Commentary: Much Ado About Marking to Market

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On March 17, the Financial Accounting Standards Board (FASB) issued proposed staff position (FSP) Financial Accounting Standard (FAS) 157-e, entitled "Determining Whether a Market is Not Active and a Transaction is Not Distressed." Proposed FAS 157-e is intended to explain FASB Statement No. 157, sometimes erroneously described as the "mark to market" rule. Its true title is "Fair Value Measurements."

On this news, the market soared like a hawk. Darwin's theory of natural selection has placed this animal on the endangered species list.

FASB Statement No. 157 does not require "mark to market" accounting, and proposed FAS 157-e would not repeal it.

At most, FASB Statement No. 157 expresses a preference for market prices. So, if there is an active market in a security, issuers preparing financial statements for public disclosure are required to use market prices to determine its value. If there is no active market in the security being valued, but active markets in similar securities, then the quoted prices in these similar securities provide indications of value that the issuer must consider. Otherwise, the issuer can use "unobservable inputs," such as formulas, algorithms or other non-market pricing methodologies.

FASB Statement No.157 further states that the use of quoted prices to determine value assumes the existence of a market where prices are set in "orderly transactions." An orderly transaction is not a "forced transaction," as would be expected in liquidation or distress sales, but allows for marketing activities that are usual and customary for transactions involving such assets or liabilities. If the quoted prices thrown off by a market represent forced or distressed sales, they are ignored under FASB Statement No. 157, and the issuer can use unobservable inputs to determine fair value.

FAS 157-e changes none of this. It only attempts to "clarify" when a market is not active and a transaction is not distressed.

FAS 157-e provides seven factors that may indicate when a market is inactive. Traders who deal in OTC equities will recognize many of these factors as indicators of the existence of a "ready market" for net capital calculations under Exchange Act

Rule 15c3-1. For example, a market may be inactive under FAS 157-e if there are few recent transactions, abnormal spreads or little public information is available about the security.

Perhaps the only controversial factor is the existence of "abnormal liquidity risk premiums or implied yields for quoted prices when compared with reasonable estimates" of credit risk. This implies that an issuer can conclude that a market for a debt security is inactive if the expected discounted yield is sufficiently greater than current market prices.

Issuers would very much like to assume that the indebtedness represented by a security would all be timely repaid. In that case, the discounted yield only reflects current interest rates. However, "reasonable" estimates of the risk of default depend very much on what you believe the future holds. Since people disagree about the likelihood of future events, what may be a reasonable estimate to one person may strike others as wildly optimistic or depressingly pessimistic.

Securities markets set prices by enabling people to express their views about the future through bids and offers – that is the function of a market. Even if we are all prepared to agree that the market gets it wrong from time to time, or all the time, it is difficult to justify using some other metric of value. The market at least represents an independent consensus view, rather than one person's opinion, particularly a corporate financial officer's opinion whose views may be affected by the fact that a low estimate of value will cause her to be fired and replaced with someone more optimistic. Like democracy, the market is the worst method for valuing things, except for all the others.

It is not, however, quite that simple. Even if the issuer reaches the conclusion that one or more of the factors listed in FAS 157-e exist, the issuer must still mark the security to market, or use market prices as a guide, unless the quoted price is associated with a distressed transaction. A transaction is not distressed if the issuer has evidence that the quoted price was determined by "usual and customary marketing activities" and there were multiple bidders for the security. OTC traders will instantly recognize this as variation of the "three-quote rule," which requires traders in OTC equities that do not have two quotes in the Pink Sheets or the OTCBB to call three unaffiliated broker-dealers to obtain quotes that establish a price for best execution. If quotes are available from multiple bidders and no one is being forced to take the first bid they get, presumably existing quotes are not distressed and the issuer must use them to determine the security's value.

So, the market's response to FAS 157-e is puzzling. Issuers will still have to mark to market in their financial reports, where there is an active market. Perhaps in a few isolated cases, an issuer can conclude that market prices can be ignored. But, the effect on financial statements should be trivial, a point confirmed recently by public statements from several issuers. Moreover, if FAS 157-e truly represented a departure from mark to market accounting, the increased uncertainty would surely reduce market prices.

Perhaps some market participants erroneously believed that a loosening of mark to market rules would enable banks and other financial institutions to pass net capital tests. This is not true because net capital rules have their own methods of determining value, which are generally heavily reliant on market prices. If there is no active market for a security, for example, broker-dealers are required to mark it to zero for net capital purposes. In contrast, FASB Statement No. 157 would allow the issuer to assign a value greater than zero based on unobservable inputs.

Personally, I like the theory that the market reacted favorably to the news that mark to market accounting had been preserved. That would suggest the market is more rational than many members of Congress.

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