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April 3, 2008

Increase in Illiquid Financial Instruments on Issuers' Balance Sheets Prompts SEC Letters Regarding Fair Value Measurements

In March 2008, the Securities and Exchange Commission (the "Commission") distributed letters (the "Letters") to certain reporting companies suggesting information such companies "may wish to consider" with regard to assets and liabilities that are not valued using observable market data when preparing Management's Discussion and Analysis sections ("MD&A") in their upcoming quarterly reports on Form 10-Q.[1] The Letters were prompted by the increase on issuers' balance sheets of securities and other financial instruments which have become less liquid over the past several months due to the events which continue to affect the credit markets adversely. The categories of affected instruments include "asset-backed securities, loans carried at fair value or the lower of cost or market and derivative assets and liabilities."

The Commission's Letters contained guidance as to the type of disclosures concerning the valuation of such instruments which issuers should consider including in their MD&A such as: how unobservable inputs as to the value of such assets, that is, valuation data derived from sources other than market prices, were determined; any material changes in assets and liabilities valued using unobservable inputs; and how the resulting valuations could affect the results of operations, liquidity and capital resources. In addition, the Letters also suggest general disclosures with regards to valuation of material assets and liabilities, regardless of the observability of their underlying inputs.

I. Background

Statement of Financial Accounting Standards 157, *Fair Value Measurements* ("SFAS 157"),[2] promulgated by the Financial Accounting Standards Board ("FASB"), provides a framework for measuring and evaluating the fair value of assets and liabilities that is compliant with

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1 See, *Sample Letter Sent to Public Companies on MD&A Disclosure Regarding the Application of SFAS 157 (Fair Value Measurements)* (Mar. 27. 2008), *available at*, http://www.sec.gov/divisions/corpfin/guidance/fairvalueltr0308.htm

2 *Available at*, http://www.fasb.org/pdf/fas157.pdf. SFAS 157 became effective for financial statements for fiscal years that began after November 15, 2007.

generally accepted accounting principles in the United States ("GAAP").[3] A central concept of SFAS 157 is the "fair value hierarchy," which categorizes the inputs used to determine fair value. Level 1 and Level 2 inputs are those with verifiable market values.[4] Level 3 inputs, in contrast, are those that reflect the company's "own assumptions about the assumptions market participants would use in pricing the asset or liability . . . developed based on the best information available in the circumstances."[5] The Letters focus on the assets and liabilities determined using Level 3 inputs ("Level 3 assets and liabilities").

Both SFAS 157 and the Letters state that assets and liabilities should be valued using Level 1 or 2 inputs where possible. However, each acknowledge that if current market prices were determined as a result of "a forced liquidation or distress sale," unobservable inputs would be appropriate. Given the current market conditions, more assets and liabilities may be valued using Level 3 inputs, as compelled sales in a market permit a move away from actual market prices.

II. Specific Considerations Suggested by the SEC

The Letters state that the following may be relevant to reporting companies' MD&A sections :

- The amount of Level 3 assets and liabilities as a percentage of total assets and liabilities;
- A discussion of any material change in Level 3 assets and liabilities, including a discussion of any inputs that the company no longer considers observable;
- Whether changes in the fair value of Level 3 assets and liabilities affect liquidity or capital resources;
- A discussion of whether the fair value of Level 3 assets and liabilities materially differs from the amount the company expects to realize on maturity;
- A description of the type of assets underlying any asset-backed securities;

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3 See, *Summary of Statement No. 157, available at* http://www.fasb.org/st/summary/stsum157.shtml (last visited Mar. 31, 2008).

4 *Id*. at 10-11. Level 1 inputs are those with readably verifiable prices, such as stock quotes, while Level 2 inputs include inputs for which there is a market, albeit one with imperfect pricing. *Id.* Examples of Level 2 inputs include inventory prices and real estate. *Id.* at 11.

5 *Id.* at 12.

- A general description of the valuation methodology used when valuing material assets and liabilities;
- A discussion of how the valuation methodology is validated; and
- A discussion of the sensitivity of the fair value estimates for material assets and liabilities, potentially including a range of values.[6]

The Letters do not modify the requirements of SFAS 157.[7] However, they do provide guidance for companies that now must adhere to SFAS 157 at a time when Level 3 assets and liabilities will likely increase relative to those valued using Level 1 and Level 2 inputs.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or e-mail Jon Mark at (212) 701-3100 or jmark@cahill.com; or John Schuster at (212) 701-3323 or jschuster@cahill.com.

6 SEC Sample Letter, *supra* note 1.

7 *See generally* SFAS No. 157, *supra* note 2.