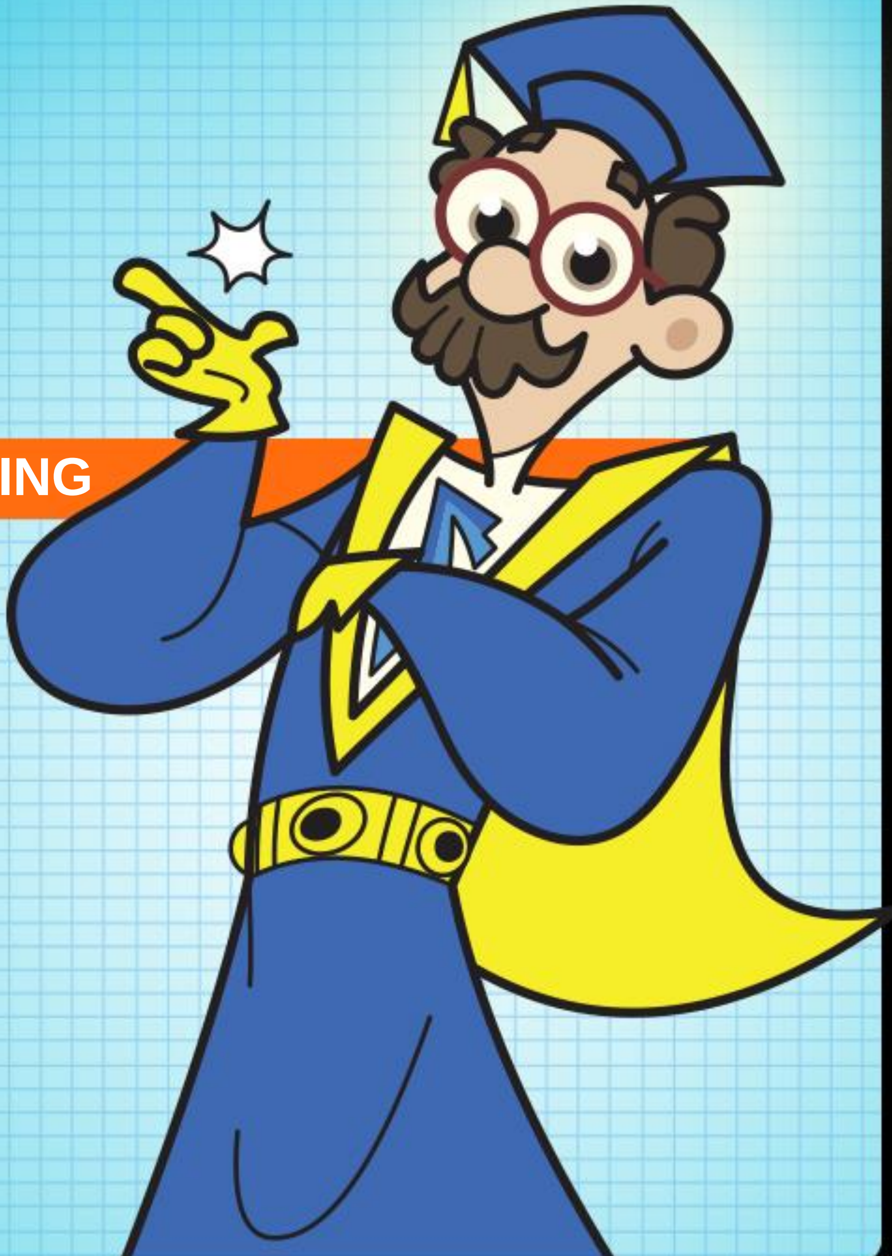
MARK-TO-MARKET ACCOUNTING



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Mark-to-market Accounting

– By Prof. *Simply* Simple™

MARK-TO-MARKET ACCOUNTING

- Accounting rules are the favourite whipping boys of the financial market during bad times.
- These days too, it is the presence of what is called ‘the mark-to-market accounting rule’ that is being touted as one of the culprits behind much of the write-downs seen in the financial market.
- However, before forming any opinion let’s try to understand how the mark-to-market accounting rule works.

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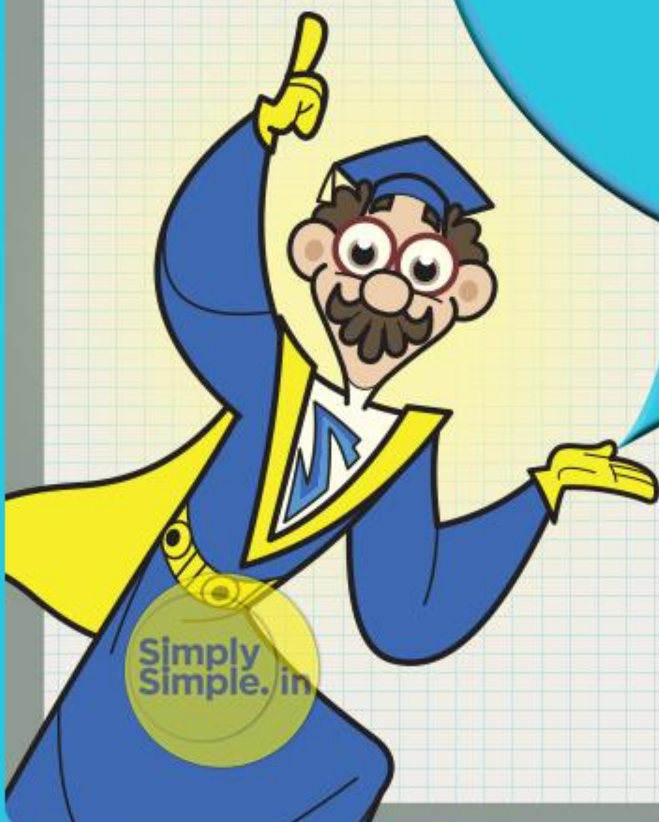
So what is a mark-to-market accounting rule?



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- **Mark-to-market is a very simple and straightforward accounting rule that prescribes a method for finding out the fair value for all kinds of financial assets.**
- **The list of financial assets, as you know, is fairly long - all your stocks, bonds, options, swaps etc can be called financial assets.**
- **How, you may wonder, does the mark-to-market accounting rule apply to so many different kinds of financial assets?**

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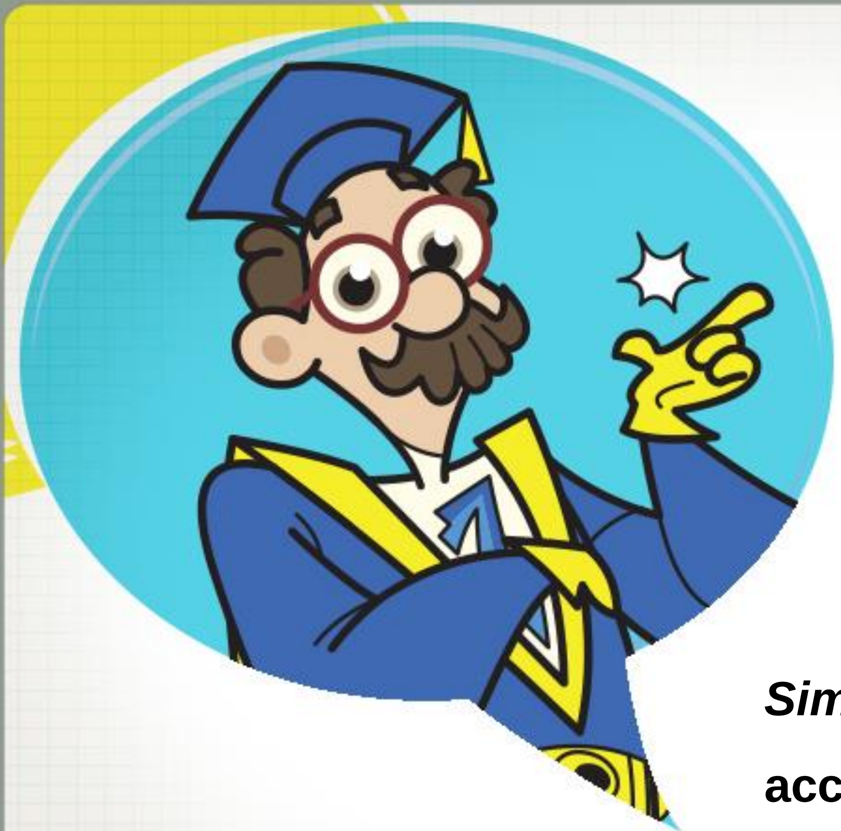

Simply put… the mark to-market accounting rule relies on the use of the current market price of your financial assets to arrive at their fair value.

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So…

- **So if you are holding a stock that is currently trading at Rs100, then as per the mark-to-market accounting rule, the fair value of your stock is Rs100.**
- **You may have actually acquired the stock by paying Rs200 and expect that one day the same stock would trade at a much higher price.**
- **But in the realm of the mark-to-market accounting rule, future expectations do not play a role.**

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Therefore…

- **The worth of your asset is always determined by the price at which you can currently sell it in the market.**

- **There is no need to look at any other statistic like future earnings, growth potential or any other fact or fiction surrounding your financial asset.**

- **Even a blindfolded man can know the fair value of any financial asset by just using the current market price as the yardstick.**

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However…

- **Many skeptics believe that while this may sound good in theory, in reality the free play of market forces may not always reflect the correct price of a financial asset.**

- **Sometimes the scale of the market may excessively tip to one side or the other, moving prices away from where they should be.**

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For instance…

- **Distress sales hardly give any chance of selling your asset at the right price.**
- **In the worst case, as the experience of the subprime crisis showed, the financial market itself may freeze completely, leaving you with assets for which there are absolutely no takers.**
- **In such situations, the mark-to-market accounting rule may become a messenger of death even when your financial assets are generating some income.**

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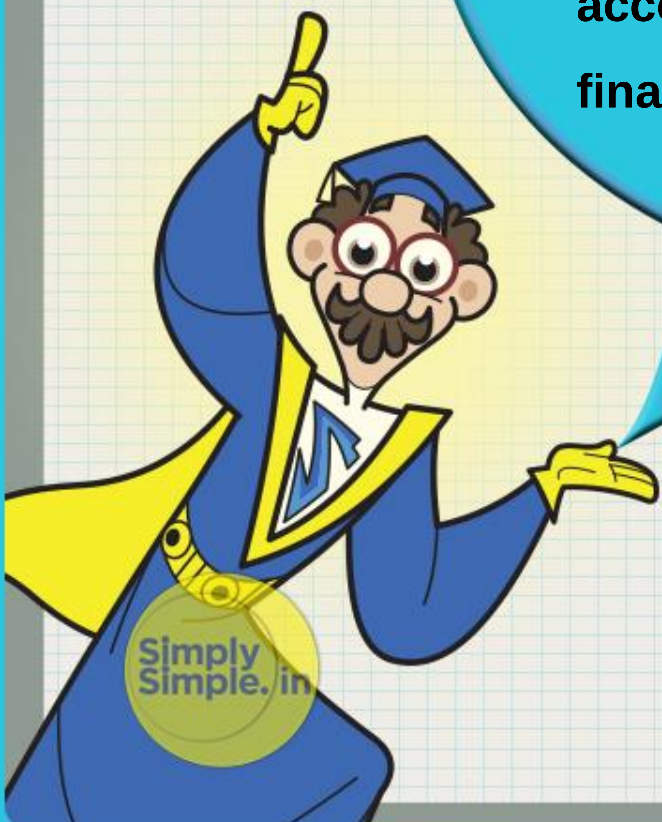
Then what conclusion can we draw? Should we completely discard the mark-to-market accounting rule when the financial market is in distress?



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Well…

- **We can’t accept the mark-to-market accounting rule as the last word on valuation of financial assets.**
- **Neither can we completely dump the mark-to-market accounting rule. We definitely need to strike a balance.**
- **The main attraction of the mark-to-market accounting rule lies in its simplicity and objectivity.**
- **The mark-to-market accounting rule compels us to look at the real picture.**

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To Sum Up

- Mark-to-market is a very simple and straightforward accounting rule that relies on the use of the current market price of your financial assets to arrive at their fair value.
- Many skeptics believe that the mark-to-market rule does not reflect the effect of market forces on the correct price.
- But, barring extreme situations, the mark-to-market accounting rule still has the potential to become the best friend of our financial market.

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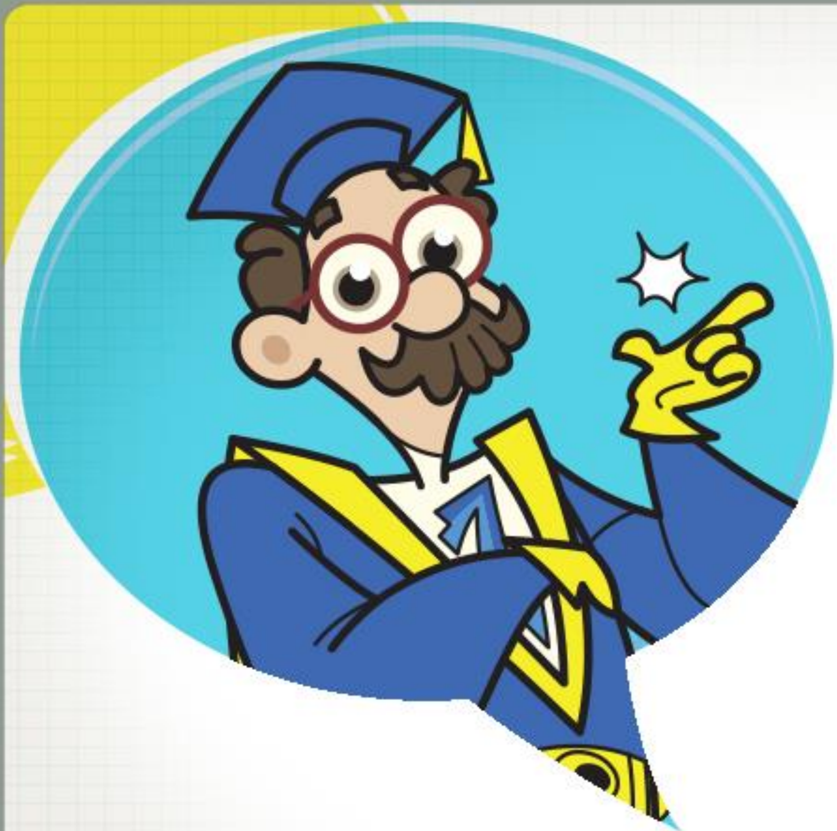

Hope you have now understood the concept of Mark-to-Market Accounting

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