

# FASB Mark-to-Market Rules Not a Cure-All

Joseph Scanlan, CFA  
Investment Analyst

The Financial Accounting Standards Board (FASB) on April 2 relaxed mark-to-market rules, the system of recording security prices that many investors say does not work well when markets lack liquidity. Such illiquidity has marked the fixed income markets for nearly two years. The changes allow companies to use “significant judgment” in gauging prices of some investments on their books, including mortgage-backed securities.

The Standard & Poor's 500 Index jumped 2.9 percent on April 2, thanks in large part to the FASB's announcement. But we believe the market's reaction was a bit overdone. The impact, while positive for smoothing out company earnings, does not strike us as significant over the long-term.

## Why the change?

Mark-to-market accounting sets the value of assets on a company's balance sheet to reflect their market prices. When securities are trading regularly, it is easy to determine their fair value. But when securities are not trading or are affected by forced selling, as has been the case with many mortgage securities over the past two years, it is difficult to determine fair value. Many investors and companies have fixed income securities in their portfolios that continue to pay interest (and in some cases, they have no plans to sell), yet their value has dropped significantly, due in part to the accounting rules. (The economic recession and fallout from subprime lending also played important roles.) Financial institutions, in particular, along with many investment portfolios, have been hurt by losses that are likely overstated due to these rules.

In a broad sense, new “fair value” rules say that an organization should not rely on quoted prices if the sales are considered distressed. Instead, an organization could determine the fair value of a

security using a model that reflects an orderly transaction between market participants on the measurement date, and auditors can now use “significant professional judgment” when valuing illiquid securities. As a result, many mortgage securities, in particular, could see their stated value rise.

In addition, the FASB modified its rules covering “other-than-temporary impairments” to give institutions greater discretion to determine whether losses in a security's value are related more to the market environment or the fundamentals of the security itself. Clearly, a company's balance sheet will look better if it can claim the securities held remain fundamentally sound and that it's the market environment that has reduced its current market value. However, two different institutions holding the same security may analyze those factors differently, blurring its actual value.

## Market impact

The new rules immediately benefitted the stock prices of financial institutions, which have sizeable mortgage-related assets in their portfolios. Despite the initial market jubilation, we do not expect this to have a significant impact over the long term. Regardless of how accountants price bonds, the market will continue to determine the true value.

Ultimately, a bond's fundamental value—based in large part on the issuer's health and economic factors—will continue to have the largest impact on the price. For example, unemployment is rising and home prices remain in decline. Should this continue, any benefits that mortgage securities receive from the new accounting rules could be more than offset by growing defaults and foreclosures.