Client Alert

Corporate and Securities

Pillsbury Winthrop Shaw Pittman LLP

Vol. 0804, No. 8045

Off-Balance Sheet Arrangements Report and Recommendations of the SEC

June 30, 2005

On June 15, 2005, the Securities and Exchange Commission ("SEC") released a staff report on off-balance sheet arrangements, special purpose entities and related issues pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 ("SOX"). SOX Section 401(c) mandates that the SEC study issuer filings and issue a report regarding the extent of off-balance sheet arrangements and whether current issuer financial statements are transparent and reflect the economics of off-balance sheet arrangements. The SEC staff report describes the results of a study conducted by the SEC staff of issuer filings in connection with off-balance sheet arrangements and provides goals and recommendations for improved transparency in financial reporting.

Summary of SEC Staff Report

- The SEC set goals for parties involved in financial reporting, focused on ensuring that financial disclosure becomes more reflective of underlying economics; and
- The SEC recommended changes in accounting and reporting requirements intended to achieve more transparent and useful financial disclosure.

What this Means for Public Companies

- **Be aware of possible future changes in off-balance sheet arrangement disclosure.** The SEC's report and recommendations may lead to changes in rules governing the way in which companies disclose off-balance sheet arrangements, such as transfers of financial assets with continuing involvement, retirement arrangements, leases and derivatives.

Overview of SEC Staff Report

Section 401(c) of SOX, which mandates that the SEC conduct a study of off-balance sheet transactions and the use of special-purpose entities, was prompted in part by the major corporate accounting scandals of 2001 and 2002, particularly Enron's collapse and the subsequent discovery of significant liabilities not reflected on its balance sheet. For example, Enron's 2001 third quarter financial statement reported debt of approximately $13 billion. On the same day, however, Enron informed its bankers that its actual debt totaled approximately $38 billion. Although there have been improvements in the financial reporting regime since the passage of SOX, the SEC staff report released on June 15, 2005 identifies new

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goals and recommendations for further improving disclosure related to off-balance sheet arrangements. This report is advisory in nature, and there is no indication thus far of the likelihood or timeframe of implementation of the goals and recommendations expressed in the report.

The SEC staff report sets several goals that it believes are important to increasing transparency and improving the quality of financial reporting, including the following:

- **Discouraging transaction structures motivated by accounting considerations rather than economics.** The SEC is concerned that financial reporting for transactions often reflects the form of the transactions rather than the underlying economics of those transactions, thereby rendering the information less transparent and credible to investors. The SEC notes that it has recently entered into settlements totaling hundreds of millions of dollars with various companies that developed or facilitated such transaction structures.
- **Expanded use of objective-oriented standards.** The SEC would like the Financial Accounting Standards Board (the "FASB") to develop objective-based standards rather than rules-based standards going forward in order to lower compliance costs, enhance transparency and reduce necessity for long and complex guidance.
- **More consistent and relevant disclosure.** The SEC notes that disclosure quality varies greatly from one issuer to the next, and would like all issuer disclosure to provide a complete and meaningful picture for investors. The SEC staff report states that, in addition to basic financial statements, further disclosures are required to enhance the usefulness of financial reporting.
- **Reporting focused more on investor communication.** The SEC prefers that issuers focus more on effectively communicating with investors through their reporting, rather than merely achieving technical rule compliance. Similar to the SEC's "plain English" initiative in 1998, the SEC is now emphasizing that financial and business information must reach investors in a form that is clear and understandable.

The SEC staff report also provides recommendations for changes in accounting and reporting standards, including the following:

- **Reconsideration of accounting standards for leases.** Current lease accounting standards rely on bright line tests causing leases to be structured based on accounting standards and increasing potential for similar lease arrangements to be accounted for differently. The SEC estimates that there may be approximately $1.25 trillion in non-cancelable future cash obligations under operating leases that are not recognized on U.S. issuer balance sheets, but instead are only disclosed in financial statement notes. The SEC suggests that the FASB study and reconsider accounting standards for leases in connection with the International Accounting Standards Board (the "IASB").

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- **Reconsideration of accounting standards for defined-benefit retirement arrangements.** Presently, accounting for defined-benefit pension plans can vary depending on how a company structures its plan, potentially resulting in netting of assets and liabilities on the balance sheet and optional delayed recognition of certain gains and losses. The SEC estimates that there may be approximately $535 billion in retirement obligations that are not recognized on U.S. issuer balance sheets. The SEC recommends that the FASB study and reconsider pension accounting in connection with the IASB.
- **Additional guidance on consolidation policy.** Whether a company consolidates the financial statements of other entities into its own financial statements hinges on the concept of control. The FASB once explored and abandoned replacing legal control with "effective control" as the trigger, instead issuing Interpretation 46(R) with a consolidation test for special purpose entities. The SEC notes that new structures have emerged to work around the Interpretation 46(R) guidance, and suggests that the FASB consider the "effective control" standard again.
- **Continued exploration of fair value reporting of all financial instruments.** The SEC notes that certain balance sheet items are reported at historical cost and others at fair market value, prompting accounting-motivated transaction structures. The SEC plans to promote discussion about increased use of fair value reporting.
- **Development of a disclosure framework.** The SEC observes that the notes to financial statements vary widely from one issuer to the next, and suggests that the FASB develop a disclosure framework for use in determining the contents of notes to financial statements, incorporating recent guidance from the IASB, with the goal of having more useful, organized and consistent disclosure.

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