

## **SEC Office of the Chief Accountant and FASB Staff Issue Press Release Clarifying the Application of SFAS 157**

On September 30, 2008, the SEC Office of the Chief Accountant and the FASB Staff issued a press release which outlined a series of clarifications on the fair value accounting framework set forth in SFAS 157.<sup>1</sup> The press release was issued in order to better assist issuers, preparers, auditors, and investors in applying the rule in the current economic environment. The effect of the guidance set forth in the press release is to afford issuers greater flexibility and an enhanced ability to utilize judgment in determining the appropriate fair value for their market assets. The press release addresses the following questions:

- Can management’s internal assumptions (e.g., expected cash flows) be used to measure fair value when relevant market evidence does not exist?
- How should the use of “market” quotes (e.g., broker quotes or information from a pricing service) be considered when assessing the mix of information available to measure fair value?
- Are transactions that are determined to be disorderly representative of fair value? When is a distressed (disorderly) sale indicative of fair value?
- Can transactions in an inactive market affect fair value measurements?
- What factors should be considered in determining whether an investment is other-than-temporarily impaired?

### **I. Background**

Statement of Financial Accounting Standards 157, *Fair Value Measurements* (“SFAS 157”),<sup>2</sup> 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 generally accepted accounting principles in the United States (“GAAP”).<sup>3</sup> 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.<sup>4</sup> 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.”<sup>5</sup>

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<sup>1</sup> Available at, <http://www.sec.gov/news/press/2008/2008-234.htm>.

<sup>2</sup> 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.

<sup>3</sup> See, Summary of Statement No. 157, available at <http://www.fasb.org/st/summary/stsum157.shtml> (last visited Oct. 1, 2008).

<sup>4</sup> *Id.* at 10-11. Level 1 inputs are those with readily verifiable prices, such as stock quotes, while Level 2 inputs include those 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.

<sup>5</sup> *Id.* at 12.

The SFAS 157 framework is designed around the concept of “fair value.” However, it is important to note that the notion of a fair value measurement assumes orderly transactions between participants in a free and active market. Orderly transactions are those which involve market participants who are willing to conduct transactions and who have adequate exposure to the market. Sales of stocks and assets which are distressed or forced, as is happening to a large extent in the current economy, are not considered orderly transactions. An active market refers to one in which there is only a small spread between the amount sellers are “asking” and the price that potential buyers are willing to pay. An active market also requires the presence of a relatively large number of “bidding” parties, all competing against one another for scarce resources. In an inactive market, by contrast, there is often a large or increasing spread between the “asking” and “bidding” price, and only a relatively small number of “bidding” parties.

## II. Key Points of Clarification Provided by the SEC and FASB Staff

- Determining fair value often requires significant use of judgment. When an active market for a security does not exist, it may become acceptable to use management estimates that incorporate assumptions regarding expected future cash flows and risk premiums. In addition, it may sometimes be more appropriate to use unobservable inputs (Level 3) than observable inputs (Level 2).
- Broker quotes may be a relevant input to consider when measuring fair value, but they are not necessarily determinative in an inactive market. In weighing a broker quote as an input to fair value, less reliance should be placed on quotes that do not reflect real market transactions. The nature of the quote (e.g., whether the quote is a binding offer or an indicative price) is also a relevant consideration to take into account.
- The results of disorderly transactions are not determinative when measuring fair value. Distressed or forced liquidation sales are not orderly transactions. Determining whether a given transaction is disorderly or forced requires judgment.
- In an inactive market, quoted market prices may be used as inputs when measuring the fair value of assets, but they are not likely to be determinative. Adjustments may be required to arrive at fair value. Determining whether a market is active or not requires judgment.
- In determining whether an investment is other-than-temporarily impaired, it is necessary to consider a number of important factors, including:
  1. The nature of the underlying investment (for example, whether the security is debt, equity or a hybrid);
  2. The length of time and the extent to which the market value has been less than cost;
  3. The financial condition and near-term prospects of the issuer; or
  4. The intent and ability of the holder to retain its investment in the issuer for a sufficient time to allow for any anticipated recovery in market value.

The SEC and FASB Staff concluded by noting that because fair value measurements and the assessment of impairment will likely require the significant use of judgment, issuers must be sure to provide investors with clear and transparent disclosures.

The interpretation of SFAS 157 provided in this press release was consistent with previous statements made by the SEC and FASB. However, it provides much needed guidance to issuers, preparers, auditors, and

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investors regarding how to more flexibly apply fair valuation principles to assets in the current economic crisis. The SEC staff and FASB staff will continue to consult with capital market participants regarding issues related to the application of fair value measurements.

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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 email Charles A. Gilman at 212.701.3403 or [cgilman@cahill.com](mailto:cgilman@cahill.com); Jon Mark at 212.701.3100 or [jmark@cahill.com](mailto:jmark@cahill.com); or John Schuster at 212.701.3323 or [jschuster@cahill.com](mailto:jschuster@cahill.com).