SEC Advises Registrants to Further Explain Fair Value in MD&A

Financial Reporting Alert 08-7

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Recently, the SEC's Division of Corporation Finance sent a letter to certain financial institutions concerning additional MD&A disclosure considerations regarding fair value for their upcoming filings on Form 10-Q. While the letter was sent only to financial institutions, we understand that the SEC staff has indicated that the letter "can be applicable to any company."

The letter reminds registrants that have significant amounts of financial instruments to consider the SEC's requirements for disclosures in Management's Discussion and Analysis (MD&A). Regulation S-K, Item 303,[1] requires registrants, among other things, to discuss in their periodic filings any known trends or any known demands, commitments, events, or uncertainties that the registrants reasonably expect to have a material impact, either favorable or unfavorable, on their results of operations, liquidity, or capital resources. A sample letter is available on the SEC's Web site.

Context for the SEC Staff Letter

This letter is in response to the challenges, resulting from current market conditions, in determining the fair value of certain financial instruments, such as asset-backed securities, loans carried at fair value or lower of cost or market (fair value), credit default swaps, and other derivative assets and liabilities. Because of the decline in or disappearance of liquidity in some markets, judgment has become increasingly important in estimating fair values. In addition, there may be a broader range of reasonable fair value estimates for some financial instruments. As a result, judgments may materially affect a registrant's reported results of operations, liquidity, or capital resources.

Most registrants have adopted FASB Statement No. 157, *Fair Value Measurements,* as of January 1, 2008, for financial instruments. This Statement provides a framework for determining fair value and includes detailed disclosure requirements for fair value measurements, including requirements to annually[2] describe the valuation techniques used to measure fair value and to categorize all fair value measurements into a hierarchy that contains the following three levels:

- Level 1 — Measurements that are based on quoted prices (unadjusted) in active markets.
- Level 2 — Measurements that are primarily based on observable market information.
- Level 3 — Measurements that use significant unobservable inputs.

Statement 157 requires additional disclosures for Level 3 measurements, including a reconciliation for recurring measurements of beginning and ending balances for the period (i.e., a rollforward from the previous period to the end of the current period) and total unrealized gains and losses reported for the period, and a description of the inputs and the information used to develop the inputs for all nonrecurring measurements.

While the Statement 157 disclosures provide financial statement users with detailed information about fair value measurements, the SEC expects that its suggested MD&A disclosures will offer additional insight into registrants' fair value measurements of financial instruments.

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1 SEC Regulation S-K, Item 303, "Management's Discussion and Analysis of Financial Condition and Results of Operations."

2 Statement 157 also requires these disclosures in the first interim period in which this Statement is applied. In addition, in the year of adoption of a new accounting pronouncement, SEC registrants are required to carry forward all disclosures (annual and interim) in their filings on Form 10-Q through the end of the year of adoption.

Contact us for more information

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