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Securities and Exchange Commission
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Dear Securities and Exchange Commission:

Here are my comments on the issue of mark-to-market accounting. In short, a hybrid model that incorporates market, model, and historic pricing information dominates using any one method. The real problem, however, is not in the accounting standards but in their application. In the post Sarbanes-Oxley environment, some accountants are excessively conservative in their application of mark-to-market accounting. The U.S. needs to deal appropriately with the auditor liability issue by providing a safe harbor for managerial judgment in asset valuation. Firms should be able to report asset values using either market, historical, or model-based methods according to their judgment, as long as the asset values using other methods are also clearly displayed in a footnote.

Many complain that mark-to-market accounting is exacerbating the current crisis by forcing companies to mark down the values of their assets based on current market conditions. Such markdowns may make the current downturn worse (that is, they are pro-cyclical) because they makes some firms appear to be in more difficulty than they really are.

Markets don't always work perfectly.

Mark-to-market accounting operates on the basic notion that the observed "market" price of a security in a liquid market fairly reflects its value. This notion is quite plausible in normal times. After all, participants in financial markets have a strong financial incentive to buy when they perceive prices are low, and to sell or short when prices are too high. Thus, market prices should reflect all of the information that is available to investors. Of course, this assumes that the market mechanism is functioning smoothly and that information flows freely among investors.

It is by now well documented that markets sometimes deviate from our ideals of perfection. Markets experience both bubbles – periods of irrational exuberance – as well as potholes – periods of extreme despair. There are also limits to arbitrage created by the finite amount of capital and expertise available at any given moment in time to trade upon mispriced assets.

We have recently witnessed an informational collapse in our capital markets. Previously the markets (and regulators) relied upon the credit rating agencies to assess the credit of numerous fixed income instruments, including the now infamous structured products. If a product was rated AAA, then many investors felt comfortable investing in those securities with only minor investigation. This is no longer the case. The ratings have lost credibility. Many investors who in the past would have purchased structured securities based mainly on ratings now hesitate to do so because they do not have the analytical capacity to evaluate them.

This situation has been exacerbated by the problems with the bond insurers. Prior to the debacle, many investors relied upon bond insurance. Since the bonds were rated AAA as a result of the insurance, investors could purchase them with confidence without having to make expensive investments in information gathering. The fall from grace of the bond insurers has also left a huge information vacuum. Once again, investors who lack the analytical capacity to look past the ratings are no longer willing to invest, leading to a freeze in our capital markets.

This collapse in the informational infrastructure in our markets has caused our credit markets to freeze up. Investors who lack information about the credit quality of various complex instruments rationally stay away from those instruments. We now experience such anomalies as high grade municipal debt with much higher yields than Treasuries. (Normally, we witness the opposite because of the tax treatment of municipal securities.) We are thus in a situation where are markets are, to say the least, not doing their normal job of fairly valuing assets.

Even when a market is liquid, the market price may not be a good indicator of value if the market is in a bubble or a pothole. That market prices are inexact indicators of value was recognized by Fisher Black in his famous "Noise" article in which he defined an efficient market "as one in which price is within a factor of 2 of value."[1]

<u>A better approach to valuation is to use ALL available information: market, model, and history.</u>

[1] Black, Fisher, 1986, Noise, *Journal of Finance 41(3),p 529-543.*

We face a valuation problem. Historic (or transaction-based) methods may not reflect the current value of an asset as the world has changed. Model-based estimates are prone to error and manipulation. And market prices are sometimes out to lunch. Even if there is a liquid market in a distressed asset, the decision of a firm to own that asset is evidence that the firm believes the asset is worth at least as much as and probably more than its market price. Otherwise it would sell it.

What would a good statistician do?

When faced with three noisy estimates of a value, a statistician would use all three estimates, weighting each according to its precision. In this way we make use of all the information available to us in order to come up with the most precise estimate. Common sense would dictate that we do the same thing in the current situation. Firms should be permitted to use combinations of historic cost, model value, and market prices. The weights used, and the impact of alternative weightings, should be disclosed in footnotes, along with the results of using other methods.

<u>"Regulatory Accounting" could repeat the mistakes of the S&L Crisis.</u>

One of the pro-cyclical problems with mark-to-market accounting is that it may make some firms appear insolvent by using fire sale prices to value assets. Such an accounting treatment could cause additional distress by making it appear that the firms are in more trouble than they really are. It is natural at such times to suggest that firms be allowed to temporarily ignore the losses for accounting purposes. This gives them some time to earn their way out of the hole. However, such "regulatory accounting" was tried during the S&L crisis, and it only made matters worse. Allowing underwater institutions to continue in business gave them the perverse incentive to take on excessive risk to see if they could gamble their way out of the hole. Alas, such excessive risk taking caused the ultimate cost to the taxpayer to expand enormously. Any modification of the implementation of FAS 157 should not go so far as to keep dangerously insolvent zombies in business.

<u>The problem is not necessarily in the standards, it is in their application in a post SarbOx world.</u>

FAS157 is, for the most part, a well thought out standard. The problem is not really in the standard, but in the implementation of that standard in the field. In the aftermath of Arthur Andersen, auditors have become extremely risk averse. I have heard many anecdotal stories of auditors' forcing firms to mark assets down to unrealistically low levels – even zero – when it was clear that there would be some cash flows coming from an asset.

All accounting requires considerable judgment, both in the creation of accounting standards and in their implementation. Alas, the U.S. legal and regulatory system imposes such excessive risk on the auditors that they have become overly cautious in their implementation, with negative consequences to the economy.

Firms need a safe harbor for applying judgment in asset valuation.

There needs to be a proper balance such that good faith judgment is not excessively ex-post penalized. The SEC should explicitly use its powers to create safe harbors for firms and their auditors to use common sense judgment in valuing assets on their balance sheets. One possibility would be to explicitly permit firms to use any method for valuing difficult assets, as long as the method is clearly displayed in a footnote along with the results using other methods. Of course, the asset values in the note under each method should be tagged with XBRL tags. Then the markets can make up their own minds as to the correct valuation method.

Respectfully submitted,

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