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To Members of Congress:

Like nearly all financial crises, the roots of the current seizure in the credit markets lie squarely in economic behaviors, not in the accounting that reflects those choices. That's why we're troubled by recent suggestions to suspend all mark-to-market accounting.

When the late Supreme Court Justice Louis Brandeis wrote that "Sunlight is said to be the best of disinfectants," he was referring to the need for more transparency in important national matters. Mark-to-market accounting achieves precisely that transparency.

An accurate, unbiased market value of assets has stood as the informational cornerstone for regulators of financial institutions for decades. In fact, mark-to-market accounting is exactly how these institutions choose to run their businesses, and report and share financial information with counterparties, investors, employees, and various other stakeholders.

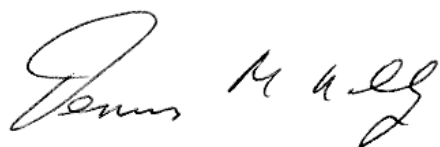
Undermining mark-to-market accounting would roll back decades of advances in transparency around accounting and reporting. In response to major economic crises, history has highlighted the need for more transparency -- not less. For instance, during the depths of the Great Depression, the concept of independently audited financial statements became a reality, giving investors more information. The savings and loan crisis in the mid-1980s further underscored the critical need for greater transparency. So the question must be asked: By what logic should we -- at the very apex of our latest crisis -- make an abrupt U-Turn and become enablers for *less* transparency?

We have seen what can happen when institutions are allowed to mask huge losses in asset values. Besides the challenges we now face, we can look beyond our borders for an iconic example. The nearly decade-long Japanese economic malaise that began in the 1990s as a result of Japan's own credit crisis can be attributed in part to a Japanese banking sector that failed to reflect the real value of its assets. Not only did the lack of transparency contribute to Japan's stagnant economic performance, it undermined the credibility of the banking sector

years after the crisis took place. Whatever its flaws, mark-to-market accounting should help prevent prolonging the current economic crisis.

The current environment is painful for all participants in the capital markets -- in the US and increasingly around the world. But suspending all mark-to-market accounting won't make that pain go away. It will only obfuscate the current economic picture for investors and regulators - and might even plant the seeds for the next crisis.

Very truly yours,



Dennis M. Nally
Chairman and Senior Partner

10 Minutes on Fair Value in Financial Reporting*

What you need to know about emerging topics essential to your business. Brought to you by PricewaterhouseCoopers.

August/September 2008

Marking to market: How far is far enough?

Highlights

- The credit crisis has highlighted the benefits of reporting fair value for financial instruments—and exposed limitations.
- Reporting fair value, although imperfect, remains the best available method for most financial instruments.
- The challenges of developing and reporting fair value become even more prominent when applied to many nonfinancial assets and liabilities.
- The desire to expand the use of fair value needs to be tempered until the method's limitations are fully understood.

Although recent market events have cast doubt on marking values to market, fair value has its place in financial reporting. It's widely acknowledged that, despite its challenges, reporting fair value for most financial instruments, particularly assets, provides investors with meaningful information to assess a company's future cash flows and management's performance. But projecting the challenges of fair value reporting onto the majority of both (1) nonfinancial assets and (2) liabilities calls into question whether the capital markets are ready for more fair value. It's time to pause, reflect on lessons learned from the credit crisis, and evaluate whether it makes sense to expand fair value beyond where it is used today.

Critical actions for today and tomorrow

1. Standard setters should refrain from expanding the use of fair value beyond where it stands today. Standard setters, management and other capital markets participants need time for reflection, analysis, and debate.
2. Standard setters need to establish a game plan for determining when to use fair value. It must demonstrate the relationships and trade-offs between relevance to investors, reliability of the information, and a company's ability to implement.
3. Financial statements should be modified to clearly distinguish between the impact of changes in fair value on earnings and the results of key business operations.
4. Management can overcome some of the limitations of fair value by explaining the context and consequences of reporting fair value.

At a glance

Financial instruments

Fair value for most financial instruments, while it has limitations, is the best available method to reflect market conditions when accompanied by appropriate disclosure.

Financial instruments currently reported using fair value include:

- most equity and debt securities held as assets
- derivatives

Most assets and liabilities

While fair value information is generally relevant to investors, it is not always sufficiently reliable or practical to implement.

These three criteria—relevance, reliability, and practicality—need to be more fully understood prior to any proposed extension of fair value to assets and liabilities where it is not used today.

Examples:

Assets

- trade receivables
- inventories used in production
- plant and equipment

Liabilities

- trade payables
- contingent liabilities
- company-issued debt
- insurance and other non-traded liabilities

We use *fair value* to mean a value derived from a market with willing buyers and sellers (or an estimate thereof).

Fair value, while imperfect, is the best available method to reflect market conditions

Reporting what most financial instruments can be exchanged for in the market—their fair value—provides valuable insight to investors. Markets, and not the business operations of a company, determine the economic value of financial instruments like bonds or common stock. For the most part, such instruments (or derivatives of them) obtain their value from contractual or residual cash flows. The expected cash flows are reflected in their market prices. Even when market prices are difficult to determine, preparers rely on these cash flows to develop estimates of fair value.

The challenges of using fair value

While fair value yields a relevant measure for financial instruments, it presents a number of challenges. Changes in fair value introduce earnings volatility, which makes it more difficult to forecast earnings.

There is a second challenge: Fair value has been criticized for producing inaccurate results in the unusual market conditions recently experienced. Such results, it is argued, hurt the company in the long run. Critics claim that recording losses in such an environment signals bad news to investors that may ultimately prove misleading.

Turmoil in the credit markets has spotlighted a third challenge: When market information is in short supply, companies are required to employ models. But at what point should companies turn from market prices to models? There is no clear-cut answer, and companies often rely on judgment to make that call. The difficulty does not end there. Once the decision to use models has been made, management—and investors interested in understanding management's judgment—must grapple with a host of other complexities inherent in modeling.

As of today, fair value remains the best available method

Some argue that fair value for financial instruments should be suspended or replaced when markets are severely distressed. But fair value increases the transparency of the impact of market forces on financial performance, which investors prefer. If fair value were replaced with some other method, investors would be left to their own devices to estimate the future cash flows of financial instruments, and their estimates would likely be less reliable. At least for now, fair value remains the best available measure for most financial instruments. Its limitations can be mitigated by appropriate explanations from management.

Where fair value is an awkward fit

The credit crisis has highlighted the challenges of reporting fair value for financial instruments. For nonfinancial assets and liabilities, those challenges become even more prominent.

Fair value is questionable for most nonfinancial assets...

The economic value of most nonfinancial assets is determined through their use in business operations, and not by markets. A manufacturing plant, for example, typically generates operational cash flows when used in conjunction with a business's other assets and liabilities.

Although it is possible to determine fair value for these nonfinancial assets, doing so may be impractical for two primary reasons: (1) markets for these assets may be limited or may not exist, and (2) the value of these assets is often generated from their use as part of a larger group, not on a stand-alone basis.

...and for most liabilities

Where most of a company's liabilities are concerned, investors are interested in the resources required to meet those obligations.

Consider, for example, debt issued by a company. In many cases, the resources required to settle that debt provide the most meaningful information about a company's future cash outlay and solvency, a key objective of financial reporting.

New fair value requirements will soon be effective for one type of liability: contingencies in mergers and acquisitions. This is an example where the relevance, reliability, and practicality of developing and reporting fair value is questionable. Contingencies tend to be company-specific and to have limited or nonexistent markets. As a consequence, estimates of their fair value could be unreliable.

Niche issues exist

From time to time, situations arise in which it is both meaningful and practical to provide investors with fair value information about nonfinancial assets and liabilities. Those situations tend to be company- or industry-specific and should be handled on a case-by-case basis. Examples include trading inventories (oil, agricultural commodities) and real estate.

Bigger than the average financial reporting issue

Severe and progressive declines in market values have converted fair value from a technical issue into a public debate.

Impact on the banking system

The credit crisis has had a heavy impact on the banking system. As markets took a turn for the worse, banks were required to mark asset holdings down to their fair value. For some banks, this has meant significant reductions in available capital. To maintain compliance with existing capital regulations, these banks have recapitalized, sold assets in distressed markets, and restricted lending—thereby extending market turmoil into the broader economy.

Concerns about the capital adequacy of banks have called into question whether regulations need to be fine-tuned or overhauled. They have also prompted calls for standard setters to retract or modify the use of fair value in the banking industry. In our view, these are separate issues that should be addressed separately; deficiencies in capital adequacy regulations should not be resolved by changing financial reporting.

Impact on the market: the procyclicality argument

Does reporting downward values drive deeper market declines and intensify market turmoil? Some think so, and as a quick fix they suggest revising reported market prices to reflect more stable circumstances. But this argument implies that bad news should be swept under the rug. It also ignores an important fact: Financial reporting does not create adverse market conditions; it captures market performance after it has occurred.

Looking forward: the move to IFRS

US companies aren't the only ones facing the challenges of reporting fair value. Many of the same challenges also surface in International Financial Reporting Standards (IFRS), the framework used by most of the world today. IFRS encourages greater use of fair value, but generally in niche areas—for example, real estate. We anticipate that, in the coming years, the US transition to IFRS is inevitable. Today's efforts to improve the use of fair value in the US, closely coordinated with international standard setting, will benefit the US and the world both now and well into the future.

Actions

It is impossible to predict how fair value will evolve over the next few years—how it will be affected by changes in investor needs, modeling techniques, the way markets monetize assets and liabilities, and legal and regulatory influences. Nonetheless, standard setters and companies can take actions to improve fair value as it exists today.

What standard setters can do

- Stop expanding the use of fair value beyond today's scope of application, in both US GAAP and IFRS.
- Modify the financial statements to distinguish the impact on earnings of changes in fair value from the financial results of ordinary business operations.
- Take into account the interaction among the relevance, reliability, and practicality of implementing fair value for most nonfinancial assets and liabilities.

What companies can do

- Identify where fair value works and where it doesn't, in light of company-specific facts and circumstances. This information needs to be shared with standard setters to help them craft solutions.
- Explain the following to investors:
 - the impact of changes in fair value on earnings separate from key business operations
 - meaningful differences between market values and underlying intrinsic values of financial instruments
 - fair value information about nonfinancial assets and liabilities where meaningful and cost-effective
- Fair value measurement and valuation modeling are demanding disciplines. It may be necessary to bring on new personnel with specialized training, and to train existing personnel in valuation techniques.

For further information on reporting fair value, please see our full white paper, available in print and online, at www.pwc.com/10minutes.

Upcoming 10Minutes topics

Harnessing the opportunities of converting to IFRS

The ripple effect of an IFRS conversion impacts much more than just debits and credits. Although many of the repercussions will require attention, others are discretionary and in danger of being overlooked. 10Minutes explores how you can make time work for you by capitalizing on IFRS opportunities now.

Why climate change matters today

Concerns over energy security and costs are heating to uncomfortable levels, both at the gas pumps and in the boardrooms. Meanwhile, consumers, employees, and communities are increasingly expecting action from businesses. Climate change has become a matter of managing risks, costs, and reputation. 10Minutes explores how you can link your response to climate change more strongly to your business strategy and your corporate performance.

The changing face of financial reporting

The income statement and balance sheet—foundations of public reporting and financial analysis—are not optimally serving investors and analysts. This has caught the standard setters' attention and they are considering major changes to basic form and content. 10Minutes provides an update on the state of play.

How PwC can help

To have a deeper discussion about how fair value impacts your business, please contact:

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In Defense of Mark-to-Market

"There are few topics in the world of accounting today that generate as much passion or get people more fired up, than 'fair value' or 'mark-to-market' accounting. (It seems as if the complaints about fair value accounting have picked up as asset values have fallen down, funny that we don't remember the same uproar when asset values were moving higher.) In particular FAS 157, Fair Value Measurements, has been blamed for everything from the credit crisis to global warming, from multi-billion-dollar write-downs and forced capital-raising to Chien-Ming Wang hurting his foot running the bases.... In our view the accounting is not the problem, it is reflecting an economic reality, asset values are falling, the sooner the accounting reflects those losses the better... The real problem was overexposure to certain assets, poor risk management, misunderstood, mispriced risks and lots of leverage (borrowing short and lending or investing long can catch up with you)... we would prefer to see the financial statements reflect real economic volatility rather than a false sense of stability."

- **David Zion, Research Analyst at Credit Suisse**

"Blaming fair value accounting for the credit crisis is a lot like going to a doctor for a diagnosis and then blaming him for telling you that you are sick."

- **Excerpt from a recent JPMorgan Chase Report**

"Another misconception is that the credit problem will vanish if only Treasury suspends "mark-to-market" accounting -- as if those bad assets wouldn't still exist. The banks themselves would know they still have this bad paper and aren't likely to engage in much new lending. Investors also don't trust the bank marks now; imagine what they'll think if the U.S. declares that cooking the books is official policy."

- **Excerpt from a 9/24 Wall Street Journal Editorial**

"To ask for a suspension in fair-value accounting is to ask the market to suspend its judgment. Fair-value reporting, when properly complied with and enforced, will simplify the information investors need to make informed decisions, and bring much needed transparency to the market. By reporting assets at what they are worth, not what someone wishes they were worth, investors and regulators can tell how management is performing.

Ultimately, those who blame fair-value accounting for the current crisis are guilty of the financial equivalent of shooting the messenger. Fair value does not make markets more volatile; it just makes the risk profile more transparent."

- **Excerpt from a 9/26 Wall Street Journal Op-ed by Lynn Turner and Arthur Levitt**

"What is the alternative? Not to try to be truthful about the current value of your assets, to use original cost or some other smoothed value that ignores current market conditions? Yet, in some cases, that is what some people have asked us to do—suspend the bad news for a while...until things get better. That is what Japan tried to do rather unsuccessfully for over a decade."

- **FASB Chairman Bob Herz**

"One suggestion that's been made is to suspend mark-to-market accounting and use banks' estimates of hold-to-maturity prices...but doing this would only hurt investor confidence because nobody knows what the true mark -- true hold-to-maturity price is."

- **Federal Reserve Chairman Ben Bernanke**

"I believe in fair value accounting...it is hard to run a financial firm without "mark to market" accounting."

- **Treasury Secretary Henry Paulson**

"Allowing companies to lie to investors and lie to themselves is not the solution to the problem, it is the problem....Lawmakers need to understand that the alternative to mark-to-market accounting is mark-to-myth, and could give banks and other financial companies the freedom to value assets at inflated amounts."

- **Barbara Roper, Consumer Federation of America**