production
 - Recorded in the revaluation account

Accounting Framework

- Accounting Identity
 - $V^* = W^* + \Pi^* + R^* + T^* - S^*$
 - Asterisks denote actual values

- Direct Measurement of Entrepreneurial Income
 - $(V + \varepsilon^V) = (W + \varepsilon^W) + (\Pi + \varepsilon^\Pi) + (R + \varepsilon^R) + (T + \varepsilon^T) - (S + \varepsilon^S)$
 - ε denotes measurement error
 - BEA methodology

- Indirect Measurement of Entrepreneurial Income
 - $\Pi = V - W - R - T + S + (\varepsilon^V - \varepsilon^W - \varepsilon^R - \varepsilon^T - \varepsilon^S)$
 - Net measurement error attributed to entrepreneurial income

U.S. Corporate Profits in the NIPAs

- Direct Measurement
 - Quarterly financial-based source data for quarterly estimates
 - Annual tax-based source data for annual estimates
 - Quarterly source data used to extrapolate and interpolate
 - BEA adjusts source data to remove holding gains and losses

- Quarterly Source Data
 - Census Bureau QFRs
 - SEC financial reports
 - FDIC call reports
 - ISO insurance data
 - Fair value accounting affects source data and introduces practical challenges

Practical Considerations

- Fair Value Accounting (FVA)
 - Certain assets and liabilities treated as sold at fair value
 - Generates holding gains and losses
 - Affects financial-based and tax-based source data

- U.S. Financial Accounting Rules for FVA
 - Apply to financial assets and liabilities
 - Characterization of gains and losses
 - Net income
 - Other comprehensive income
 - Trading securities
 - Under increasing scrutiny
 - Financial industries particularly affected in recent recession

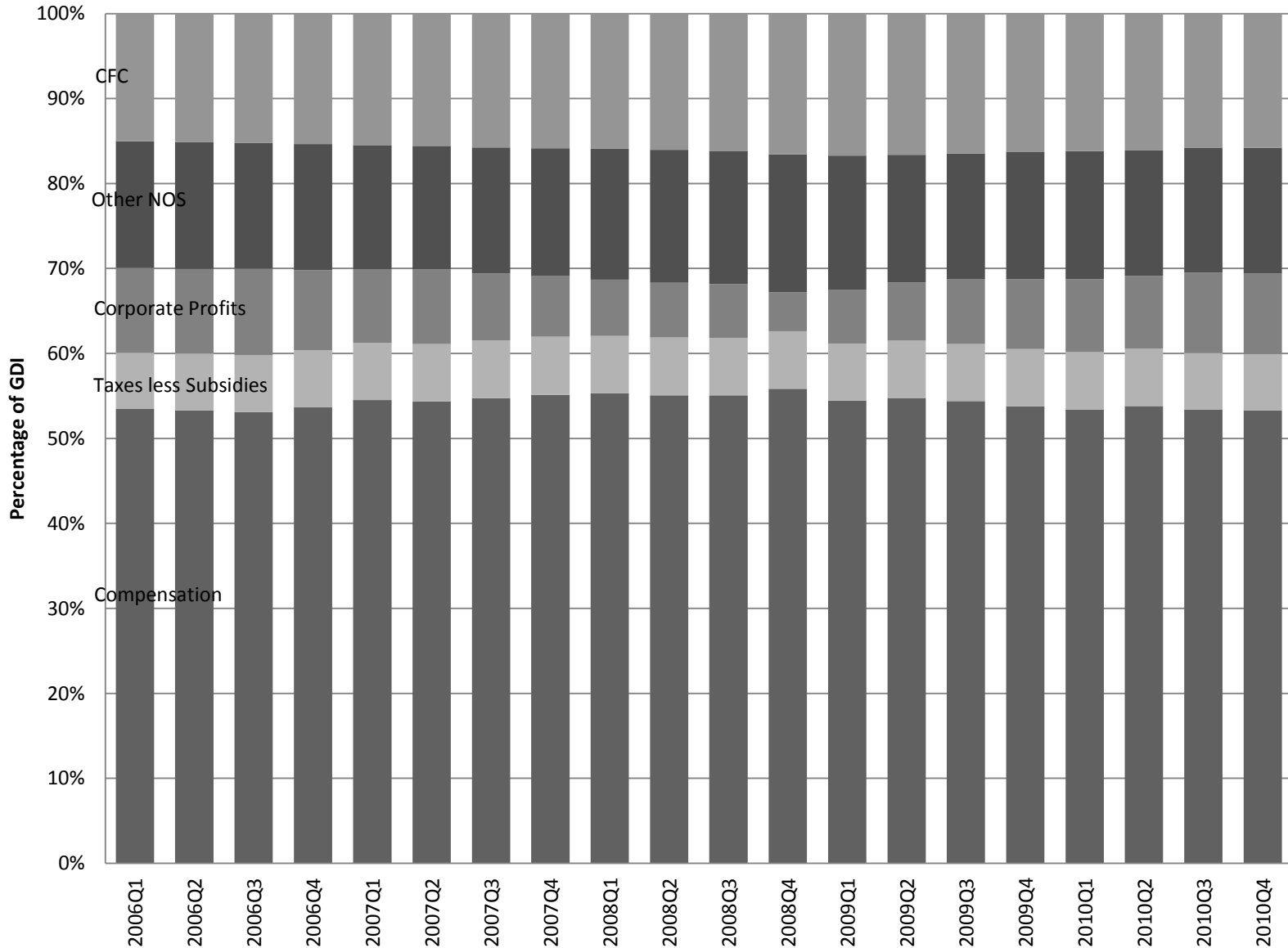
Quarterly U.S. Corporate Profits



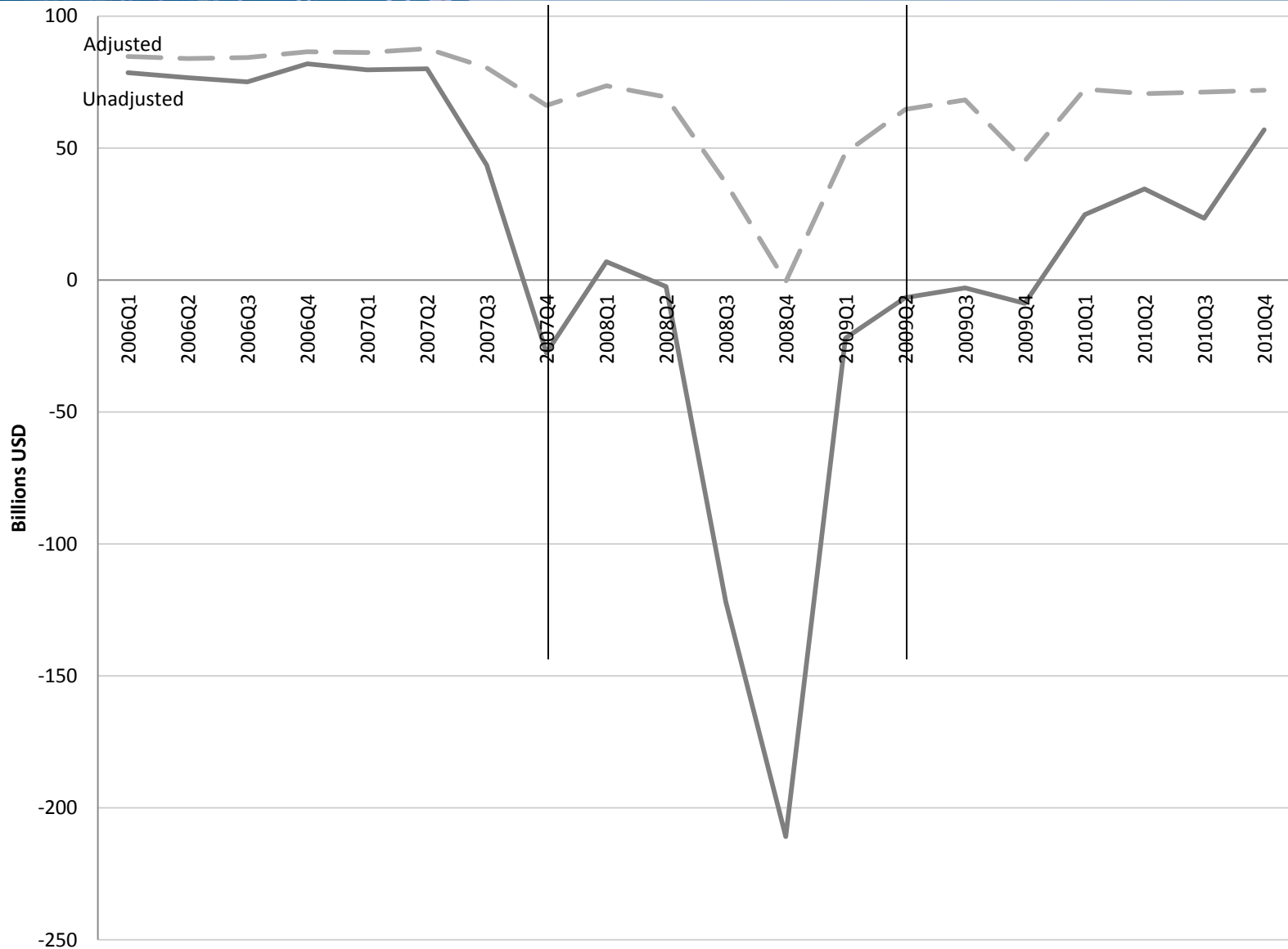
Quarterly U.S. Corporate Profits



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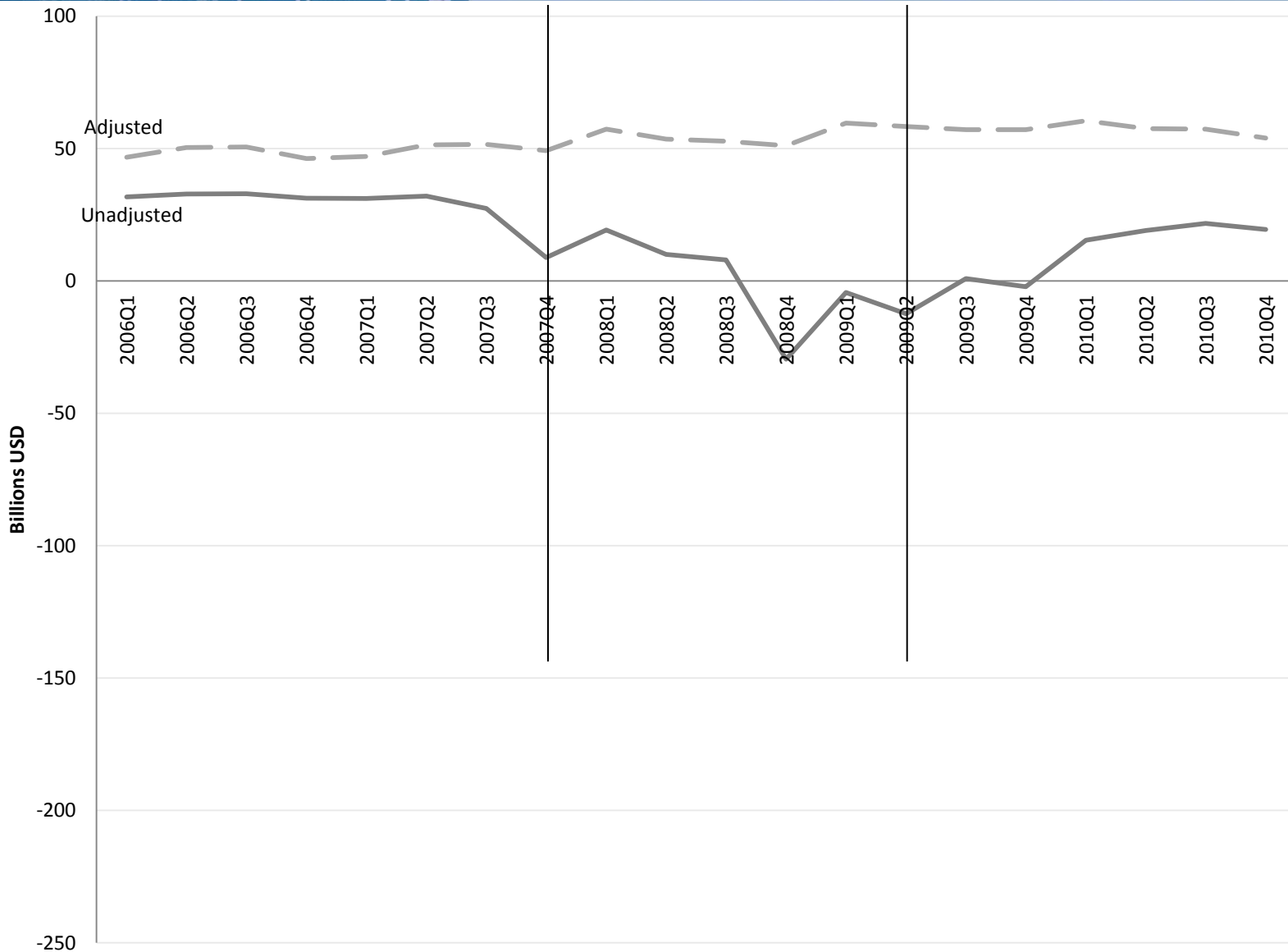
Quarterly Source Data: SEC Data for NAICS 52



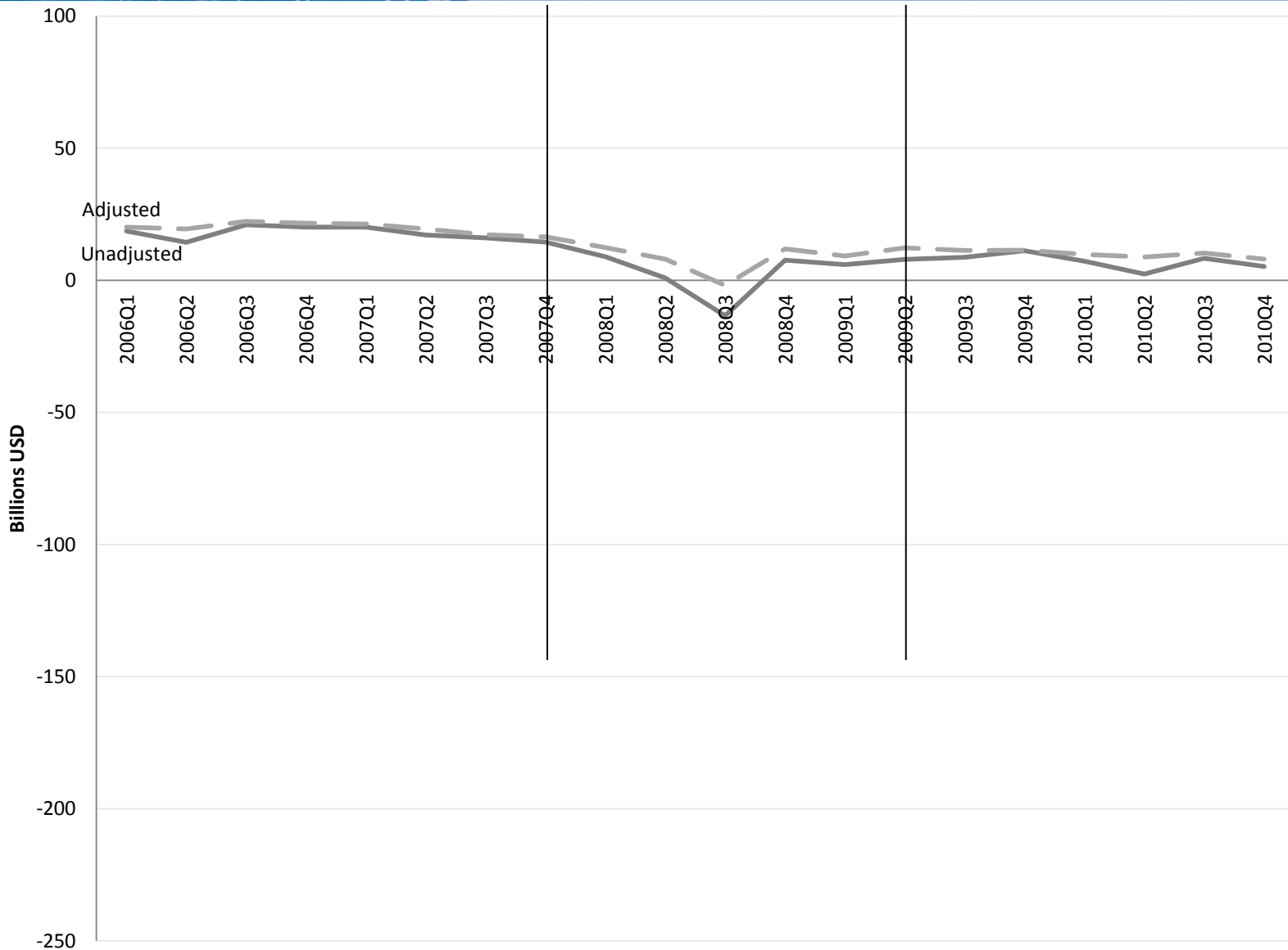
Quarterly Source Data: SEC Data for NAICS 52229, 523, 52411, 52599



Quarterly Source Data: FDIC Data for NAICS 5221



Quarterly Source Data: ISO Data for NAICS 524126



FV Gains and Losses in Lieu of Service Fees

Income Statements from SEC Data for NAICS 523

| Line | | 2006 | 2007 | 2008 | 2009 | 2010 |
|------|------------------------------------|----------------|-------------|-------------|-------------|-------------|
| | | (billions USD) | | | | |
| 1 | Revenues: | | | | | |
| 2 | Investment Banking | 15.0 | 19.5 | 13.0 | 15.4 | 15.2 |
| 3 | Trading and Investing | 47.8 | 21.9 | -27.9 | 43.8 | 48.2 |
| 4 | Service Fees and Commissions | 26.3 | 30.3 | 31.7 | 26.2 | 27.5 |
| 5 | Net Interest Income | 9.6 | 12.3 | 11.5 | 11.8 | 6.1 |
| 6 | Other | <u>0.5</u> | <u>1.2</u> | <u>6.1</u> | <u>0.8</u> | <u>1.2</u> |
| 7 | <i>Net Revenues</i> | 99.3 | 85.2 | 34.4 | 98.1 | 98.3 |
| 8 | Expenses: | | | | | |
| 9 | <i>Total Non-Interest Expenses</i> | <u>67.8</u> | <u>77.0</u> | <u>71.6</u> | <u>69.4</u> | <u>75.2</u> |
| 10 | <i>Income before Income Taxes</i> | 31.5 | 8.2 | -37.2 | 28.7 | 23.0 |

- Removal of FV gains and losses yields persistently negative profits
- Service fees may not adequately compensate risks assumed
- Calls into question *SNA* guidance on holding gains and losses

Results and Conclusions

- Published U.S. corporate profits experience a disproportionate decline relative to other GDI components.
- The magnitude of adjustments required to remove FV losses is significant for the recessionary period 2007Q4 to 2009Q2.
- The patterns of unadjusted series and adjusted series suggest published quarterly U.S. corporate profits may reflect FV losses.
- NAICS 523 firms appear to use FV gains in lieu of service fees.
- Current quarterly source data available to measure quarterly corporate profits are inadequate without significant adjustments.
- Quarterly source data based on surveys designed for statistical purposes would be a valuable alternative to current source data.