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OFF-BALANCE SHEET DISCLOSURES IN MD & A

Complying with Sarbanes-Oxley, the SEC Has Issued Final Rules Requiring MD & A Disclosure of Off-Balance Sheet Arrangements that Are Least Reasonably Likely to Have a Current or Future Material Effect on a Registrant's Business. The required Disclosures Include the Nature and Purpose of Such Arrangements, Their Benefits, and Potential Risks.

By Marc Morgenstern*

The corporate and securities worlds were dramatically altered by The Sarbanes-Oxley Act of 2002.[1] Its laudable goal (though not necessarily its result) was to restore investor confidence in the public marketplace after the emotional and financial devastation stemming from the Enron and other public company scandals. The Sarbanes-Oxley Act and the rules stemming from it are complex and highly interrelated, and affect all public companies, their directors, lawyers, and accountants.

Section 401(a)(j) of Sarbanes-Oxley mandated the Securities and Exchange Commission to issue final rules providing that each annual and quarterly financial report filed with the SEC disclose all "material" off-balance sheet arrangements.[2] In fulfillment of this mandate, the SEC issued proposed rules for comment in November, 2002, and final rules[3] (the "Final Rules" or the "2003

1. P.L. 197-204, 116 Stat. 745.

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2. *Id.* at §401(a)(j); *see also* Rel. No. 33-8182 (2003) [hereinafter, "Off-Balance Sheet Release."] The Sarbanes-Oxley Act's definition is modestly different from the SEC's definition of off-balance sheet arrangements. Compare Sarbanes-Oxley, 15 U.S.C. § 78m(j) with Regulation S-K, 17 C.F.R. 229.303(a)(4).
3. These new requirements became effective for fiscal years ended after June 15, 2003. Companies (other than small business issuers) must also include specified, detailed tables in numerous filings or reports for fiscal years ending on or after December 15, 2003. A "small business issuer" means any entity that: (1) has annual revenues of less than $25,000,000; (2) is a U.S. or Canadian issuer; (3) is not an investment company; and (4) if a majority-owned subsidiary, has a parent corporation that is also a small business issuer. 17 C.F.R. §228.10(a)(1). An entity is *not* a small business issuer if the aggregate market value of its outstanding equity securities held by non-affiliates is $25,000,000 or more. Off-Balance Sheet Release, at 115; 17 C.F.R. § 228.10. The definition of "small business issuer" is extremely rigid, and so limited that it appears to apply only to a relative handful of "pink sheet" and other thinly traded stocks. The disclosure requirements for small business issuers are set forth in Regulation S-B, 17 C.FR. §228.10 *et. seq.* Of the S-B

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Rules") in January, 2003 governing the Management's Discussion and Analysis ("MD&A") disclosure of "off-balance sheet arrangements." Technically this was achieved by amending Section 303(a) of Regulation S-K.[4] Overall, the threshold for disclosure (although not the format) is consistent with existing MD&A rules and interpretations, and retains important materiality filters. The SEC has indicated that it regards at least portions of the Final Rules as either merely codifying its views of existing MD&A requirements, or causing disclosure of information already contained in the footnotes to a registrant's financial statements. The 2003 amendments continue to reflect the SEC's emphasis on the importance of MD&A and its centrality in an integrated disclosure system.

Off-balance sheet transactions include a registrant's relationship with unconsolidated entities or other persons that either have (or are reasonably likely to have) a "material *current* or *future*" effect on the issuer's "financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses."[5] Such arrangements are routinely used to minimize or reduce the financial risk and/or exposure of a company or other third parties. Common examples include accounts receivable financing, synthetic leases and other real estate monetizations, parent guarantees of subsidiary debt, indemnification agreements, and derivatives.

MD&A has long played a critical role in required disclosures for various reports and registration statements filed with the Commission.[6] The analysis is expected to be a "narrative explanation" of the financial statements as seen through the eyes of management.[7] Historically, the SEC's instructions regarding MD&A have been intention-

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rules requirements generally, which purport to (but do not) provide significant relief and lowered costs to small issuers, Richard Leisner from the Trenam Kemker law firm once trenchantly observed that "S-B is nothing more than S-K Lite."

4. Regulation S-K is found at 17 C.F.R. § 229.10 *et seq.*
5. Off-Balance Sheet Release (emphasis added).
6. Amy Bowerman and Steven L. Hawrof et al., *Management's Discussion and Analysis of Financial Conditions and Results of Operations*, ALI-ABA Course of Study, SH030 ALI-ABA 269, 269 (April 24-24, 2003). MD&A is required disclosure in reports and registration statements under the Exchange Act (Forms 10-K, 10-Q, 10-KSB and 10-QSB) and registration statements under the Securities Act (Forms S-1, S-2, S-4, S-11, and SB-2). 17 C.F.R. § 229.10(a) (setting forth application of Regulation S-K).
7. Rel. No. 33-6835(1989) [hereinafter, the "Interpretive Release"]. In May, 2003, *SEC Commissioner Alan L. Beller indicated the SEC's intention to promulgate additional comprehensive interpretive guidance on MD&A disclosure. SEC to Offer Guidance on Improving Reports*, (May 7, 2003) available at http://securities.stanford.edu/news-archive/2003/20030507_headline06_staff.htm (last visited December 10, 2003). To date, the SEC has issued no such interpretive guidance.

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ally general with the expressed goal of encouraging more meaningful disclosure and avoiding boilerplate discussions.[8] As characterized by the SEC:

> The MD&A requirements are intended to provide, in one section of a filing, material historical and prospective textual disclosure enabling investors and other users to assess the financial condition and results of operations of the registrant, with particular emphasis on the registrant's prospects for the future.[9]

Item 303 of S-K delineates the basic requirements for MD&A,[10] while additional guidance has been provided through periodic SEC interpretive releases as well as the more drastic lessons learned from observing the consequences of SEC enforcement actions, including the landmark 1992 enforcement action against Caterpillar, Inc.[11]

Despite the significant furor arising from the 2003 Rules, the concept of disclosing off-balance sheet transactions is not new.[12] The rules (and amended Item 303(a)) do, however, provide some clarification and considerable detail about presentation and format.[13] The combination represents further integration of disclosure between the numerical and financial information contained in a public company's financial statements and the MD&A narrative and analysis contained in the text of its public filings.[14] Consistent with the SEC's drive for plain English, transparency, and comprehensibility, the new required information must be presented so that a broad range of investors in the public markets (rather than only financial analysts, industry experts, or accountants) can understand the disclosure.

In many ways, the amended MD&A disclosure requirements are simply the logical consequence of the SEC's long-term evolution to a fully integrated disclosure system. From this perspective, the Final Rules merely accelerate a well-established evolutionary trend. One significant consequence of such acceleration is that, for better or worse, the concept of an "off-balance" sheet transaction is now sharply restricted for public companies. Facts about off-balance sheet financings and arrangements must now be effectively integrated with traditional "on-bal-

8. Indeed, "boiler plate rhetoric may generate SEC review." Quinton F. Seamons et al., *Requirements and Pitfalls of MD&A Disclosure*, 11 No. 8 INSIGHTS 9, 9 (August, 1997).
9. Interpretive Release.
10. 17 C.F.R. § 229.303.10 *et. seq.* The MD&A discussion "shall provide information . . . with respect to liquidity, capital resources and results of operations and also shall provide such other information that the registrant believes to be necessary to an understanding of its financial condition, changes in financial condition and results of operations."
11. *In re Caterpillar, Inc.*, Rel. No. 34-30532 (1992). This enforcement action was particularly noteworthy because it was the first action predicated entirely on inadequate MD&A disclosures. The SEC's allegations focused upon Caterpillar's failure to disclose: (1) the over-reliance of Caterpillar on its Brazilian subsidiary, and (2) the *future* impact of a known certainty, *i.e.*, significant economic reforms proposed by Brazil's new president elect. *Id.*
    Brazil's new president was elected in December 1989. At a board meeting held in mid-February of 1990, less than two weeks before filing its 1989 10-K, Caterpillar's directors were told that Brazil was "volatile" and that the situation might significantly reduce projected results for 1990. In its 10-K Caterpillar noted only that "sales in Brazil . . . could be hurt by post-election policies which will likely aim at curbing inflation." The SEC found this disclosure to be inadequate and, despite the tight time frame involved with Caterpillar, emphasized that companies must have "adequate procedures" in place to identify and analyze material trends in a timely fashion.
    The SEC did not elaborate on what these "adequate procedures" would entail. In a recent SEC enforcement action, the SEC observed that issuer Edison Schools had not "implemented an adequate system of internal controls" and did not properly maintain books and records to prevent MD&A disclosure inaccuracies. Among other things, Edison Schools was ordered to
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    establish an internal audit function that did not previously exist. *In re: Edison Schools, Inc.*, Rel. No. 45925 (2002). In a final rule issued on June 5, 2003, the SEC promulgated regulations relating to the requirements of certain reporting companies to include in their annual report a report outlining management's internal control over the financial reporting of the company. Rel. No. 33-8238 (2003).
12. The SEC's view is that the new Off-Balance Sheet disclosure requirements will not impose significantly greater disclosure requirements than already exist. "We believe that registrants already must collect the information required by the amendments in order to prepare their financial statements, meet their existing disclosure requirements and to maintain adequate internal controls." Off-Balance Sheet Release.
13. Perhaps not surprisingly, the increased precision of MD&A disclosure required or proposed by the SEC over the years has been met with criticism by commentators, who argue that the new disclosure regime will result in longer, more complex, MD&A disclosures accomplishing little besides obscuring the information that is actually material to investors.
14. After the financial statements themselves, MD&A is generally considered the most important portion of an issuer's disclosure. *See* Linda C. Quinn and Ottilie L. Jarmel, *MD&A 2002: Linchpin of SEC Post-Enron Disclosure Reform*, 1364 PLI/Corp. 105 (2003) (citing Remarks of Alan L. Beller, Director, SEC Division of Corporate Finance before the Rocky Mountain Securities Conference (May 17, 2002)).

ance" sheet disclosures.[15] The required integration is both complex and extensive.

At the same time, however, the 2003 Rules consistently and repeatedly demonstrate the SEC's commitment to the "principles-based" approach found in current MD&A rules, so that "insignificant" and "unnecessarily speculative" information should be omitted from MD&A.[16] Accordingly, the Final Rules *only* require disclosure of an off-balance sheet arrangement "to the extent necessary" to obtain an understanding of the off-balance sheet arrangements and their *material* effects on the company's business.

The vocabulary needed to comply with the MD&A requirements, already distinctive, has become even more esoteric. The rules themselves involve an increasingly interdisciplinary interplay between "accounting" and "legal" concepts. Traditional financial statement standards and sources are heavily used (*i.e.*, GAAP, SEC Staff Accounting Bulletins, Financial Accounting Standards Board Statements, and FASB Interpretive Releases). There are also significant "legal" sources of guidance, such as Sarbanes-Oxley, and SEC rules, regulations, and releases.

After briefly discussing the recent SEC releases serving as a prelude to the 2003 Rules, this article discusses the costs, compliance obligations, and MD&A mandated formatting changes created by the 2003 Rules (particularly from the perspective of mid-cap issuers), and also addresses practices and concerns under the new rules.

15. In a parallel effort to fully reflect a company's liabilities on its balance sheet, the Financial Accounting Standards Board issued an action in May, 2003, requiring companies to classify certain types of preferred securities (such as "mandatorily redeemable" or "trust preferred" stock) as liabilities. Previously companies had routinely classified such arrangements in the "mezzanine" sections of their balance sheets, which is a sort of "no-man's land" between debt and equity. The net impact will be to reduce companies' net worth and adversely affect their debt-equity ratios. FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characterizations of Both Liabilities and Equity* (May, 2003); *see also* Michael Rapoport and Jonathan Weil, *More Truth-in-Labeling for Accounting Carries Liabilities*, the Wall Street Journal, August 28, 2003, at C-1.
16. *See* Off Balance Sheet Release ("We believe that the "reasonably likely" threshold best promotes the utility of disclosure requirements by reducing the possibility that investors will be overwhelmed by voluminous disclosure of insignificant and possibly unnecessarily speculative information.")

PRELUDE TO THE 2003 RULES

Following the collapse of Enron, renewed emphasis was placed upon corporate disclosure, including the adequacy of MD&A disclosures. In December 2001, the SEC issued a statement offering "cautionary advice" to issuers regarding the disclosure of critical accounting policies in connection with MD&A disclosures.[17] Specifically, the SEC advised companies that they should:

(1) be able to defend the quality and reasonableness of selected accounting policies and procedures, and

(2) include in their MD&A a balanced explanation of the effects of their critical accounting policies, as well as the likelihood of materially different reported results under different assumptions and conditions.

According to the SEC, "the selection and application of the company's accounting policies must be appropriately reasoned."

In January, 2002, the Commission issued a statement noting the need for improved MD&A disclosure in three specific areas: (1) liquidity and capital resources; (2) trading activities involving non-exchange traded contracts accounted for at fair value; and (3) related party transactions.[18]

In May, 2002, the SEC proposed revised MD&A requirements to promote "higher-quality, more insightful, financial information."[19] Specifically, the proposal would have required disclosure: (1) concerning the methodology, assumptions, and decision-making process underlying any "critical" accounting estimates, and (2) regarding the process underlying the initial adoption of an accounting policy that had a material impact on a company's financial condition.[20]

17. Rel. No. 33-8040 (2001).
18. *See* Rel. No. 33-8056 (2002).
19. *See* Rel. No. 33-8098 (2002).
20. Not unpredictably, opinions were expressed by lawyers, accountants, and public companies that the Proposed Rules were too mechanical, overly burdensome, and would confuse investors with an over-abundance of disclosure. *See, e.g.*, Comment Letter of former SEC Commissioner Joseph A. Grundfest dated August 20, 2002, in Response to Rel. No. 33-8098, *available at* http://www.sec.gov/rules/proposed/s71602/grundfest.01.htm (last visited December 10, 2003) (collective effort of Stanford Law School professor of securities law and lawyers practicing in the Silicon Valley area).

All of this served as the predicate for the 2003 Rules.

THE FINAL RULES

On January 22, 2003, the SEC issued the Off-Balance Sheet Release and amended Item 303(a) of Regulation S-K to require MD&A disclosure of off-balance sheet arrangements.[21] The definition of "off-balance sheet arrangements" incorporated certain existing GAAP concepts to require disclosure of four types of arrangements:

1. certain guaranties;[22]
2. retained or contingent liabilities;[23]
3. certain derivative instruments;[24] and
4. variable interests.[25]

Unlike the 2002 Proposed Rules, the 2003 Rules only require disclosure of off-balance sheet arrangements that either have (or are "reasonable likely" to have) a current or future material effect on a registrant's "financial condition, changes in financial condition, revenues and expenses, results of operations, liquidity, capital expenditures and capital resources."[26] In implementing this standard, the SEC rejected the more demanding standard set forth in the proposed rules, which would have required disclosure unless "the likelihood of either the occurrence of an event implicating an off-balance sheet arrangement, or the materiality of its effect, is remote."[27] The Commission has consistently expressed its view that the "reasonably likely" standard requires the disclosure of less information than would have been the case had the proposed rule been enacted.[28] Hindsight analysis based on what actually happened (and when it happened) always colors the disclosure "probability analysis" that occurs in the real world in real time.

The disclosure of off-balance sheet arrangements must now be presented in a separate section of MD&A.[29] The information to be disclosed in this section includes:

1. the nature and business purpose of the off-balance sheet arrangement;
2. the benefits of the off-balance sheet arrangement;
3. any event, trend or other contingency that is reasonably likely to result in the termination of the off-balance sheet arrangement; and

21. Rel. No. 33-8182 (2003). Registrants must comply with the majority of the disclosure requirements of the Off-Balance Sheet Release in registration statements, annual reports, and proxy or information statements for their fiscal years ending on or after June 15, 2003.
Also on January 28, 2003, the SEC issued final rules concerning "Conditions for Use of Non-GAAP Financial Measures," resulting in new Regulation G and new Item 10 of Regulation S-K. *See* Regulation G, 17 C.F.R. Part 244. Regulation G is expected to have a "substantial impact" on the MD&A disclosures of those companies that include non-GAAP information in their SEC filings. It is not, however, addressed in this article.
22. The Off-Balance Sheet Release requires disclosure of any guarantee contract that has any of the characteristics identified in paragraph 3 of FASB Interpretation No. 45, but also notes that "paragraphs 6 and 7 of FASB Interpretation No. 45 exclude certain guarantee contracts from the recognition and measurements provisions of FASB Interpretation No. 45."
23. FASB Interpretation No. 5 (discussion of contingent gains and losses).
24. The regulations require disclosure of any obligation under a contract that is both indexed to the registrant's own stock and classified in stockholder's equity in the registrant's statement of financial position, and therefore excluded from the scope of FASB Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities (June 1998).
25. *See* FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* (January 2003) (defining "variable interest" as a contractual, ownership or other pecuniary interest in an entity that changes with changes in the entity's net asset value"). On October 31, 2003, FASB issued a proposed modification to FASB Interpretation No. 46 clarifying what constitutes a variable interest entity. *See* FASB News Release, *FASB Publishes Exposure Draft on Consolidation of Variable Interest Entities* (October 31, 2003), available at http://www.fasb.org.news (last visited December 10, 2003). Comments to the proposed modification were due December 1, 2003. Revised FASB Interpretation was published on December 24, 2003 and applies to financial statements for most public entities for periods ending after March 15, 2004.
26. Off-Balance Sheet Release. The 2003 Rules do not require disclosure of preliminary off-balance sheet arrangements. Disclosure is required only upon either: (1) the execution of a contract or (2) when settlement occurs.
27. The SEC chose to apply the "reasonably likely" disclosure threshold because it "best promotes the utility of the disclosure requirements" by using consistent disclosure thresholds throughout MD&A and reducing the likelihood of "insignificant and possibly unnecessarily speculative information." The SEC acknowledged, but disagreed with, the views of commentators who felt that the "reasonably likely" threshold would be difficult to apply, and confusing, and would yield voluminous disclosures not important to investors.
28. Former SEC Commissioner Edward H. Fleischman has stated that the "reasonably likely" standard means a 40% or more probability of occurrence. *Fleischman Addresses MD&A Issues Before Southern Securities Institute*, THE SEC TODAY, Vol. 91-51 (March 15, 1991).
29. 17 C.F.R. § 229.303(a)(5).

4. the potential material risks arising from the off-balance sheet arrangement.[30]

Sharpened attention is also now drawn to internal or external events that can trigger contingent and off-balance sheet liabilities, as well as adverse factors such as credit rating downgrades that may result in the company's inability to obtain or retain its off-balance sheet arrangements.

In all cases, disclosure is only required "to the extent necessary to an understanding of a registrant's off-balance sheet arrangements."[31] As stated by the SEC:

> The [2003 Rules] contain a *principles-based* requirement stating that a registrant must provide other information that it believes to be necessary for an understanding of its off-balance sheet arrangements and the *material effects* of these arrangements on its financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources. The disclosure should provide investors with management's insight into the *impact and proximity* of the potential material risks that are *reasonably likely* to arise from material off-balance sheet arrangements.[32]

Many companies use asset securitizations (such as accounts receivable financing) to generate cash and enhance their liquidity and capital resources. If securitization of receivables occurs under a conventional secured credit facility, the financial impact will generally already be disclosed on a registrant's balance sheet. A securitization that arises in a separate off-balance sheet "sale" to a single-purpose (frequently bankruptcy-remote) vehicle, by contrast, will be accounted for as an off-balance sheet transaction. To the extent that such financings form a component of a registrant's liquidity and capital resources, companies must now disclose the frequency of such financings, the financings' relative importance as a source of company liquidity, analyze the changes in the amounts of such financings, and explain any material increase or decrease.

A key disclosure is the extent to which any off-balance sheet financing *transfers* capital risk from the registrant to another entity, as well as disclosing the extent of the capital risk that is *retained* by the registrant. Parent corporations frequently must provide direct financial support to induce an independent third-party financing source to enter into an off-balance sheet arrangement with a single-purpose entity specifically formed by the registrant to enter into the transaction. Depending on GAAP treatment, a parent corporation's balance sheet may not currently fully reflect such retained contingent liabilities; thus, the full risk borne by the registrant is not transparent to investors. As an example, in many receivable financing securitizations, the company selling the resceivables retains a contractual obligation to reimburse the financing source within specified limits if transferred receivables are not ultimately collected. Under the 2003 Rules the amount of the retained liability would generally be required to be reflected in MD&A, thereby increasing transparency.

Item 303(a)(5) of the Final Rules requires companies (except "small business issuers"[33]) to show in a new tabular format the amounts of payments due under certain contractual obligations for specified time periods.[34] The SEC's rationale is that "aggregate[ing] information about a registrant's contractual obligations in a single location will provide useful context for investors to assess a registrant's short- and long-term liquidity and capital resource needs and demands."[35] The tabular disclosure format is also expected to improve investors' ability to consistently compare the financial results of different registrants. The table must appear in all annual reports but does not have

30. Off-Balance Sheet Release, at 14-16.
31. *Id.* at 14.
32. *Id.* (emphasis added).
33. With respect to smaller issuers, the SEC observed that "section 401(a) of The Sarbanes-Oxley Act does not distinguish between small entities and other companies." Off-Balance Sheet Release (emphasis added). Nevertheless, because the tabular format disclosure was not explicitly required by Sarbanes-Oxley, the SEC concluded that "excluding small business issuers from this requirement would reduce their regulatory burden." *Id.*
34. Off-Balance Sheet Release, at 17-18. Examples of types of contractual obligations specified in Regulation S-K and the Off-Balance Sheet Release are "Long-Term Debt Obligations," "Capital Lease Obligations," "Operating Lease Obligations," "Purchase Obligations," and other "Long-Term Liabilities" reflected on the registrant's balance sheet under GAAP. 17 C.F.R. § 229.303(a)(5); Off-Balance Sheet Release. A company may "disaggregate the specified categories of contractual obligations using other categories suitable to its business," provided that the table discloses all of the information required by the defined categories. *Id.*
35. Off-Balance Sheet Release, at 17.

to be in *quarterly* filings unless material changes in categories outside of the ordinary course of business occurred during the quarter.

The table must disclose the total amount of payments due under each type of contractual obligation, as well as payments due by time period, and must appear in substantially the following format:[36]

CONTRACTUAL OBLIGATIONS	TOTAL	LESS THAN 1 YEAR	1-3 YEARS	3-5 YEARS	MORE THAN 5 YEARS
Long-Term Debt Obligations					
Capital Lease Obligations					
Operating Lease Obligations					
Purchase Obligations					
Other Long-Term Liabilities Reflected on the Registrant's Balance Sheet under GAAP					
Total					

Compliance with these disclosure requirements is facilitated because Long-Term Debt Obligations, Capital Lease Obligations, Operating Lease Obligations, and other Long-Term Liabilities are existing GAAP concepts. Financial statements already require the identification and quantification of such amounts.

A Purchase Obligation, on the other hand, is not defined by reference to GAAP but rather is defined in the 2003 Rules as follows:

> Purchase Obligation means an agreement to purchase goods or services that is enforceable and legally binding on the registrant that specifies all significant terms, including: fixed or minimum quantities to be purchased; fixed, minimum or variable price provisions; and the approximate timing of the transaction.[37]

Because the amount of Purchase Obligations would not otherwise be calculated for GAAP financial statements, there is a new cost for registrants to identify the amounts of Purchase Obligation and provide the required information in the tabular format.

In the Off-Balance Sheet Release the SEC expressed its view that the Final Rules will not generally cause disclosure of "routine transactions" such as employment agreements, leases, licenses, or employee pension plans.[38] Additionally, contingent liabilities (stemming from litigation, arbitration, or regulatory matters) are not required off-balance sheet disclosures unless such liabilities are otherwise material under other sections of Item 303.[39]

The Final Rules effectively require incorporating information currently contained in a company's financial statement footnotes into MD&A. The SEC's goal appears to be to increase transparency by integrating the substance of footnotes about off-balance sheet arrangements into MD&A so that investors can see (and evaluate) in a single location, information not otherwise included in the textual narrative and analysis. Companies may fulfill this mandate by making clear cross-references to the information in the financial statements.[40] It may be difficult, however, to comply with the SEC admonition that cross-referencing should not diminish the quality of the discussion of off-balance sheet arrangements.

Finally, in compliance with the ironically named Paperwork Reduction Act,[41] the Commission estimated that the amended disclosure requirements will increase a registrant's annual compliance costs by approximately $5,000. To the surprise of no one, the cost of compliance with Sarbanes-Oxley (legal and accounting) would appear to be orders of magnitude higher.

PRACTICE AND CONCERNS

Certain procedures to be followed by public companies and their advisors in light of the 2003 Rules (and to a

36. The tabular presentation should be accompanied by footnotes: (1) to describe the provisions that create, increase or accelerate obligations, or other pertinent data to the extent necessary for an understanding of the timing; or (2) to describe material contractual provisions or other material information necessary for an understanding of the timing and amounts of the obligations. *See* 17 C.F.R. § 229.303(a)(5); Off-Balance Sheet Release.
37. 17 C.F.R. § 229.303(a)(5)(ii)(D).
38. Off-Balance Sheet Release ("We agree that certain modification of the proposed definition [of "Off-Balance Sheet Arrangement"] are necessary to eliminate disclosure of routine arrangements that could obscure more meaningful information.")
39. *Id.* ("We are not adopting a disclosure requirement for contingent liabilities and commitments.")
40. Off-Balance Sheet Release (instructions to paragraph (c) of Item 303).
41. 44 U.S.C. § 3501 *et. seq.* The amendments to Regulation S-K enacted by the Final Rules contain "Collection of Information" requirements within the meaning of the Paperwork Reduction Act. *Id.*; *see also* Off-Balance Sheet Release.

lesser extent, Sarbanes-Oxley) seem clear. Paramount is a thorough review by management, outside accountants, and the Audit Committee designed to identify transactions (existing and proposed) that may require MD&A off-balance sheet disclosure. Focus should be placed on categories of the registrant's business in which off-balance sheet arrangements are the norm and will occur predictably in the future, one-time transactions subject to the new regulatory definitions and disclosure, and a review of identified transactions to determine if changes in prior assumptions, or alterations of trends, alter the required disclosure analysis. Some transactions will obviously satisfy the SEC's defined parameters. Others (including structured contracts with indemnification or contingent liability features) may be less than obvious.

After all transactions that may satisfy the regulatory definition have been identified, management must: (1) determine if the transaction is material and requires narrative disclosure (rather than composite disclosure in tabular format), and (2) assess the likelihood that events or effects under such transactions will occur (analyzed by reference to the "reasonably likely" standard). If the registrant concludes that a material event or effect is not "reasonably likely to occur," then no MD&A disclosure is required.[42]

If management is unable to make that negative determination, the company must then evaluate objectively the consequences of any known trend, demand, commitment, event or uncertainty on the off-balance sheet arrangement assuming that such effects will come to fruition. Disclosure is then required unless management determines that no *material effect* on the registrant's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures, or capital resources is "reasonably likely" to occur. Companies must prepare and employ assumptions that are "objectively reasonable"[43] in assessing the likelihood of the occurrence of any known trend, demand, commitment, or uncertainty that may affect an off-balance sheet arrangement.

There is a long-standing debate among the securities bar in a broader context whether documenting a registrant's securities disclosure analysis and process is advisable. Some lawyers save every draft of registration statements to evidence the care and precision exercised in reaching disclosure conclusions; others equally zealously discard all drafts. The latter group believes that the final work product should speak for itself. In the new MD&A environment, this debate is significant; particularly for potential disclosures that were analyzed but ultimately not disclosed. Documentation is clearly a two-edged sword. Contemporaneously-created documents can be used to defend (or attack) the company in subsequent securities litigation. Well-conceived documents illuminating the "objective reasonableness" of assumptions can evidence compliance with the 2003 Rules standard.[44] Written analyses (and drafts), however, can equally serve as Plaintiff's "Exhibit A." Plaintiff's allegations may be that based on facts and "known trends" the company's written assumptions were not objectively reasonable, or that if reasonable, were not well-applied. In either case, plaintiff's allegations will be that a better analysis by the registrant would have concluded that MD&A disclosure thresholds had been satisfied and disclosure should have been made.

The 2003 Rules also require registrants to disclose "potential *material risks*" arising from off-balance sheet arrangements (emphasis added). Many issuers already (and more will) incorporate their Form 10-K Risk Factors into their interim periodic reports. Despite the SEC's oft-expressed negative views about "boilerplate," it is easy to anticipate that new boilerplate risk factor disclosures will develop and be routinely included in MD&A about off-balance sheet arrangements. The utility of such boilerplate is always and inherently uncertain. By contrast, thoughtful and appropriate disclosure crafted to identify the scope, limitations, and basis for risk factors, predicated on the registrant's specific circumstances and industry, will more likely achieve the goal of minimizing a registrant's litigation exposure.

42. *See* Off-Balance Sheet Release.
43. Off-Balance Sheet Release ("Consistent with other disclosure threshold determinations that management must make in drafting MD&A, the assessment must be objectively reasonable at the time the determination is made.") (citing Rel. No. 33-6835).
44. Materials can also establish the good faith of management's conclusions and the integrity of the company's process. Unfortunately, the CEO and CFO certifications required under Section 302 of the Sarbanes-Oxley Act do not provide a "good faith" or "best of knowledge" standard, so even reasonable processes may not protect such officers from violating the certification standards.

Properly-framed cautions will secure protection for the registrant about disclosure of forward-looking information in accordance with the "Safe Harbor Rules."[45]

Companies are significantly increasing the scope, extent, and, most importantly, the collaborative nature of their quarterly review processes. Best practice clearly suggests greater teamwork, internal and external involvement between senior management, the Audit Committee, and the outside accountants. Drafts of quarterly financial information and 10-Q's should be reviewed and ultimately approved by the Audit Committee. Even though the registrant's outside accountants provide no formal comment on the unaudited interim financial statements, the Committee should nonetheless verify that the outside accountants have been involved with the preparation of, and reviewed and "approved," such financial statements and the judgment calls reflected therein. This same extended group should also intensively review press releases prior to issuance and document the assumptions that led companies to disclose (or not to disclose) certain information.

Routine practice has been for the registrant's quarterly statements to be reviewed only by the local office of national accounting firms. After Sarbanes-Oxley became effective, numerous registrants experienced problems during their next fiscal year-end when the national office of such accounting firms overruled interim period presentations reflecting the judgment of the accounting firm's local partners. This resulted in time delays, costs, and marketplace surprises for numerous issuers at year-end. To avoid this problem, it is suggested that *prior* to the release of interim financial statements companies receive assurance from their outside accountants that all judgment calls and application of accounting principles reflected on quarterly financial statements have been confirmed by their outside accountant's national offices and will be sustained in the year-end audited financial statements.

In an era of enhanced scrutiny, registrants may consider distributing Director and Officer and Related Parties Questionnaires and confirmations on a quarterly basis.[46] Again, the goal is to ensure that the quarterly financial information is correct, discloses all required information, and leads comfortably and easily to preparation of the company's year-end financial statements and SEC disclosures.[47]

Some issuers, in response to Sarbanes-Oxley (as well as to the personal CEO and CFO certifications required under Sections 302 and 906 of that act), have already discussed the benefit of a separate Disclosure Committee whose explicit obligation is to review the issuer's periodic reporting and confirm compliance with applicable law. The Off-Balance Sheet Rules may hasten the formation of such committees (particularly for issuers with large boards of directors) and their involvement in ongoing disclosure analyses.

Most of the foregoing is applicable to issuers of all sizes. The practical and financial consequences to smaller issuers of the new off-balance sheet disclosures, however, is more severe. While the absolute cost of legal and outside accounting analysis may be the same, the fiscal consequences tend to be more significant for mid-cap issuers as a percentage of their revenues and net income.

In addition, mid-cap companies generally have more limited financial staffs (frequently with less public company experience) compared to larger issuers, or may only have a single financial officer. Chief financial officers of mid-cap companies commonly play multiple roles in finance, administration, and operations. These issuers may find that management is spending a disproportionate amount of time on SEC disclosure and compliance rather than operations and profitability.

Finally, while not a new issue, the definition of materiality (by its nature)[48] requires mid-cap issuers to disclose more information about smaller contracts than their larg-

45. "Statutory Safe Harbors" are the protections provided in Section 27A of the Securities Act and Section 21E of the Exchange Act as applied to "forward looking information." 15 U.S.C. §§77z-2 and 78s-5.

46. For a discussion of the use of Director and Officers Questionnaires in the private placement context, see Marc H. Morgenstern, *Private Placement Guidelines-A Lawyer's Letter to a First-Time Issuer*, 48 THE BUSINESS LAWYER 257, 270 (Nov. 1992).

47. Such questionnaires will also facilitate disclosure of a registrant's related-party transactions as encouraged by the SEC. Rel. No. 33-8056.

48. Although the SEC has advised against using quantitative figures as a dispositive indicator of materiality, such figures are often used by issuers as "rules of thumb" driving the materiality analysis. SAB No. 99, Materiality (Nov. 24, 1999).

er counterparts. The consequences that may arise from a million dollar transaction (or the impact of a million dollar effect under an off-balance sheet arrangement) for a mid-cap company may be material, while even dozens of such transactions for their larger competitors may not be material. The inevitable consequence is that smaller companies are forced to disclose significant amounts of sensitive information that can be of real assistance to their larger competitors and exacerbate the inherent competitive handicap of mid-cap companies.

CONCLUSION

At the most fundamental level, the 2003 Rules may cause companies to re-examine whether there is a compelling business reason to enter into off-balance sheet arrangements. If off-balance sheet arrangements occur because business fundamentals support such an arrangement, then these transactions will probably continue to be structured in this fashion. To the extent that off-balance sheet transactions were primarily designed from a financial statement perspective to make a company's balance sheet appear robust for the analytical and investor community, then such arrangements may well diminish.

The company's analysis should include the effect of balance sheet structure and disclosure on other important corporate constituencies whose perception of, and reliance on, a company's financial position are meaningful. This group includes landlords, customers, and suppliers. Each may legitimately evaluate a company's balance sheet and creditworthiness through a different financial prism. Management, the Audit Committee, and the board of directors need to assess the motivations for off-balance sheet arrangements and make reasoned decisions reflecting their understanding of the impact of off-balance sheet arrangements on all corporate stakeholders.

Compliance with the Final Rules requires foresight, analysis, and planning. Because of the rules' interdisciplinary nature, and the heightened integration of the financial statements and MD&A disclosure, good corporate practice should now involve greater, earlier, and more frequent collaboration among a company, its senior management, Audit Committee, lawyers, and accountants. Success can only be achieved through processes involving the entire team. To succeed in an integrated disclosure world, a registrant's preparation for its SEC reports may come to resemble the traditional IPO process with an emphasis on "all-hands" disclosure meetings. While costly and time-consuming, this team approach will facilitate the in-depth understanding of facts and trends necessary to ensure that the correct questions are posed by the company. Getting the predicates established, and the right questions asked, is usually the key to correct analysis and disclosure.

There is a real and significant cost to registrants from the 2003 Rules. Hopefully, it is not overly optimistic to believe that there will be a commensurate benefit to complying companies, their investors, and the overall public marketplace. ■