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# SEC Makes Mark-to-Market Accounting Markedly Better

*David C. John and James L. Gattuso*

Accounting rules rarely garner much public attention, and for good reason: The business of toting up numbers is both devilishly complex and profoundly uninteresting to most Americans.

This week, however, accounting was suddenly in the national spotlight as policymakers grappled with the ongoing financial crisis. At issue was a concept known as "mark-to-market." On Tuesday, the Securities and Exchange Commission (SEC), along with the Financial Accounting Standards Board (FASB)—the private regulatory body charged by the SEC with determining such arcane things—issued new guidance on how companies should apply mark-to-market rules to their balance sheets. It sounds like a small thing, especially when compared to a $700 billion rescue plan, but it is a significant step toward addressing the causes of the credit crisis.

**Mark-to-Market v. Historic Cost.** In the simplest terms, mark-to-market accounting (also known as "fair-value accounting") means that firms should value their assets based on their current market prices rather than at the price the firm originally paid for them. As a general principle, this is good policy—if a firm holds stock, for instance, it is natural that it be valued at the current trading price rather than the price the firm paid for the stock perhaps years previously. Both investors and regulators can make better decisions if they know the real value of a company as opposed to a valuation that hides gains or losses.

The problem with mark-to-market, however, comes when assets are not easily measured. Last November, the FASB issued new rules concerning how firms should value assets for which there is no actual or even comparable market price. The rule, known as FAS 157, made it harder for firms to avoid putting market prices on so-called Level 3 assets, the ones that are hardest to value.

**Problems in Today's Marketplace.** Unfortunately, FASB's timing could not have been worse. Growing problems with mortgage-related securities meant there were an increasing amount of often complex assets for which there simply was no trading value—especially recently. Further, many institutions have been forced to dump assets at fire sale prices. As a result, firms began to reflect the radically reduced value of these assets on their accounting statements even in cases where the company had planned from the beginning to hold the assets for some time. Not only did this misrepresent their real condition, but for regulated entities it triggered an immediate need to raise more capital. The effect was substantial: One source at the time estimated that reported asset values would be reduced by some $100 billion due to the accounting change.[1]

This paper, in its entirety, can be found at:
*www.heritage.org/Research/Economy/wm2095.cfm*

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214 Massachusetts Avenue, NE
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(202) 546-4400 • heritage.org

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Faced with this situation, many in Congress and elsewhere called for mark-to-market to be scrapped. The problem, however, was that, as flawed as the application of the rules has been, going back to historic cost would be no more accurate. Sure, firms' books would look better in these unsettled markets, but they would still not reflect reality. In addition, intervention by Congress, however well-intended, would inject politics into the accounting rulemaking process, further undercutting its integrity and reliability.[2]

Faced with this dilemma, the FASB, along with the SEC, found a solution. Rather than dump mark-to-market, it simply issued revised guidelines for interpreting last year's FAS 157 on how to apply that rule to troubled assets. Among other things, the new guidance makes clear that:

- Firms can use their own estimates as to the value of a security—based on expected cash flows or other factors—when an active market does not exist;
- Quotes from brokers or pricing services are not necessarily determinative as to value if an active market does not exist; and
- Distressed or forced liquidation sales are not necessarily determinative in measuring value.

The guidance also lays out the factors to be considered by a firm in determining whether an investment is only "temporarily impaired" and thus need not be revalued.

Throughout, the SEC and FASB make clear that the proper application of this rule is a matter of judgment, not just a matter of applying formulas. Along with clear and transparent disclosures, the ability to exercise discretion in determining value should help to ensure that financial reports provide—as they should—useful and meaningful information about a firm's financial condition.

These clarifications are good ones, and—without fanfare—go far to address the problems with mark-to-market. By itself, of course, the notification does not solve the financial markets' problems. But it is one among many steps that can be taken to address the current crisis. The SEC and FASB clarifications both address shortcomings in the application of the existing rule and will help to ensure that investors, regulators, and the public have a more accurate picture of a firm's financial position.

*—David C. John is Senior Research Fellow in Retirement Security and Financial Institutions and James L. Gattuso is Senior Research Fellow in Regulatory Policy in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.*

1. John Glover, "Banks Face $100 Billion of Writedowns on Level 3 Rule (Update 3)," Bloomberg.com, November 7, 2007, at *http://www.bloomberg.com/apps/news?pid=20601087&sid=ap42s_XrP58Q&refer=home* (October 2, 2008).
2. See David John, "Expensing Employee Stock Options," Heritage Foundation *Regulation in Brief* No. 15, June 30, 2004, at *http://www.heritage.org/emails/regulation_063004.htm.*


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