

## Weil Briefing:

# SEC Disclosure and Corporate Governance

Updated November 5, 2008

### Recent SEC and FASB Guidance on Fair Value Measurement and Disclosure for this Quarter's Form 10-Q and Upcoming Form 10-K

By the time the third fiscal quarter came to an end, the Securities and Exchange Commission ("SEC") and the Financial Accounting Standards Board ("FASB") had taken positive steps to address serious concerns that application of so-called "fair-value," or "mark-to-market," accounting had artificially depressed corporate balance sheets due to the necessity of using steeply declining market prices to value financial assets. Although several provisions of U.S. GAAP have mandated use of fair-value measurements for some time,<sup>1</sup> the market-oriented "exit price" valuation and disclosure requirements of FASB Statement No. 157, *Fair Value Measurements* ("FAS 157"), that came into effect for many companies in the first quarter of 2008, have triggered a firestorm of criticism from preparers of corporate financial statements. In this Alert, we outline the following steps taken by the SEC and FASB that we believe will be most useful to companies preparing financial statements and accompanying Management Discussion and Analysis ("MD&A") section of this quarter's Form 10-Q and subsequent periodic reports:

- a joint statement issued by the accounting staffs of the SEC and FASB on September 30, 2008, offered to "clarify" the application of FAS 157 in today's turbulent credit environment;
- the adoption of a new FASB Staff Position – FSP FAS 157-3 – designed to provide additional guidance on issues related to determination under FAS 157 of the fair value of financial assets in inactive markets;
- a sample comment letter sent by the SEC accounting staff in September 2008, to Chief Financial Officers of certain public companies – a "Dear CFO" letter – that offers useful guidelines for analyzing difficult MD&A disclosure questions arising from the application of FAS 157 to measure the value of financial assets and liabilities; and
- another sample "Dear CFO" comment letter from the SEC accounting staff, published in March 2008, which discusses such potential MD&A disclosure topics as management's determination of material unobservable inputs in assigning values to financial instruments, a description of valuation techniques or models used for determining fair value, and the classification (or change of classification) of financial assets (and liabilities) as Level 1, 2, or 3 in the FAS 157 hierarchy.

This recent guidance from the SEC and the FASB staffs should go far toward alleviating companies' concerns that they might be forced to mark down the value of financial assets carried on their balance sheets to "fire-sale" or liquidation prices, despite management's view that these assets eventually could be worth far more when current negative market conditions improve.

The trade-off, however, is that both the SEC and the FASB expect much more transparency in companies' MD&A and financial statements with respect to management judgments and assumptions made in marking the value of financial assets (and liabilities) to "model" rather than "market."

Careful review of the latest SEC/FASB guidance will be particularly important to the two senior officials responsible for certifying to the accuracy and completeness of a company's Form 10-Q – the Chief Executive Officer ("CEO") and the Chief Financial Officer ("CFO"). These officials also are responsible for helping their companies design and maintain disclosure controls and procedures that provide reasonable assurance of timely, truthful and reliable disclosure to the investing public of both financial and non-financial information, through periodic reports and other documents filed with or submitted to the SEC. Given the current market uncertainty and the heightened focus by investors and regulators alike on the adequacy of disclosures relating to companies' financial condition and operating performance, along with their future prospects, we recommend that CEOs, CFOs and Disclosure Committees, along with others who assist them in evaluating the effectiveness of their companies' disclosure controls and procedures (as well as their internal control over financial reporting, the effectiveness of which will have to be evaluated as of the end of this fiscal year), consider whether some re-calibration is needed to produce disclosure in their upcoming periodic reports (Form 10-Q and Form 10-K) that meets the expectations of the SEC, the FASB and, last but not least, investors. Going forward, companies should continue to follow these issues because the PCAOB expects to issue a concept release on fair value and the use of valuation specialists by the end of 2008,<sup>2</sup> and reportedly is considering whether to issue a Practice Alert addressing a number of audit issues related to the credit crisis, which may include matters pertaining to fair value, other-than-temporary impairment, credit derivatives and disclosure.<sup>3</sup>

### **Brief Summary of Recent SEC/FASB Guidance on Fair-Value Issues and Related Developments**

On September 30, 2008, the accounting staffs of the SEC and FASB issued a joint statement to "clarify" the application of FAS 157 in today's turbulent credit environment. These clarifications are intended to assist public companies and their auditors with resolution of several knotty fair-value measurement and disclosure issues that have arisen due in major part to the unprecedented immobilization of certain segments of the nation's credit markets and the resultant illiquidity of many financial instruments. The press release containing this relatively new guidance, entitled "SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting" ("September 30 SEC/FASB Statement"), is available at <http://www.sec.gov/news/press/2008/2008-234.htm>.

On October 10, 2008, the FASB issued a new FASB Staff Position – FSP FAS 157-3 – which provides additional guidance on issues related to determination of the fair value of financial assets in inactive markets under FAS 157, available at [www.fasb.org](http://www.fasb.org). The FSP is consistent with and "amplifies" the September 30 SEC/FASB Statement, and provides an illustrative

example. As discussed below, the final FSP has been revised from its proposed form (FSP FAS 157-d) to clarify that the existence of a disorderly market does not automatically compel a conclusion that all such transactions necessarily are distressed or disorderly – the analysis should be performed at the transaction level (rather than at the market level) and may require significant judgment. The FSP became effective upon issuance, and applies to prior periods for which financial statements have not been issued – in other words, calendar year-end reporting companies would apply the new guidance in preparing the financial statements required to be filed as part of their third-quarter Form 10-Qs.

The Emergency Economic Stabilization Act of 2008 (“EESA”),<sup>4</sup> which was signed into law by the President on October 3, 2008, contains two provisions dealing with FAS 157. One provision (Section 132 of EESA) re-affirms the SEC’s existing authority to suspend “mark-to-market” accounting as prescribed by FAS 157.<sup>5</sup> The other provision (Section 133 of EESA) directs the agency – in consultation with the Federal Reserve Board and the U.S. Treasury – to conduct a study on mark-to-market accounting as it applies to commercial banks and other financial institutions. The study, which must be completed and submitted to Congress by January 2, 2009, must cover a number of topics, including the impact of FAS 157 on the balance sheets of financial institutions, this standard’s role in the bank failures of 2008, and the quality of financial information provided to investors. The SEC has already commenced the study (*see* SEC press release at <http://www.sec.gov/news/press/2008/2008-242.htm>), and has created a webpage dedicated to the study and related materials -- <http://www.sec.gov/spotlight/fairvalue.htm>. On October 29, 2008, the SEC hosted a roundtable on mark-to-market accounting to explore its impact on financial reporting by financial institutions, any potential impact on market behavior, usefulness to investors and ways to improve upon these accounting standards.<sup>6</sup> The SEC will host its next roundtable on November 21, 2008.<sup>7</sup> Of more immediate relevance may be the decisions of responsible officials at the Treasury Department and elsewhere within the federal government regarding what prices to pay for distressed financial assets that will be purchased from firms participating in the newly authorized financial rescue program.

In mid-September 2008, the SEC accounting staff published a sample comment letter that offers useful guidelines for analyzing the difficult MD&A disclosure questions preparers are facing this quarter as they weigh the materiality of credit risk and its role in their companies’ fair-value measurements. While the letter was sent primarily to CFOs of financial institutions, the staff has indicated informally that the guidance it furnishes would be relevant to all companies that report in their financial statements a significant amount of asset-backed securities, credit-based derivative assets and liabilities, and loans carried at fair value or the lower of cost or market. The September 2008 “Dear CFO” letter, available at <http://www.sec.gov/divisions/corpfin/guidance/fairvalueltr0908.htm>, supplements a prior “Dear CFO” letter issued by the staff in March 2008, to help companies resolve fair-value measurement disclosure issues in the first quarter 10-Q’s MD&A upon initial adoption of FAS 157. This March 2008 letter is available at <http://www.sec.gov/divisions/corpfin/guidance/fairvalueltr0308.htm>.

Highlights of the joint SEC and FASB staff guidance from September 30, 2008, the FSP FAS 157-3 issued by FASB on October 10, 2008, and the SEC accounting staff's two "Dear CFO" letters addressing the application of fair-value accounting and related MD&A disclosures, are outlined below, together with some practice tips that we hope will be useful to companies in preparing this quarter's Form 10-Q or the annual report on Form 10-K. As previously noted, careful consideration of the implications of this guidance for periodic reports is important not only to the CEOs and CFOs who will be called upon to certify to the accuracy and completeness of the financial statements and explanatory MD&A, but also to those who assist these officials in meeting their obligations to evaluate the effectiveness of their companies' disclosure controls and procedures as of the end of the most recently completed fiscal quarter.

## **Discussion of Recent SEC/FASB Guidance on Fair-Value Issues**

### **Highlights from the SEC and FASB Staff Guidance Issued September 30, 2008**

Generally speaking, the joint SEC and FASB staff guidance addresses when a company and its auditor may consider other evidence of value (or inputs) in addition to market bids or quotes for certain financial assets, in situations where the relevant markets are either dysfunctional or non-existent. As such, this guidance should reassure companies that they may classify financial assets (and, presumably, liabilities if pertinent) as Level 3 under FAS 157 – thereby permitting management to use a "mark-to-model" measurement approach – during periods of extreme market turbulence and/or illiquidity. Consistent with previously issued SEC staff guidance contained in the 2008 "Dear CFO" letters we address later in this Alert, full MD&A disclosure regarding fair value measurements deemed material, including an explanation of any model used and the related unobservable inputs for Level 3 financial assets, will be key to meeting SEC expectations regarding transparency.

Specific topics covered by the joint statement are outlined below:

#### ***Determining Fair Value When an Active Market Does Not Exist***

- The SEC and FASB staff guidance states clearly that it is acceptable for companies to use management estimates that include market participants' expectations of future cash flows from the particular financial asset, along with "appropriate risk premiums," when an active market for that security does not exist. Discounted cash flow analysis is not the only technique that can be applied in the absence of reliable "observable inputs" – or market data points – as the staff itself explained. Instead, FAS "157 discusses a range of information and valuation techniques that a reasonable preparer might use to estimate fair value when relevant market data may be unavailable, which may be the case during this period of market uncertainty. This can, in appropriate circumstances, include [but is not necessarily limited to] expected cash flows from an asset."
- FAS 157 expresses a clear preference for "mark-to-market" classification of assets under Level 1, and permits dropping an asset into Level 2 – thereby enabling management to look to market prices of similar assets, or "observable inputs," for measurement purposes – only where "observable inputs" in the form of market prices for that asset are unavailable. Even

where observable inputs under a Level 2 classification may be determinable, however, the staff acknowledges that categorizing an asset as Level 3 and using unobservable inputs may be preferable because of the need for significant adjustments to Level 2 inputs.

- In sum, the SEC/FASB staff guidance makes clear that multiple inputs from a variety of sources may provide better evidence of fair value than actual market prices for a financial asset (Level 1) or comparable asset prices (Level 2), and that, in such cases, anticipated cash flows (appropriately discounted) would be one consideration along with other information collected. How much weight to give each of these inputs necessarily entails the exercise of “significant judgment,” and will depend on the extent to which they provide reliable information about the value of the asset (or liability) and are relevant in arriving at a reasonable estimate. As explained further below, however, the trade-off for such flexibility is that the SEC staff will expect management to outline in the MD&A those significant judgments and assumptions that were made in determining the classification of a financial instrument and, ultimately, its fair value, where material to the company’s financial condition, results of operation and liquidity – not merely for the reporting period, but also in future periods. Companies should not be surprised to receive staff comments on their third-quarter 10-Qs and subsequent periodic reports asking whether management’s reliance on judgments, assumptions and estimates in applying FAS 157 was, or will be, so material to the financial statements as to warrant critical accounting treatment in the MD&A.
- Determining whether a market is active or inactive itself requires judgment and, per the September 2008 “Dear CFO” Letter, companies should discuss the criteria used to make this determination. The SEC and FASB staff guidance states that if an asset that is identical to the asset being valued is traded in an active market, then the quoted market price must be used, in most cases, without adjustment. If the market for the asset is inactive, transactions in that market may be inputs, but would not be determinative. While orderly transactions should be considered as evidence, adjustments may need to be made if the prices in the inactive market do not reflect current prices for the same or similar assets. Other indicators to be considered when a market is inactive include a significant increase in the spread between the “asking” price and the “bid,” or whether there are a small number of “bidders” (*i.e.*, whether the asset is thinly traded).

**Practice Tip:** Management should review any policies and/or procedures related to the company’s process for determining fair-value measurements and related disclosure. In particular, consider the extent to which any policies and/or procedures are applied consistently and any susceptibility to management override. Also, consider whether the existing policies and/or procedures may need to be revised in light of the company’s financial condition (including its credit risk or that of counterparties) and fast-changing market conditions. Such revisions may constitute a material change to the company’s internal control over financial reporting (or a change reasonably likely to materially affect its internal control over financial reporting in the future) and therefore would be required to be disclosed in the upcoming periodic report (*see* Item 308(c) of Regulation S-K). Management should also take into consideration any potential impact on the company’s disclosure controls and procedures during its quarterly evaluation and adjust those processes as needed to support a conclusion of effectiveness.



***The Use of Market Quotes to Determine Fair Value Based on a Mix of Information***

- Broker quotes are not determinative of fair value in the absence of an active market for the security or other asset, although they may be an input to be considered along with other factors. The staff guidance indicates that a broker may rely on models with inputs based on information available only to that broker when markets are less active. Thus, in weighing the evidence related to fair value, a broker quote that does not reflect the results of market transactions should be given less weight. Another consideration is the nature of the quote – whether it is a binding offer or a mere indication of price.

***Practice Tip:*** If the asset inputs include quotes or bids, review the process used by the broker-dealer or valuation expert to gather this information, which may also constitute part of management’s review of any changes to internal control over financial reporting during the reporting period. Some issues to consider include how the broker or valuation expert decides which market to use (*i.e.*, does the broker or service use quotes or bids from the most advantageous market or the primary market in which the security is traded), how many quotes or bids are collected, and if the broker or service is unable to collect quotes or bids, explore why (*i.e.*, is the market thinning or did it stop functioning altogether?). *See also* the MD&A disclosure guidance in the September 2008 “Dear CFO” Letter, discussed below, which specifically addresses issues related to the use of brokers and pricing services. Generally, in applying FAS 157, it is assumed that the transaction occurs in the asset’s principal market (the market having the greatest volume or level of activity) or, in the absence of a principal market, in the most advantageous market.<sup>8</sup> Accordingly, prices derived from the principal market should be used even if a better price could be obtained in a different market.<sup>9</sup>

***Fair Value and Distressed Transactions***

- An important concept in fair value determinations is the existence of orderly transactions between market participants – *i.e.*, transactions where buyers and sellers are willing to engage in transactions and that allow for adequate exposure to the market. Distressed or forced liquidation sales are “disorderly” transactions and therefore cannot be determinative of fair value. As a consequence, the fact that a transaction was disorderly should be considered along with other relevant evidence of fair value. Management’s determination whether a given transaction was disorderly or distressed itself requires judgment.

***Factors to Consider in Determining When an Investment is Other-Than-Temporarily Impaired***

- We understand that this has been a particular area of discussion, and occasional disagreement, between public companies and their independent auditors. In determining whether a financial asset’s impairment is other-than-temporary, management should use reasonable judgment based on the facts and circumstances of each investment. This determination should begin with an assessment of the nature of the underlying asset (*i.e.*, whether the asset is debt, equity or a hybrid) because that may impact the assessment of the probability of recovery.
- SAB Topic 5M, *Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities*, and AU 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, the latter of which was adopted by the PCAOB as an interim

auditing standard, provide a number of factors to be considered here. It is important to note that these standards do not provide an exhaustive list of factors, and other factors not so identified therefore may need to be considered. The guidance provided by the SEC and FASB staffs identify the following factors to be evaluated in deciding whether a particular asset has been other-than-temporarily impaired:

- The length of time and extent to which the market value has been less than cost;
- The issuer's financial condition and near-term prospects, including any specific events that may influence the issuer's operations (*e.g.*, changes in technology that may impair the earnings potential of the investment or the discontinuation of a business segment that may impact future earnings potential); or
- Management's intention, and the company's ability, to hold the securities long enough for them to recover their market value. At the end of the day, all available information must be analyzed in determining the applicable recovery period.

***Practice Tip:*** Management should be careful when using pre-established parameters, such as a determination that an asset is other-than-temporarily impaired once an asset's fair value has fallen below a certain percentage of its cost or has remained under a certain threshold for a specified period of time. Recall, in this connection, SAB 99's admonition against excessive reliance on quantitative or "bright-line" materiality thresholds. While these triggers may provide a starting point for the analysis, a policy regarding the determination of when an asset is other-than-temporarily impaired that is consistently applied and documented may be helpful.<sup>10</sup> As noted in the SEC and FASB staff guidance, there are a number of factors to be considered in making this determination.

### **Highlights of FAS FSP 157-3, Issued by FASB on October 10, 2008**

The FASB issued FAS FSP 157-3 to clarify how FAS 157 should be applied in an inactive market. In response to comments, the FASB revised the proposed guidance (FAS FSP 157-d) to make clear that the existence of a disorderly market does not mean that companies should automatically conclude that those market transactions are also disorderly or distressed. As discussed below, companies need to make this determination at the transaction level taking into account the facts and circumstances, which may require the use of significant judgment.

FAS 157-3 focuses on three primary application issues that have arisen in "markets that are not active":

- How the reporting entity's own assumptions (that is, expected cash flows and appropriately risk-adjusted discount rates) should be considered in the fair-value measurement process when relevant observable (*i.e.*, market) data do not exist;
- How available observable inputs in a market that is not active should be evaluated when measuring fair value; and
- How the use of market quotes – such as broker quotes or pricing services for the same or similar financial assets – should be considered when assessing the relevance of observable and unobservable data available to measure fair value.

FSP 157-3 inserts into FAS 157 a fairly complicated example (involving a public company's investment in a Triple B-rated tranche of a collateralized debt obligation security, with unguaranteed, non-conforming residential loans serving as collateral) that would serve to illustrate the following "key existing principles" of FAS 157 (as delineated in Paragraph 9 of the FSP). These principles, which are set forth below, closely mirror the guidance presented in the September 30 SEC/FASB Joint Statement.

- A fair-value measurement of a financial asset represents the price at which a sale transaction would occur between market participants on the measurement date. If there is little or no market activity on such date, the fair-value objective remains the same – to determine the price that the seller would receive in an orderly transaction that is not a forced liquidation or distressed sale as of the measurement date. It is not appropriate to conclude that the existence of a dislocated market means that all market activity represents forced liquidations or distressed sales; nor is it appropriate automatically to conclude that such transactions are determinative of fair value. "Determining fair value in a dislocated market depends on the facts and circumstances and may require the use of significant judgment about whether individual transactions are forced liquidations or distressed sales."
- A reporting entity's own assumptions regarding future cash flows and appropriately risk-adjusted discount rates may be used in determining the fair value of a financial asset, in situations where relevant observable inputs are not available. FAS 157 discusses a range of information and valuation techniques that a company in this situation might employ to estimate fair value. There may be other situations in which observable inputs that otherwise would trigger Level 2 classification and measurement would have to undergo such significant adjustments, based on unobservable data, that Level 3 treatment would be justified. By way of example, observable inputs may not be relevant and may require significant adjustment if "the volume and level of trading activity in the asset have declined significantly, the available prices vary significantly over time or among market participants, or the prices are not current." Whatever the valuation method applied, companies in these circumstances must include the types of "appropriate" risk adjustments that market participants would make for nonperformance and liquidity risks.
- Although broker (or pricing service) quotes may be an appropriate input in measuring fair value, such quotes may not be determinative if an active market for the financial asset in question does not exist. Ordinarily, a broker quote for an actively traded financial asset should reflect market pricing data derived from actual transactions; the same is not necessarily the case when markets are not active, which may prompt a broker to rely more on models with inputs based on information available only to the broker. Accordingly, in weighing a broker price quote as an input to fair-value measurement, the company should place less reliance on quotes that do not reflect the results of actual market transactions. Another relevant factor to weigh in this regard is whether the quote is merely an indicative price versus the product of a binding offer.

Paragraph 10 of FSP 157-3 reminds companies that they must reconcile (in the financial statements) the beginning and ending balances for recurring Level 3 fair-value measurements, while separately presenting changes that occurred during the reporting period (*i.e.*, the third



quarter for a calendar-year registrant) that are attributable to transfers in and out of Level 3. With respect to both recurring and nonrecurring fair value measurements using significant unobservable inputs (Level 3), paragraphs 32 and 33 of FAS 157 require companies to describe the inputs on which a fair-value estimate is based, along with the information used to develop these inputs.<sup>11</sup>

### **Highlights of SEC Staff Guidance from the September 2008 “Dear CFO” Letter**

In mid-September 2008, the accounting staff of the SEC’s Division of Corporation Finance sent a letter to the CFOs of certain public companies discussing disclosure issues management should consider in preparing the MD&A for the upcoming Form 10-Q and annual report on Form 10-K. When reviewing the staff’s September 2008 “Dear CFO” Letter, companies should give appropriate weight to the SEC staff’s suggestion that companies include in their fair value disclosure the information required by FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (“FAS 159”), regarding gains or losses on financial instruments that companies choose (but are not otherwise required) to carry on their balance sheets at fair value **and** that have a material impact on the company’s results of operations. The MD&A disclosure guidance set forth in this recent letter is intended to build on the staff’s previous MD&A disclosure guidance in the March 2008 “Dear CFO” Letter, which has continuing relevance to MD&A drafting and is discussed further below.

The SEC staff hopes to elicit “clearer and more transparent disclosure” in the MD&A regarding the fair-value measurements of financial assets that are not currently actively traded and that have, or are reasonably likely to have, a material effect on the company’s financial statements. In particular, the staff seeks information about the judgments and assumptions made by management in formulating those fair-value determinations, the sensitivity of such measurements to management’s assumptions, together with details about the method used for valuation purposes and the various inputs to which the method is applied. Documenting the process by which fair-value determinations are made, including the reasons for key decisions regarding the use of certain models and inputs, may provide a useful record for management and the independent auditor.

Depending on the valuation technique chosen to measure the fair value of Level 3 financial assets (or liabilities), management necessarily will be called upon to assess the nature and scope of future performance of a given asset (*e.g.*, measured in terms of future cash flows as appropriately discounted). Such forward-looking assessments lie at the heart of the MD&A requirement that management discuss and analyze currently known trends, demands, commitments, events and uncertainties that will have or are reasonably likely to have a material impact on the company’s liquidity, capital resources and/or results of operations. Accordingly, management should give investors a “heads-up” in the MD&A with respect to the prospective, as well as the historical, impact of the current negative credit environment on a company’s performance.

**Practice Tip:** The same disclosure treatment will be expected for off-balance sheet arrangements that have the potential to become material, on-balance sheet obligations. For more

detail on SEC staff expectations in this area, see Sample Letter Sent to Public Companies That Have Identified Investments in Structured Investment Vehicles, Conduits or Collateralized Debt Obligations (Off-balance Sheet Entities (Dec. 2007), available at <http://www.sec.gov/divisions/corpfin/guidance/cfoffbalanceltr1207.htm>.

Returning to the September 2008 Dear CFO Letter, the SEC staff “encourages” management to consider including the following additional disclosures in its MD&A, to the extent material to the company’s “own facts and circumstances”:

- Significant judgments made in determining whether a financial instrument should be classified as Level 1, 2 or 3 (the fair-value hierarchy of FAS 157).
- Disclosure regarding credit risk and how such risk is incorporated and weighed in the valuation of financial assets or liabilities – whether or not the company elects to carry the specific financial asset or liability at fair value under FAS 159, or must do so to comply with another applicable standard, such as FAS 133 relating to derivatives accounting and hedging.
- Even though companies are not required to do so by other GAAP standards, the staff recommends that they “consider” providing the more extensive disclosure prescribed by FAS 159 (for assets and liabilities electively carried at fair value) for financial instruments that must be carried at fair value, if the resultant gains or losses (as the case may be) on such instruments are material to the companies’ results of operations. Specifically, the staff urges companies to consider explaining in their MD&As:
  - The impact of the company’s, or a counterparty’s, credit risk on the valuation of derivative liabilities and resulting gain or loss reported in earnings based on changes in either the company’s or the counterparty’s credit risk;
    - The impact on the company’s financial statements of any deterioration in a counterparty’s credit and the company’s ability to collect on a particular derivative asset.
- To facilitate investor understanding, the staff further “suggests” that companies combine, in a single location within the MD&A, the recommended disclosure of all items carried at fair value – whether on a voluntary (under FAS 159) or mandatory (for example, under FAS 133) basis.
- Discuss the criteria used to determine whether the market for a financial instrument is active or inactive.
- Identify the financial instruments impacted by the lack of market liquidity, and explain how that illiquidity influenced the valuation technique or model used in connection with the fair-value determination.
  - To illustrate, the staff notes in the letter that if a company uses a discounted cash flow approach for determining the fair value of a financial instrument (*e.g.*, auction-rate securities, mortgage-backed securities, loans held for sale – to name just a few), it should discuss the specific change in the discount rate or other analysis used to account for the lack of liquidity, including how and why the assumptions changed from prior periods.

- If brokers or pricing services are used to assist management in determining fair value, explain how the information is obtained and used in developing fair value measurements reported in the financial statements. While the nature and form of this information may vary under the facts and circumstances, consider addressing:
  - The nature and amount of assets (including the classification of those assets as either Level 1, 2 or 3 under FAS 157) valued using the broker or pricing services;
  - The number of quotes or prices obtained for each instrument and, if multiple quotes or prices were obtained, how the ultimate value reported in the financial statements was determined;
  - Whether management adjusted quotes or prices obtained from brokers or pricing services and, if so, how and why those adjustments were made;
  - The extent to which the broker or pricing service used observable market information, as opposed to unobservable inputs and/or proprietary models, when making valuation judgments and determinations;
  - Whether the quotes used are binding or non-binding; and
  - The procedures performed to validate the prices obtained to ensure consistency of the fair-value determination with FAS 157, and proper classification of the underlying assets and liabilities within that standard's fair-value hierarchy.

### **Highlights of SEC Staff Guidance from the March 2008 “Dear CFO” Letter**

The guidance delineated in the March 2008 “Dear CFO” Letter covers such topics as the determination of material unobservable inputs, a description of valuation techniques or models used for determining the fair value of material assets, and the classification (or change of classification) of assets as Level 1, 2, or 3 in the fair-value hierarchy. More specifically, the staff's letter offers guidance on MD&A disclosure regarding the use of valuation models for Level 3 measurements under SFAS 157, including management's judgment and assumptions as to how the market would price that particular asset or liability for purposes of financial reporting (unobservable inputs). Where the use of unobservable inputs is material to the company's financial statements, the company should disclose in its MD&A how those inputs were determined and how the resulting fair value of those assets, and possible changes to that value, impacted or might impact (in future reporting periods) the company's results of operations, liquidity, and capital resources.

In cases where a company's use of unobservable inputs to determine the value of Level 3 assets and liabilities is material, the company should consider providing the following disclosure in its MD&A:

- The amount of assets/liabilities measured using significant unobservable inputs as a percentage of total assets/liabilities measured at fair value;
- The amount and reason for material increases or decreases due to the transfer of those assets/liabilities from, or to, Level 1 or 2;
- If there has been such a material transfer of assets/liabilities into Level 3 during that reporting period, the company should discuss:

- the significant inputs no longer considered observable, and
- any material gains or losses recognized on those assets during the period, including the amount excluded from the line item amount reported as realized/unrealized gains (losses);
- To the extent material to the company's Level 3 assets/liabilities, discuss:
  - whether realized/unrealized gains (losses) had an impact on results of operations, liquidity or capital resources for that period;
  - the reasons for any material decline or increase of fair value; and
  - whether management believes fair values differ materially from the amounts that management currently expects to realize on settlement or maturity (including a discussion why and the reasons for management's view);
- The nature and type of assets underlying asset-backed securities (*e.g.*, the type of loan – sub-prime, HELOC, Alt-A), the years of issuance, the credit ratings assigned to those securities and changes or potential changes to those ratings.

Regardless of how a company has classified its assets and liabilities within the FAS 157 framework, the staff suggests that it consider the need for disclosure of such additional classification information (unless already explained in the last Form 10-K) as:

- What types of valuation models or techniques have been used, including any material changes made during the reporting period to those models and why they were made (include the quantitative effect of those changes);
- How the company used or considered market indices in applying its valuation model, including a description of material adjustments made during the reporting period based on those market indices and the reasons for the adjustment(s);
- How the company validated its model, including whether and how often it calibrates the model to market, or back-tests or otherwise validates it;
- The sensitivity of the fair-value estimates for material assets/liabilities in connection with the significant inputs used in the valuation model. Companies should consider providing a range of values to give investors a sense of how the fair-value estimate might change as the significant inputs vary. Also, discuss why that range is appropriate, including identification of key drivers of variability and how the inputs were developed. For guidance, the staff refers companies to Section V (“Critical Accounting Estimates”) of SEC Interpretive Release “Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations”, No. 33-8350 (December 19, 2003), available at <http://www.sec.gov/rules/interp/33-8350.htm>; and
- Discuss how increases/decreases in the aggregate fair value of assets/liabilities may impact the company's liquidity and capital resources.

**Practice Tip:** For many companies, the valuation of financial instruments may be highly subjective and complex where market data are not available, and thus may qualify as a critical accounting estimate. In this regard, be aware that the staff seems to favor identification of fair-value determination as a critical accounting estimate if a company has a significant amount of financial instruments that must be measured in terms of fair value. Senior SEC

staff continue to urge companies to remember the fundamental purpose of critical accounting estimates disclosure: to enable investors to get a sense that, although the financial statements are full of seemingly “hard” numbers, there are sometimes many judgments and estimates underpinning those results. A sensitivity analysis should be used where appropriate to help investors understand that a particular reported result may be the product of several estimates/judgments and therefore might well vary if those estimates and/or judgments were to be altered – meaning ultimately that where sensitivity analyses are reasonably available and would be useful to investors, they should be applied and a range of values disclosed. The idea is to let investors know that you could have ended up at several different places within a given range, not just the single data point produced by your selected estimates and assumptions.

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If you have any questions on these matters, please do not hesitate to speak with your regular contact at Weil, Gotshal & Manges LLP or members of the Firm’s Public Company Advisory Group: Howard B. Dicker, [howard.dicker@weil.com](mailto:howard.dicker@weil.com), 212-310-8858; Cathy Dixon, [cathy.dixon@weil.com](mailto:cathy.dixon@weil.com), 202-682-7147; Gil Friedlander, [gil.friedlander@weil.com](mailto:gil.friedlander@weil.com), 214-746-8178; Holly J. Gregory, [holly.gregory@weil.com](mailto:holly.gregory@weil.com), 212-310-8038; P.J. Himelfarb, [pj.himelfarb@weil.com](mailto:pj.himelfarb@weil.com), 202-682-7197; Robert L. Messineo, [robert.messineo@weil.com](mailto:robert.messineo@weil.com), 212-310-8835; and Ellen J. Odoner, [ellen.odoner@weil.com](mailto:ellen.odoner@weil.com), 212-310-8438.

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<sup>1</sup> FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (“FAS 133”) is a notable example of a U.S. GAAP accounting standard that involves the use of fair-value measurements when accounting for credit derivatives.

<sup>2</sup> See PCAOB Standing Advisory Group Meeting: Standards-Setting Accomplishments and Priorities as of October 23, 2008, available at [http://www.pcaobus.com/Standards/Standing\\_Advisory\\_Group/Meetings/2008/10-22/2009\\_Proposed\\_Activities\\_Remarks.pdf](http://www.pcaobus.com/Standards/Standing_Advisory_Group/Meetings/2008/10-22/2009_Proposed_Activities_Remarks.pdf).

<sup>3</sup> See Financial Executives International (“FEI”) Financial Reporting Blog dated October 24, 2008, available at [www.fei.org](http://www.fei.org).

<sup>4</sup> Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343 (2008).

<sup>5</sup> The American Bankers Association sent a letter (dated October 13, 2008) to SEC Chairman Christopher Cox requesting the SEC to override FASB’s new FSP FAS 157-3, available at <http://www.aba.com/aba/documents/press/ChrmnCoxLtr.101308.pdf>. In contrast, the Center for Audit Quality, the CFA Institute, the Council of Institutional Investors and the Consumers Federation of America sent a joint letter to Chairman Cox expressing concern that a decision to suspend fair value accounting would adversely impact investor confidence among other things, available at <http://www.sec.gov/comments/4-573/4573-65.pdf>. More recently, Robert E. Denham, the Chairman of the Financial Accounting Foundation which oversees the FASB, sent a letter to Chairman Cox urging the SEC to resist calls for suspension or overriding of FASB accounting standards, available at <http://www.sec.gov/comments/4-573/4573-83.pdf>. On October 2, 2008, Mr. Denham sent a letter expressing similar concerns to the Chairman of the Committee on Financial Services of the U.S. House of Representatives, Representative Barney Frank, available at [http://www.fasb.org/DenhamLetter\\_10-2-08.PDF](http://www.fasb.org/DenhamLetter_10-2-08.PDF). Another joint letter requested the SEC to provide guidance on the use of judgment when making fair-value determinations in the context of an inactive market under FAS



157. See Letter from the U.S. Chamber of Commerce, the Financial Services Roundtable, Property Casual Insurers Association of America, American Council of Life Insurers, Mortgage Bankers Association, and American Insurance Association to SEC Chairman Christopher Cox (October 23, 2008), available at <http://www.sec.gov/comments/4-573/4573-61.pdf>.

<sup>6</sup> Some of the panelists appearing at the SEC's Roundtable on Mark-to-Market Accounting, held October 29, 2008, expressed the view that fair-value accounting did not cause the credit crisis, and asked the SEC to expand the scope of its study to consider "root causes" of the crisis. Other panelists disagreed, noting in particular the strong views of William Isaac, former Chairman of the FDIC, who argued that fair-value accounting was "destroying" capital for banks. He also said that while he was at the FDIC, the agency had studied mark-to-market accounting for more than one year and decided not to pursue that method for three reasons – a) it would yield misleading results, b) interfere with the ability of banks to accept short-term deposits and convert them to long-term loans (one of their primary functions), and c) pro-cyclicality. An archived version of the Roundtable on Mark-to-Market Accounting held on October 29, 2008, and related materials, are available at <http://www.sec.gov/spotlight/fairvalue.htm>.

<sup>7</sup> Previously the SEC hosted a roundtable on Fair Value Accounting Standards on July 9, 2008, archived version available at <http://www.sec.gov/spotlight/fairvalue.htm>.

<sup>8</sup> PCAOB Staff Audit Practice Alert No. 2: Matter Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists (December 10, 2007), available at [http://www.pcaobus.com/Standards/Staff\\_Questions\\_and\\_Answers/2007/12-10\\_APA\\_2.pdf](http://www.pcaobus.com/Standards/Staff_Questions_and_Answers/2007/12-10_APA_2.pdf).

<sup>9</sup> *Id.*

<sup>10</sup> See generally PricewaterhouseCoopers Dataline 2208-24: Third Quarter Considerations Given Current Market Conditions, at 2.

<sup>11</sup> The PCAOB also specifically cites to the disclosure guidance provided by the SEC staff in the "Dear CFO" Letters from March 2008 and September 2008. See note 3 to FSP FAS 157-3.

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