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Corporate Finance Insights

Mark-to-Market Controversy

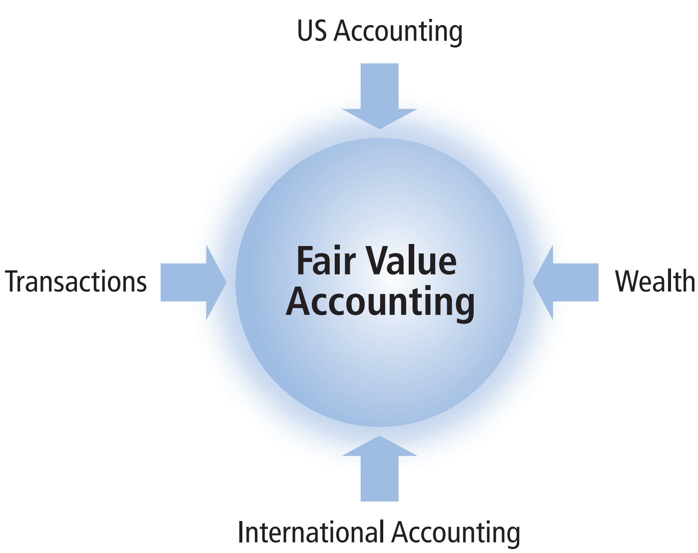
There has been a great deal of controversy over the past year about mark-to-market accounting and the role it has played in the current financial crisis. But it is not just a hotly discussed topic among policy-makers and news reporters. It has also triggered a debate among accountants across the country.

Mark-to-market accounting is actually related to a broader concept known as fair value accounting, which is a rather recent change in the accounting rules in America. A number of reasons are cited for the change to the new fair value accounting rules. The most frequently mentioned is that it makes corporate financial statements more "transparent" so problems in accounts can be seen earlier. Another, and no less important, reason is that fair value accounting has been adopted to help change-over US accounting rules to more closely match international accounting rules (Fair value accounting has been used much more broadly under international rules than it was under US rules).

Changing the rules hasn't been a walk in the park. The new fair value rules, the most prominent being SFAS 157, have created quite a stir. Many politicians and commentators on the Sunday news programs have regularly referred to "mark-to-market" accounting rules as having had a large impact in the current credit crisis. Although there isn't any clear indication how much impact accounting rules have had on the health of our capital markets, there are valid reasons why there is dissent about the new rules.

History

While it is not discussed much, there are two over-riding trends affecting accountants in America today. Both these trends intersect at the point of fair value accounting as shown in the graphic to the left.



An intersection of trends isn't necessarily a bad thing, unless there are deeply-rooted disagreements underlying them. In both cases there are severe disagreements which go back many years.

First let's take the opposing concepts titled "transactions" and "wealth." When modern accounting was being developed early in the 20th century the focus was on recording transactions accurately, and attempting

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to report earnings as precisely as possible. But starting in the early 1970's accounting rules began to shift to focus on the wealth of a firm. Under this new focus the balance sheet became much more important, and measuring earnings precisely became more difficult.

This all sounds fairly obscure, but in the accounting world it was a meaningful shift. There are many accountants that still have trouble with it even to this day. The difficulty we have today is that fair value accounting has often been described as the final and ultimate step in making the wealth of a firm the primary focus of accounting and not earnings. The new fair value accounting rules have reopened and widened these divisions among accountants.

Jump forward to the year 2002 for the second trend labeled in the graphic as "US Accounting" and "International Accounting". That is when the US accounting rule-maker (the FASB) and its international counterpart (the IASB), formally agreed to "converge" their accounting standards. At that time both standard-setters agreed to make their rules more like each others' with the goal of making them substantially the same. Once the rules were "converged" the United States would adopt international accounting rules. For all practical purposes what happened is that US standards were changed to be more like international standards, with important changes revolving around the idea of fair value accounting.

It's All in a Name

Accounting is just accounting, isn't it? Why should it matter which rules we use, as long as the rules are good rules? Many accountants, however, have an honest disagreement about whether we should be using fair value accounting in its current form, and whether we should be adopting international standards.

The name we give accounting rules could provide some insight into their concerns. In the United States accountants call their rules Generally Accepted Accounting Principles ("GAAP"). The words "generally accepted" are important because they reflect that there is already broad agreement about the underlying theory before a new accounting rule is adopted. General acceptance comes from a bottoms-up approach to standard-writing to ensure broad-based support for any rule.

That did not happen with fair value accounting or with the switch to international rules. Many elements of fair value accounting (as it is written today) do not rise to the level of general acceptance. In fact certain elements are highly questionable in the opinion of some accountants. Instead there has been a top-down approach which has been accompanied by something like a political campaign to convince U.S. accountants that this is all a good thing. There is no doubt that the accounting standard-setters are operating in good faith. However their actions have resulted in unintended consequences, the most damaging being that the new rules have created even more fundamental questions than they have answered.

America's accounting profession is the strongest and most technically proficient in the world. The fact that there is a robust debate about accounting standards should be expected. But the fact that a debate persists, long after rules are issued, can only mean that something is amiss in the standard-setting process. It is unclear at this point whether the controversy will subside anytime soon.

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