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Capital Markets  
Accounting Developments  
Advisory 2008-3  
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## March 2008 SEC Letter Regarding MD&A Fair Value Disclosures

### Overview

In response to current market conditions, the SEC issued a letter to CFOs ("the Letter") recommending incremental fair value information and disclosures in the MD&A beyond the specific disclosures required by Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* ("FAS 157") (see Attachment).

The Letter was sent to companies that reported a significant amount of the following items in their most recent Form 10-K:

- asset-backed securities,
- loans carried at fair value or the lower of cost or market, and
- derivative assets and liabilities.

**FICG Observation:** The Letter indicates that, as a result of current market conditions, companies may need to use valuation models that require significant unobservable inputs for these items. The lack of significant observable inputs will require companies to classify these assets and liabilities as Level 3 measurements under FAS 157.

The Letter provides guidance only for MD&A disclosures. It does **not** modify FAS 157, nor does it provide any guidance or interpretation on the application of FAS 157, including the term "orderly transaction" or the phrase "unless those prices are the result of a forced liquidation or distress sale." Furthermore, the effective date of FAS 157 is not changed by the Letter.

The Letter acknowledges that current market conditions (i.e., lack of trading activity) may require the use of valuation models with significant unobservable inputs. However, it emphasizes that valuations should be based on management's assumptions of what market participants would use in pricing an asset or liability only when actual market prices or relevant observable inputs are not available. The SEC believes their view is consistent with the requirements of FAS 157 (see paragraphs 21 and 30).

Actual market prices, or observable inputs, should be considered even when the market is less liquid than historical market volumes. The only exception is when actual observed prices are the result of a forced liquidation or distress sale.

The emphasis of the use of market data is consistent with the requirements of FAS 157 regarding "orderly transactions" (see paragraphs 5 and 7) and the October 2007 Center for Audit Quality whitepaper entitled "Measurements of Fair Value in Illiquid (Or Less Liquid) Markets."

Companies should consider the CAQ whitepaper when determining whether a transaction constitutes a forced liquidation or distress sale.

The disclosures outlined in the Letter are consistent with what the SEC expects would be disclosed under Item 303 of Regulation S-K related to material trends, commitments, events and uncertainties that could reasonably be expected to have a material favorable or unfavorable impact on the entity's results of operations, liquidity, and capital resources.

### **Disclosures of Material Level 3 Assets and Liabilities**

The Letter highlights certain disclosure matters relating to FAS 157 and MD&A as companies prepare their Form 10-Q. Specifically, the Letter requests that companies explain the impact of management's judgments and use of unobservable inputs on the results of operations, liquidity, and capital resources.

The Letter suggests the following disclosures may be appropriate if material:

- Level 3 assets and liabilities as a percentage of total assets and liabilities measured at fair value,

- the amount and reason for any material increase or decrease in Level 3 items due to transfers between Levels of the FAS 157 hierarchy,
- additional information regarding asset-backed securities, including nature and type of collateral, vintage year, and credit rating,
- if a material amount of assets or liabilities was transferred into Level 3:
  - the inputs that are no longer considered observable,
  - the amount of any material gain or loss recognized on those assets or liabilities during the period, and
  - the amount, if any, of realized/unrealized gains (losses) excluded from the Level 3 reconciliation (roll forward), and
- for material Level 3 items, a discussion of:
  - the impact of realized and unrealized gains (losses) on operations, liquidity and capital resources,
  - the reason for any material decline or increase in the fair values, and
  - whether the company believes the reported fair values will diverge materially from the amounts currently anticipated to be realized on settlement or maturity and why.

***FICG Observation:*** Some companies use conventions for the Level 3 reconciliation and unrealized gains (losses) disclosures (see paragraphs 32c and 32d of FAS 157) that exclude the gains or losses recognized for items transferred into Level 3 during the period. The Letter states that the excluded amounts should be disclosed if material.

When companies believe the amounts anticipated to be realized on settlement or maturity are materially different than the fair values disclosed, the basis for such views should be disclosed.

### **Valuation Disclosures**

The Letter also suggests that the following disclosures be made for material items regardless of how the items are classified within the fair value hierarchy:

- Information regarding valuation techniques used, including descriptions and changes to the techniques during the period,

- information regarding the use of market indices as part of the valuation process, including adjustments made based on those indices,
- information regarding how valuation techniques are validated (e.g., through calibration or back testing),
- how changes in the fair value of assets and liabilities may affect liquidity and capital resources, and
- information on the sensitivity of the fair value estimates to significant inputs used, including a range of values, why the range is appropriate, the key drivers of variability, and how the inputs used in determining the range were developed.

***FICG Observation:*** The Letter acknowledges that current market conditions may lead to a wide range of fair value estimates for certain items. In those circumstances, companies should consider providing expanded disclosures, including sensitivity information.

The process used by many companies does not result in a range of values, and Companies are assessing how to best disclose useful information that explains the inherent judgments needed to estimate fair value in the current markets.

### Questions

Questions regarding this Advisory, financial instruments, or credit in general may be directed to:

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## **Attachment: Sample Letter Sent to Public Companies on MD&A Disclosure Regarding the Application of SFAS 157 (Fair Value Measurements)**

In March 2008, the Division of Corporation Finance sent the following illustrative letter to certain public companies identifying a number of disclosure issues they may wish to consider in preparing Management's Discussion and Analysis for their upcoming quarterly reports on Form 10-Q.

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March 2008

Name  
Chief Financial Officer  
XYZ Corporation  
Address

Dear Chief Financial Officer:

Item 303 of Regulation S-K requires you to discuss, in your Management's Discussion and Analysis, any known trends or any known demands, commitments, events or uncertainties you reasonably expect to have a material favorable or unfavorable impact on your results of operations, liquidity, and capital resources.

We note that you reported a significant amount of asset-backed securities, loans carried at fair value or the lower of cost or market, and derivative assets and liabilities in your financial statements in your recent Form 10-K.

Statement of Financial Accounting Standards No. 157, Fair Value Measurements, defines fair value, provides a framework for you to measure the fair value of your assets and liabilities, and requires you to provide certain disclosures about those measurements.

Fair value assumes the exchange of assets or liabilities in orderly transactions. Under SFAS 157, it is appropriate for you to consider actual market prices, or observable inputs, even when the market is less liquid than historical market volumes, unless those prices are the result of a forced liquidation or distress sale.

Only when actual market prices, or relevant observable inputs, are not available is it appropriate for you to use unobservable inputs which reflect your assumptions of what market participants would use in pricing the asset or liability.

Current market conditions may require you to use valuation models that require significant unobservable inputs for some of your assets and liabilities. As a consequence, as of January 1, 2008, you will classify these assets and liabilities as Level 3 measurements under SFAS 157.

In this letter, we highlight some disclosure matters relating to SFAS 157 that you may wish to consider as you prepare your Form 10-Q. Given the judgment you must apply in using unobservable inputs to determine the fair value of your assets and liabilities, your use of them can have a material effect on your results of operations, liquidity, and capital resources, where for example, the fair value you determined falls within a broad range.

If you conclude that your use of unobservable inputs is material, please disclose in your MD&A, in a manner most useful to your particular facts and circumstances, how you determined them and how the resulting fair value of your assets and liabilities and possible changes to those values, impacted or could impact your results of operations, liquidity, and capital resources.

Depending on your circumstances, the following disclosure and discussion points may be relevant as you prepare your MD&A:

- The amount of assets and liabilities you measured using significant unobservable inputs (Level 3 assets and liabilities) as a percentage of the total assets and liabilities you measured at fair value.
- The amount and reason for any material increase or decrease in Level 3 assets and liabilities resulting from your transfer of assets and liabilities from, or into, Level 1 or Level 2.
- If you transferred a material amount of assets or liabilities into Level 3 during the period, a discussion of:
  - the significant inputs that you no longer consider to be observable; and
  - any material gain or loss you recognized on those assets or liabilities during the period, and, to the extent you exclude that amount from the realized/unrealized gains (losses) line item in the Level 3 reconciliation, the amount you excluded.

- With regard to Level 3 assets or liabilities, a discussion of, to the extent material:
  - whether realized and unrealized gains (losses) affected your results of operations, liquidity or capital resources during the period, and if so, how;
  - the reason for any material decline or increase in the fair values; and
  - whether you believe the fair values diverge materially from the amounts you currently anticipate realizing on settlement or maturity. If so, disclose why and provide the basis for your views.
- The nature and type of assets underlying any asset-backed securities, for example, the types of loans (sub-prime, Alt-A, or home equity lines of credit) and the years of issuance as well as information about the credit ratings of the securities, including changes or potential changes to those ratings.

Regardless of how you have classified your assets and liabilities within the SFAS 157 hierarchy, if you have not already done so in your Form 10-K, consider providing the following additional information in your MD&A:

- A general description of the valuation techniques or models you used with regard to your material assets or liabilities. Consider describing any material changes you made during the reporting period to those techniques or models, why you made them, and, to the extent possible, the quantitative effect of those changes.
- To the extent material, a discussion of the extent to which, and how, you used or considered relevant market indices, for example ABX or CMBX, in applying the techniques or models you used to value your material assets or liabilities.

Consider describing any material adjustments you made during the reporting period to the fair value of your assets or liabilities based on market indices and your reasons for making those adjustments.

- A discussion of how you validate the techniques or models you use. For example, you may wish to discuss whether and how often you calibrate the technique or models to market, back-test, or otherwise validate it.

- A discussion of how sensitive the fair value estimates for your material assets or liabilities are to the significant inputs the technique or model uses.

For example, consider providing a range of values around the fair value amount you arrived at to provide a sense of how the fair value estimate could potentially change as the significant inputs vary.

To the extent you provide a range, discuss why you believe the range is appropriate, identifying the key drivers of variability, and discussing how you developed the inputs you used in determining the range.

You may wish to refer to Section V of FR-72 "Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations" on Critical Accounting Estimates for guidance. FR-72 is available on our website at <http://www.sec.gov/rules/interp/33-8350.htm>.

- If material, a discussion of how increases and decreases in the aggregate fair value of your assets and liabilities may affect your liquidity and capital resources.

Please contact me if you have any questions.

Sincerely,

Senior Assistant Chief Accountant

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This letter is available at:

<http://www.sec.gov/divisions/corpfin/guidance/fairvalueltr0308.htm>