Recent Developments Relating to SFAS 157

This memorandum discusses recent developments relating to Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* ("SFAS 157"),[1] including:

- The issuance of FASB Staff Position FAS 157-3 ("FSP FAS 157-3") on October 10, 2008, clarifying the application of SFAS 157 to assets in inactive markets and providing an illustrative example setting forth key considerations in determining fair value when the market for a given asset is not active.[2]

- A press release issued by the International Accounting Standards Board ("IASB") in October 2008 in which the IASB in part reacted to the September 30, 2008 joint statement by the SEC and Financial Accounting Standards Board ("FASB") providing guidance on how to apply SFAS 157 fair value accounting principles to assets in inactive markets.[3]

- A letter sent in September 2008 by the Securities and Exchange Commission ("SEC") to about 30 CFOs suggesting additional information that 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 ("MD&A") sections in their forthcoming quarterly reports.[4]

- The recently commenced SEC study on "mark-to-market" accounting, authorized by Section 133 of the Emergency Economic Stabilization Act.[5]

I. Background

The FASB promulgated SFAS 157 in September 2006, and it became effective for financial statements issued for fiscal years that began after November 15, 2007. SFAS 157 provides a framework for measuring and evaluating the fair value of assets and liabilities for purposes of complying with generally accepted accounting principles in the United States ("U.S. GAAP"). A central concept of SFAS 157 is the "fair value hierarchy," which categorizes the inputs used to determine fair value. Level 1 inputs are those with readily verifiable prices, such as stock quotes. Level 2 inputs are those for which there is a market, albeit one with imperfect pricing. Examples of Level 2 inputs include inventory prices and real estate. Level 3 inputs, in contrast, are those that

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1 *Available at* http://www.fasb.org/pdf/fas157.pdf.

2 *See* FASB Staff Position No. FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset is Not Active* (Oct. 10, 2008), *available at* http://www.fasb.org/pdf/fsp_fas157-3.pdf.

3 *See IASB Announces Next Steps in Response to Credit Crisis* (Oct. 3, 2008), *available at* http://www.iasb.org/NR/rdonlyres/C852569A-8BA6-4636-8C0D-DB7EEB088A26/0/IASBannouncesnextstepsinresponsetothecreditcrisis.pdf.

4 *See Sample Letter Sent to Public Companies on MD&A Disclosure Regarding the Application of SFAS 157 (Fair Value Measurements)* (Sept. 16, 2008), *available at* http://www.sec.gov/divisions/corpfin/guidance/fairvalueltr0908.htm.

5 *See SEC Commences Work on Congressionally Mandated Study on Accounting Standards* (Oct. 7, 2008), *available at* http://www.sec.gov/news/press/2008/2008-242.htm. Also see text of Emergency Economic Stabilization Act, *available at* http://thomas.loc.gov/cgi-bin/query/z?c110:H.R.1424.enr:. See also our recent firm memorandum, *The Emergency Economic Stabilization Act of 2008: an Overview*, Oct. 13, 2008 (discussing selected provisions of the Emergency Economic Stabilization Act, including Section 133), *available at* http://www.cahill.com/news/memoranda/000116.

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."

Although SFAS 157 states that assets and liabilities should be valued using Level 1 and 2 inputs where possible, it acknowledges that if current market prices are determined as a result of "a forced liquidation or distress sale," unobservable inputs may be appropriate. Under circumstances in which compelled sales taking place in the market predominate, SFAS 157 permits issuers to value their assets and liabilities using Level 3 inputs. Indeed, this was the subject of a recent joint press release by the SEC and FASB staffs. On September 30, 2008, the SEC and FASB staffs issued guidance to clarify the application of SFAS 157-required fair value measurements and "mark to market" accounting principles as they relate to inactive markets.[6]

II. FSP FAS 157-3

On October 10, 2008, the FASB released FSP FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset is Not Active*. The guidance provided in this FSP is consistent with and amplifies the guidance contained in the September 30, 2008 joint press release by the SEC and FASB staffs. FSP FAS 157-3 addresses the following issues:

- How a reporting entity's expected cash flows and appropriately risk-adjusted discount rates should be considered when measuring fair value when relevant observable inputs do not exist;

- How available observable inputs in a market that is not active should be considered in determining fair value; and

- How the use of market quotes (for example, broker quotes or pricing services for the same or similar financial assets) should be considered when discerning the relevance of observable and unobservable inputs available to measure fair value.

FSP FAS 157-3 also attempts to clear up a potential misconception arising from the SEC and FASB joint statement. Specifically, some FASB board members were concerned that some people might have interpreted the SEC and FASB press release to say that if a market is disorderly, *all* sales are therefore necessarily distressed transactions. In FSP FAS 157-3, the FASB clarified that a determination that a given market transaction is a forced liquidation or distressed sale requires judgment at the *individual transaction* level. Additional key points of clarification and guidance provided in FSP FAS 157-3 include:

- When there is little, if any, market activity for an asset at the measurement date, the fair value measurement objective remains the same—the price that would be received by the holder of the financial asset in an orderly transaction that is not a forced liquidation or distressed sale.

- In determining fair value for a financial asset, use of a company's own assumptions about future cash flows and appropriately risk-adjusted discount rates is acceptable when relevant observable inputs are not available. In some cases, it is appropriate for an entity to determine that observable inputs require significant adjustment based on unobservable data. Regardless of the valuation technique used,

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6 *See SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting*, *available at* http://www.sec.gov/news/press/2008/2008-234.htm. In addition, see our recent firm memorandum, *SEC Office of the Chief Accountant and FASB Staff Issue Press Release Clarifying the Application of SFAS 157,* Oct. 2, 2008, *available at* http://www.cahill.com/news/memoranda/000113.

however, an entity must be sure to include appropriate risk adjustments that market participants would make for liquidity risks and nonperformance.

- Broker quotes or pricing service quotes may be appropriate inputs when measuring fair value in a market that is not active, but they are not necessarily determinative. In weighing a broker quote as an input to a fair value measurement, less reliance should be placed on quotes that are not reflective of actual market transactions. The nature of the quote (e.g., whether the quote is an indicative price or a binding offer) should also be considered.

FSP FAS 157-3 also amended SFAS 157 by adding an example to illustrate use of these key considerations when determining the fair value of a financial asset in inactive markets. This FSP became effective when issued on October 10, 2008, including for prior periods for which financial statements have not yet been issued.

III. The October 3, 2008 IASB Press Release

On October 3, 2008, the IASB issued a press release in which it announced the next steps it would take in response to the current credit crisis. The IASB noted that among other tasks, it would undertake to ensure consistency of fair value measurement guidance between International Financial Reporting Standards ("IFRS") and U.S. GAAP. In this vein, the IASB stated that it had reviewed the September 30, 2008 joint statement by the SEC and FASB providing guidance on fair market valuation in inactive markets, and considered it consistent with International Accounting Standard ("IAS") 39, *Financial Instruments: Recognition and Measurement*. The guidance provided by the SEC and FASB staffs was also consistent with the draft guidance put forth on September 16, 2008 by the IASB staff on fair value measurement of financial instruments in inactive markets.[7] The IASB expressed its commitment to continue to ensure that any IFRS guidance is consistent with the clarification provided by the SEC and FASB staffs for those companies using U.S. GAAP.

IV. The September 2008 SEC Letter Sent to CFOs

In an effort to promote accurate and transparent disclosure to investors, the SEC distributed letters in March 2008 to certain reporting companies suggesting information that they should consider including in the MD&A sections of their upcoming quarterly reports regarding assets and liabilities that were not being valued using observable market data.[8] With economic conditions continuing to deteriorate, the SEC sent another letter to approximately 30 CFOs of public companies in September 2008 setting forth additional considerations for disclosure when valuing certain assets using measures other than market prices.[9] The SEC stated that the

7 *See IASB Expert Advisory Panel: Measuring and Disclosing the Fair Value of Financial Instruments In Markets That Are No Longer Active (Draft)*, *available at* http://www.iasb.org/NR/rdonlyres/F309C029-84B4-4F1F-BFB6-886EE9922A42/0/Expert_Advisory_Panel_draft_160908.pdf

8 *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. Also see our firm memorandum, *Increase in Illiquid Financial Instruments on Issuers' Balance Sheets Prompts SEC Letters Regarding Fair Value Measurements*, Apr. 3, 2008 (discussing the March 2008 SEC letter).

9 *See also Testimony Concerning Transparency in Accounting, Proposed Changes to Accounting for Off-Balance Sheet Entities* (Sept. 18, 2008), *available at* http://www.sec.gov/news/testimony/2008/ts091808jww-jlk.htm (discussing the Sept. 2008 testimony of Division of Corporation Finance Director John White and SEC Deputy Chief Accountant James Kroeker on transparency in accounting given before the Senate Banking Committee. In their testimony, Messrs. White and Kroeker explained that the March 2008 and September 2008 letters that were sent to reporting company CFOs illustrated efforts to improve the transparency of financial reporting).

following additional considerations may be relevant to the reporting contained in public companies' MD&A disclosures:

- The significant judgments made in classifying a particular financial instrument in the fair value hierarchy;

- An explanation of how credit risk is incorporated and considered in the valuation of assets and liabilities;

- Disclosure of gains or losses on financial instruments that a company is *required* to carry at fair value and an explanation of:
    - how the company's credit risk affected the valuation of derivative liabilities and the resulting gain or loss that was included in earnings related to changes in that credit risk;
    - how counterparty credit risk affected the valuation of derivative assets and the resulting gain or loss that was included in earnings relating to changes in that credit risk;
    - how deterioration of the counterparty's credit combined with an inability to collect on a derivative asset would impact ensuing financial statements;

- Discussing the implications of items the company has *elected* to carry at fair value in the same section as the similar discussion pertaining to items that the company is *required* to carry at fair value;

- The criteria used to determine whether the market is inactive or active for a given financial instrument;

- Which financial instruments are affected by the inactivity, how the lack of liquidity impacts the valuation technique used, and how the company used illiquidity when determining fair value of those financial instruments; and

- The extent to which, and how, information is obtained and used from brokers or pricing services in developing fair value measurements.

The letter says executives should "continue to evaluate whether [they] could provide clearer and more transparent disclosure regarding [their] fair value measurements." The SEC is prodding companies to provide clear and full disclosure to justify their value measurements when economic conditions require that they value their securities using Level 3 inputs.

V. The Recent SEC Commencement of the Congressionally Mandated Study of "Mark-to-Market" Accounting

On October 7, 2008, the SEC commenced a study of the "mark-to-market" accounting standards required by SFAS 157. The study was authorized and mandated by Section 133 of the Emergency Economic Stabilization Act of 2008, signed into law on October 3, 2008.[10] Section 133 requires that the SEC, in consultation with the

[10] The Act was part of H.R. 1424 (Oct. 3, 2008). Text of the Act is available at http://thomas.loc.gov/cgi-bin/query/z?c110:H.R.1424.enr:.

Board of Governors of the Federal Reserve System and the Secretary of the Treasury, conduct a study of SFAS 157 mark-to-market accounting standards as they are applicable to financial institutions, including depository institutions. Section 133 mandates that the study shall consider at a minimum:

- the effects of such accounting standards on a financial institution's balance sheet;
- the impacts of such accounting on bank failures in 2008;
- the impact of such standards on the quality of financial information available to investors;
- the process used by the FASB in developing accounting standards;
- the advisability and feasibility of modifications to such standards; and
- alternative accounting standards to those provided in SFAS 157.

The SEC is required to submit a report of the study to Congress within 90 days of the enactment of the Emergency Economic Stabilization Act. The report should contain the findings and determinations of the SEC, including such administrative and legislative recommendations as the SEC deems appropriate.

The study is being spearheaded by SEC Deputy Chief Accountant James Kroeker and is expected to be completed by January 2, 2009. The SEC also announced that it will schedule public roundtables to gather input into the study from investors, accountants, standard setters, business leaders, and other interested parties. The first such roundtable has been scheduled for October 29, 2008. Further, the SEC is soliciting public comment related to the study. The public comment period will last 30 days from the date of publication of the request for comment in the Federal Register.

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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; Jon Mark at 212.701.3100 or jmark@cahill.com; or John Schuster at 212.701.3323 or jschuster@cahill.com.