35TH ANNUAL INSTITUTE ON SECURITIES REGULATION

Marc Morgenstern

Biographical Information

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Marc Morgenstern, Managing Partner
Kahn Kleinman, LPA
1301 E. Ninth Street, Suite 2600, Cleveland, OH 44114
Phone: 216/736-3322
E-Mail: morgenstern@kahnkleinman.com

Primary Areas of Practice: Securities and Corporate law; Private Equity

Law School: Boston University (1975)

College: Yale University (1972)

Memberships: Executive Committee of the SEC's Small Business Capital Formation Conference; Board of Rock and Roll Hall of Fame and Museum; Board of the Cleveland Foodbank; Dean's Technology Council of Case Western Reserve University School of Medicine

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THE OFF-BALANCE SHEET RULES (A MID-CAP PERSPECTIVE)

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The author gratefully acknowledges the invaluable assistance of Peter Nealis in the preparation of this article.

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I. INTRODUCTION

The corporate and securities worlds were dramatically altered by The Sarbanes-Oxley Act of 2002 (the "Act" or "Sarbanes-Oxley").[1] Its laudable goal (though not necessarily result) was to restore investor confidence in the public marketplace after the emotional and financial

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This article is dedicated to the memory of my friend, colleague, and partner, Morlee A. Rothchild (1938 – 2003). His dedication to his clients and law as a calling and profession were an inspiration to all who knew and loved him.

Marc Morgenstern is the Managing Partner of Kahn Kleinman in Cleveland, Ohio and can be reached at (216)736-3322 or morgenstern@kahnkleinman.com

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

devastation stemming from the Enron and other public company scandals.[2] The Act and the rules stemming from the Act, are complex and highly interrelated, and affect all public companies, their directors, lawyers, and accountants.

Section 401(a)(j) of the Act mandated the Securities and Exchange Commission (the "SEC" or the "Commission") to issue final rules providing that each annual and quarterly financial report filed with the SEC disclose all "material" off-balance sheet arrangements.[3] In fulfillment of the legislative mandate, the SEC issued Final Rules[4] in January, 2003 (the "Final Rules" or the "2003

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[2] *Id.* at Preamble ("An Act to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws.").

[3] *Id.* at §401(a)(j); *see also* SEC Release No. 33-8182, *Final Rule: Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations* (January 28, 2003) [hereinafter, "Off-Balance Sheet Release."] The 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).

[4] 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 <u>not</u> an investment company; and

Rules") governing the Management's Discussion and Analysis ("MD&A") disclosure of "off-balance sheet arrangements."[5] Technically this was achieved by amending Section 303(a) of Regulation S-K.[6] 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

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(4) if a majority-owned subsidiary, has a parent corporation that is also a small business issuer. *See* 17 C.F.R. §228.10(a)(1) (emphasis added). An entity is <u>not</u> a small business issuer if the aggregate market value of its outstanding equity securities held by non-affiliates is $25,000,000 or more. *See* Off-Balance Sheet Release, at 115; *see also* 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 is set forth in Regulation S-B, 17 C.FR. §228.10 *et. seq.* Of the S-B 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."

[5] *See generally* Off-Balance Sheet Release.

[6] Regulation S-K is found at 17 C.F.R. § 229.10 *et seq.* In a separate release, the SEC also dealt with "non-GAAP" financial measures through the enactment of Regulation G. *See* SEC Release No. 33-8176, *Final Rule: Conditions for Use of Non-GAAP Financial Measures* (January 22, 2003). On June 13, 2003, the SEC Division of Corporate Finance issued a list of responses to 33 "frequently asked questions" concerning Regulation G. *See* SEC Division of Corporate Finance, *Frequently Asked Questions Regarding the Use of Non-GAAP Financial Measures*

codifying the SEC's 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"[7] (emphasis added). 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

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(June 13, 2003) *available at*: http://www.sec.gov/divisions/corpfin/faqs/nongaapfaq.htm.

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.[8] The analysis is expected to be a "narrative explanation" of the financial statements as seen through the eyes of management.[9] Historically, the SEC's instructions regarding MD&A have been intentionally general with the expressed goal of encouraging more meaningful disclosure and avoiding boilerplate discussions.[10] As characterized by the SEC:

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[7] *See generally* Off-Balance Sheet Release.

[8] *See* 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). *See* 17 C.F.R. § 229.10(a) (setting forth application of Regulation S-K); *see also Bowerman and Hawrof*, *supra*.

[9] *See* SEC Release No. 33-6835, *Management's Discussion and Analysis of Financial Condition and Results of Operations* (May 18, 1989) [hereinafter, the "Interpretive Release"].

[10] *See* Interpretive Release. 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).

> 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.[11]

Item 303 of S-K delineates the basic requirements for MD&A,[12] 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.[13]

Despite the significant furor arising from the 2003 rules, the concept of disclosing off-balance sheet transactions is not new.[14] The Final Rules and amended Item 303(a) do,

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[11] *Id.*

[12] *See* 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." 17 C.F.R. § 229.303(a).

[13] *See* EXHIBIT 2 SOURCES OF GUIDANCE FOR MD&A PREPARATION *infra*.

[14] 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

however, provide some clarification and considerable precision about presentation and format.[15] 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.[16] 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

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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.

[15] 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. *Cf. et. al* Comment Letter of former SEC Commissioner Joseph A. Grundfest (the "Grundfest Letter" dated August 20, 2002, in Response to SEC Release No. 33-8098*, available at* http://www.sec.gov/rules/proposed/s71602/grundfest.01.htm (last visited 8/22/03) (collective effort of Stanford Law School professor of securities law and lawyers practicing in the Silicon Valley area).

[16] *See* Interpretive Release. 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

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. The concept of MD&A disclosure took its present form in the early 1980's as part of an SEC initiative to integrate the disclosure requirements of the Securities Act of 1933 and the Securities Exchange Act of 1934.[17] 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

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Corporate Finance before the Rocky Mountain Securities Conference (May 17, 2002)).

[17] *See* SEC Release No. 33-6231, *Amendments to Annual Report Form, Related Forms, Rules, Regulations, and Guides, Integration of Securities Act System* (September 25, 1980) ("The amendments are part of a series of revisions and proposals intended to improve disclosure, reduce disclosure burdens, and to facilitate the integration of disclosure systems under the two acts"); *see also* Ronald M. Loeb and Kevin A. Frankel, *The Focus of MD&A*, 854 PLI/Corp. 235, *239-240 (19894), and n.1 (noting that "the overall integrated disclosure system is based on the assumption that the information relevant to an investor who is purchasing shares from

of “off-balance” sheet is now considerably eviscerated for public companies. Facts about, and the impact of, off-balance sheet financings and arrangements are now effectively integrated with traditional “on-balance” sheet disclosures.[18] The scope of the integration is complex, extensive, and required.

At the same time, however, the Final 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

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the issuer is also information which is pertinent to an investor purchasing shares in the open market”).

[18] 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. *See* 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-l.

from MD&A.[19] 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.[20]

The vocabulary[21] 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[22], SEC Staff

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[19] *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.")

[20] *Id.*

[21] MD&A disclosure involves numerous technical definitions found in a variety of accounting and legal resources. *See* EXHIBIT 1 - GLOSSARY OF KEY TERMS AND CONCEPTS, for an integrated, definitional glossary of key terms in MD&A from accounting and legal resources.

[22] Generally accepted accounting principles in the United States. GAAP identifies the accounting principles used in the preparation of primary financial statements.

Accounting Bulletins ("SABs")[23], Financial Accounting Standards Board Statements ("FASB"), and FASB Interpretive Releases ("FINs")). There are also significant "legal" sources of guidance, such as the Act, and SEC rules, regulations, and releases.[24]

This article: (1) briefly traces MD&A's history in order to provide a meaningful context within which the impact of the Off-Balance Sheet Release and the 2003 Rules can be viewed, (2) discusses the costs, compliance obligations, and MD&A mandated formatting changes created by the 2003 Rules (particularly from the perspective of mid-cap issuers), (3) addresses practices (and concerns) under the 2003 Rules, (4) provides a Glossary defining the myriad complex terms used within the MD&A system, and finally, (5) provides an annotated list of the interdisciplinary

[23] SABs offer informal guidance from the SEC about the SEC's views with respect to particular accounting and disclosure issues for public companies. *See Quinn and Jarmel*, *supra*, at *130, n. 38. This interstitial perspective frequently addresses unanswered or inconsistent accounting literature or holes in GAAP.

legal and accounting resources that need to be understood and referenced in order to fully comply with MD&A.

II. A BRIEF HISTORY OF MD&A – PART I[25]

A. MD&A GENESIS AND DEVELOPMENT

MD&A was originally conceived[26] as a limited requirement for registrants to provide a summary of earnings, along with summary statements explaining unusual conditions that might render their financial statements "inappropriate."[27] Although the SEC issued a 1974 release requiring additional discussion of variances in income

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[24] *See* EXHIBIT 2 SOURCES OF GUIDANCE FOR MD&A PREPARATION, for a listing of resources used in preparing MD&A disclosures.

[25] With appropriate acknowledgements and apologies to Mel Brooks.

[26] The concept of MD&A-types disclosure in SEC filings was originally promulgated in 1968. *See* SEC Release No. 4936, *Guides for Preparation and Filing of Registration Statements* (Dec. 9, 1968). For an overview of the early development of MD&A disclosure policies *see Loeb & Frankel*, *supra*, at *239.

[27] *See* SEC Release No. 4936, *supra*; *see also* Suzanne J. Romajas, *The Duty to Disclosure Forward-Looking Information: A Look to the Future of MD&A*, 61 FORDHAM L. REV S245, S255 (1993).

statement items, the MD&A rules as we know them did not take effect until 1980.[28]

In 1980, the SEC rescinded the previous MD&A requirements and replaced them with then-Item 11 of Regulation S-K.[29] According to the SEC, the previous MD&A system had resulted in "an often mechanistic commentary on percentage variations."[30] Thus, the requirements of MD&A were intentionally changed to make them less rigid. The 1980 changes came as part of the SEC's attempt[31] to integrate the disclosure requirements for initial

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[28] *See* SEC Release No. 5520 (August 14, 1974). Later, the SEC adopted a rigid percentage test for companies to apply when determining whether a particular disclosure was "material." The percentage test was strictly applied by the SEC to require companies to disclose items that were either irrelevant or required further explanation in order not to be misleading. *See Loeb & Frankel*, *supra*, at *239.

[29] *See* SEC Release No. 33-6231, *Amendments to Annual Report Form, Related Forms, Rules, Regulations, and Guides, Integration of Securities Act Disclosure System* (September 25, 1980); SEC Release No. 33-6349, *Management's Discussion and Analysis of Financial Condition and Results of Operations* (September 28, 1981).

[30] SEC Release No. 33-6349, *supra; see also Quinn & Jarnell*, *supra* at 129 ("In the early years, MD&A disclosures tended to be rote recitations of disclosures concerning year-to-year line item variations.")

[31] For a discussion of open issues remaining following the SEC integration initiative, see Milton H. Cohen, *The Integrated Disclosure System – Unfinished Business*, 40 BUS. LAW. 987 (May 1985).

public offerings and primary market concerns addressed in the Securities Act of 1933 and the secondary market, trading, and compliance obligations and liabilities covered in the Securities Exchange Act of 1934.[32]

Item 11 of Regulation S-K required registrants to provide information with respect to liquidity, capital resources, and results of operations, as well as "such other information which the registrant believes may be necessary

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[32] Even more ambitious integration efforts were previously (but unsuccessfully) undertaken. In the 1970's, the late Professor Louis Loss, spearheaded the American Law Institute's proposed Federal Securities Code, an attempt to harmonize and integrate into a single statute all of the then extant federal statutes involving securities laws: The Securities Act of 1933, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-aa); The Securities Act of 1934, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-jj); The Public Utility Holding Company Act of 1935, 49 Stat. 803 (codified as amended at 15 U.S.C. §§ 79); The Trust Indenture Act of 1939, 53 Stat. 1149 (codified as amended at 15 U.S.C. §§ 77aaa et seq.); The Investment Company Act of 1940, 54 Stat. 847 (codified as U.S.C. §§ 80a-1 et seq.); and The Investment Advisers Act of 1940, 54 Stat. 847 (codified as amended 15 U.S.C. §§ 80b-1 et seq.).

The goal of the ALI Code was:

[N]ot only to achieve a unifying integration of these separate statutes, addressed at different times to closely related problems, but also to point the way toward their improvement, clarifying their obscurities, eliminating inconsistencies, articulating important norms developed in interpretive judgments and, within the limits of the basic legislative policy, proposing improvements that informed opinion favors and seems ready to support.

1 ALI, Federal Securities Code, at vii-viii (1980).

to an understanding of its financial condition, changes in financial condition and results of operations."[33] Item 11 encouraged, but specifically did not require, forward-looking disclosures.[34] Item 11 was representative of the continued evolution of the SEC's disclosure policy, which at one time

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[33] *See* SEC Release No. 33-6231, *supra* (including text of Regulation S-K, Item 11 as adopted).

[34] *Id.* ("Registrants are encouraged, but not required, to supply forward-looking information."). Item 11 specifically noted, and current Item 303 notes, that "any forward-looking information supplied is expressly covered by the safe harbor rule for projections." *Id.* (citing Securities Act Release No. 6084 (June 25, 1979). The statutory safe harbors contain provisions to protect forward-looking statements against private legal actions that are based on allegations of a material misstatement or omission. *See* 15 U.S.C. § 77z-2(b) and § 78u-5(b). While the statutory safe harbors by their terms do not apply to forward-looking statements included in financial statements prepared in accordance with GAAP, they do cover MD&A disclosures. *See* Off-Balance Sheet Release. The statutory safe harbors would not apply, however, if the MD&A forward-looking statement were made in connection with: an initial public offering, a tender offer, an offering by a partnership or a limited liability company, a roll-up transaction, a going private transaction, an offering by a blank check company or a penny stock issuer, or an offering by an issuer convicted of specified securities violations or subject to certain injunctive or cease and desist actions. *See* 15 U.S.C. § 77z-2(b) and § 78u-5(b).

prohibited,[35] but now encourages (and may in some cases require), the disclosure of forward-looking information.[36]

The SEC, however, distinguished forward-looking disclosures from "presently known data which will impact upon future results," *i.e.,* information that "may" be subject

[35] *See Romajas, supra* at S249 (discussing the evolution of the SEC's stance on forward-looking information); *see also Statement by the Commission on Disclosure of Projections of Future Economic Performance*, Exchange Act Release No. 9984 (February 2, 1973).

[36] *See generally Romajas*, *supra* (discussing the ongoing evolution of SEC disclosure philosophy in the context of MD&A).

to required disclosure.[37] This is a gossamer-thin distinction that is difficult to apply.[38]

The SEC refused to propose specific requirements for MD&A, but indicated its belief that:

> adequate guidance can be provided through periodic releases which, in addition to discussing the views of

[37] *Id.* (citing as an example a known increase in the costs of labor or materials). In a separate release reviewing the disclosures made during the first year of Item 11, the SEC concluded that overall "the Staff was pleased with the quality of the [MD&A] discussion for the first year," and offered examples on how various companies sought to meet the new requirements. *See* SEC Release No. 33-6349, *Management's Discussion and Analysis of Financial Condition and Results of Operations* (September 28, 1981). The SEC observed that the forward-looking disclosures varied from brief comments to an extensive five-year forecast of revenues and cash flow. *Id*. ("The disclosures, which varied from brief comments to broader discussions, including in some cases a five-year forecast of revenues and cash flow, demonstrated that the discussions need not be quantitative to be meaningful.") However, the SEC refused to propose specific requirements for MD&A at that time. Rather, the SEC indicated its belief that "adequate guidance can be provided through periodic releases which, in addition to discussing the views of the Staff regarding the necessity of including more or different information, also includes examples of how various companies have sought to meet the new requirements." *Id.*

[38] *See Seamons, supra*, at *9 (noting that "the difference between these two types of disclosure may be subtle and is often unclear"). The SEC has indicated that the possibility of an SEC or staff interpretation on MD&A prior to the 2004 annual report season is "real." See Notes from the Meeting of ABA Committee on Federal Regulation of Securities (August 11-12) *archived at* http://www.abanet.org/buslaw/fedsec/subcommitees/securitiesregistration (notes from dialogue with Alan L. Beller, Director, SEC Division of Corporate Finance). One area where the SEC has expressed an interest in providing further guidance is the definition of "known trends and uncertainties." *Id.*

> the Staff regarding the necessity of including more or different information, also includes examples of how various companies have sought to meet the new requirements.[39]

After issuing a 1987 Concept Release,[40] and getting substantial comments from the major accounting and law firms, the SEC provided an Interpretive Release in 1989, focusing on areas where public companies' disclosure had been deficient. Particular emphasis was placed on the extent of prospective information required in MD&A.[41] The SEC

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[39] *See* Release No. 6231.

[40] The SEC issued a "Concept Release" seeking comment on the adequacy of the MD&A rules as they existed and the costs and benefits of the revisions suggested by the then Big 7 accounting firms. *See* SEC Release No. 33-6711, *Concept Release on Management's Discussion and Analysis of Financial Condition and Operations* (April 24, 1987) (hereinafter, "Concept Release"). Agreeing with virtually all responses, the SEC chose not to amend the MD&A rules. *See* Interpretive Release. However, in light of multiple comments requesting stricter enforcement and review of MD&A disclosures, the SEC undertook a comprehensive review in a variety of different industry groups and found that most companies were not adequately complying with the MD&A requirements. Based upon the survey, the SEC issued its Interpretive Release which discussed the SEC's review, gave examples on how to file MD&A, and cautioned companies on the importance of full compliance. *See* Interpretive Release, *supra*; *Loeb & Frankel, supra*, at 242.

[41] *See* Interpretive Release, *supra*. The SEC also provided interpretive guidance in the following areas: (1) long and short-term liquidity and capital resources analysis; (2) material changes in financial statement line items; (3) required interim period disclosure; (4) MD&A analysis on a segment basis; (5) participating in high yield financings, highly leveraged transactions or non-investment grade loans and investments; (6) the

reaffirmed that "descriptions of known material trends in the registrant's capital resources and expected changes in the mix and cost of such resources are required"[42] (emphasis added). The Interpretive Release also attempted to distinguish between "prospective information that is required to be discussed from voluntary forward-looking disclosure in an area requiring additional attention."[43] Required disclosures, on the one hand, were to be based on "current known trends, events and uncertainties that are reasonably expected to have material effects."[44] Optional forward-looking disclosures, on the other hand, were to involve "anticipating a future trend or event or anticipating a less predictable impact of a known event, trend or uncertainty."[45]

The SEC expressed its intention to monitor a company's performance and review the registrant's prior

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effects of federal financial assistance upon the operations of financial institutions; and (7) preliminary merger negotiations. *Id.*

[42] *Id.* (citing 17 C.F.R. 229.303(a)(2)(ii)).

[43] *Id.*

[44] *Id.* (quoting Concept Release (portion of emphasis removed).

[45] *Id.*

disclosures to see whether with 20-20 hindsight and the luxury of time a particular trend "should" have been disclosed.

> Where a material change in a registrant's financial condition (such as a material increase or decrease in cash flows) or results of operations appears in a reporting period and the likelihood of such change was not discussed in prior reports, the commission staff as part of its review of the current filing will inquire as to the circumstances existing at the time of the earlier filings to determine whether the registrant failed to discuss a known trend, demand, commitment, event or certainty as required by Item 303.[46]

B. MD&A ENFORCEMENT ACTIONS DURING THE 1990'S

During the 1990's, the SEC demonstrated its willingness to enforce proper MD&A disclosures by taking the position that inadequate disclosures constituted an independent violation of the reporting requirements under Section 13(a) of the Exchange Act.[47] In 1989, the SEC

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[46] *Id.*

[47] Previous SEC enforcement actions had only included MD&A disclosure violations along with other charges. *See* Seamons, *supra*, at *11.

commenced its well-publicized, and frequently cited, enforcement action against Caterpillar, Inc. 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,[48] and (2) the future impact of a known certainty, *i.e.,* significant economic reforms proposed by Brazil's new president elect.[49]

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[48] *In re Caterpillar, Inc.*, Release No. 34-30532, 51 SEC Docket (CCH) 147 (March 31, 1992). Although the Caterpillar Brazil subsidiary was not considered a material foreign corporation requiring additional disclosure under GAAP, the SEC concluded that additional disclosure was necessary "given the magnitude of [Caterpillar Brazil's] contributions to Caterpillar's overall earnings." *Id.*

[49] *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 establish an internal audit function that did not previously exist. *See In re Edison Schools, Inc.* SEC Exchange Act Release No. 45925 (May 14, 2002). In a final rule issued on June 5, 2003, the SEC promulgated regulations relating to the requirements of certain

As noted by one commentator, "[t]he SEC's emphasis on early disclosure may cause considerable tension regarding the timing of disclosures—the inherent dilemma of disclosing promptly or investigating further to ensure that information is reliable and ripe for disclosure."[50]

The Caterpillar decision has been viewed as a "message case" demonstrating the SEC's: (1) desire for improved MD&A disclosures, and (2) willingness to take action against, and impose liability on, registrants that do not comply with that mandate.[51] The SEC imposed no monetary penalties on Caterpillar but did require Caterpillar to end its violations of Item 303 and establish procedures for ensuring MD&A compliance.[52] Over the next few years, the SEC

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reporting companies to include in their annual report a report outlining management's internal control over the financial reporting of the company. SEC Release No. 33-8238, *Final Rule, Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports* (June 5, 2003).

[50] *Seamons*, *supra*, at *11.

[51] *See Romajas*, *supra*, at S258.

[52] *See In re Caterpillar*, *supra*. Item 303 of Regulation S-K does not provide a private right of action for shareholders. *See Romajas*, *supra*, as

continued to highlight the significance of compliance through other high-profile enforcement actions,[53] further confirming the Commission's intent to enforce MD&A disclosure requirements.

C. 2001 AND 2002: "CAUTIONARY ADVICE"

Following the collapse of Enron, renewed emphasis was placed upon corporate disclosure, including the adequacy of MD&A disclosures.[54] 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

S261. However, commentators have observed, based upon indications from the courts, "that a Rule 10b-5 action based on Item 303 violations may be viable." *Id.* at S268.

[53] *See, e.g.*, *In re Kahler Corp.*, Release No. 34-32916 (September, 1993) (companies failed to disclose uncertainties relating to partnership losses); *In re Bank of Boston Corp.*, Release No. 34-33454 (January 11, 1994) (failure to disclose known trends relating to registrant's real estate portfolio); *In re Westwood One, Inc.*, Release No. 34-33489 (January 19, 1994) (failure to disclose adverse effects of deferral of certain payments to affiliated radio stations); *In re Shared Medical Systems Corp.*, Release No. 34-33632 (February 17, 1994) (failed to disclose effects of lower than expected sales activity); *see also Seamons et al., supra* (discussion of the foregoing).

disclosures.[55] 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.[56]

According to the SEC "the selection and application of the company's accounting policies must be appropriately reasoned."[57]

In January, 2002, the SEC issued a statement noting the need for improved MD&A disclosure in three specific areas: (1) liquidity and capital resources; (2) trading activities

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[54] *See Quinn & Jarnel*, *supra* (commenting that this increased focus on MD&A was largely due to the circumstances surrounding Enron).

[55] *See* SEC Release No. 33-8040, *Cautionary Advice Regarding Disclosure About Critical Accounting Policies* (December 12, 2001).

[56] *Id.*

[57] *Id.*

involving non-exchange traded contracts accounted for at fair value; and (3) related party transactions.[58]

In May, 2002, the SEC proposed revised MD&A requirements (the "Proposed Rules") to promote "higher-quality, more insightful, financial information."[59] 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.[60]

Not unpredictably, opinions were expressed by lawyers, accountants, and public companies that the Proposed Rules were too mechanical, overly burdensome,

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[58] *See* SEC Release No. 33-8056, *Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations* (January 22, 2002).

[59] *See* SEC Release No. 33-8098, *Proposed Rule: Disclosure in Management's Discussion and Analysis About the Application of Critical Accounting Policies* (May 10, 2002).

[60] *See also Quinn et al., supra*, at * 114.

and would confuse investors with an over-abundance of disclosure.[61] Among the observations was the view that:

> [a]s currently proposed, even the most diligent of issuers will encounter significant compliance concerns. Indeed, the amount of quantitative disclosure required represents a profound change in disclosure philosophy and would present particular problems for technology companies because of their volatility in results of operations and the rapid rate of technological innovation in their product offerings. Smaller issuers could also be forced by the Proposed Rules to disclose a disproportionate amount of sensitive confidential information.[62]

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

III. THE FINAL RULES (2003)

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.[63] The definition of "off-balance sheet

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[61] *See, e.g.*, Grundfest Letter; Comment Letter submitted by Cleary Gottlieb Steen & Hamilton (August 2, 2002) *available at* http://www.sec.gov/rules/proposed/s71602/clearygottlieb1.htm; Comment Letter submitted by Sullivan & Cromwell (July 19, 2002) *available at* http://www.sec.gov/rules/proposed/s71602/sullivancromwell.htm.

[62] *See* Grundfest Letter (emphasis added).

[63] *See* Off-Balance Sheet Release, *supra*. Registrants must comply with the majority of the disclosure requirements of the Off-Balance Sheet

arrangements" incorporated certain existing GAAP concepts to require disclosure of four types of arrangements:

1. certain guaranties[64];
2. retained or contingent liabilities[65];

Release in registration statements, annual reports, and proxy or information statements for their fiscal years ending on or after June 15, 2003. *Id*

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. *Quinn & Jarmel*, *supra*, at *120.

Regulation G requires disclosure of "non-GAAP financial measures" defined as a numerical measure of a registrant's historical or future financial performance, financial position or cash flows that either: (1) excludes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded from the most directly comparable measure so calculated and presented; or (2) includes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded from the most directly comparable measure so calculated and presented. *See* Regulation G, 17 C.F.R. §244.101 The most commonly-cited example of a non-GAAP financial measure is earnings before income taxes, depreciation and amortization ("EBITDA"). The Non-GAAP disclosure rules require the issuer to include: a presentation of: (1) "the most directly comparable financial measure presented in accordance with GAAP"; and (2) a reconciliation (by schedule or other clearly understandable method) of the differences between the non-GAAP measure and the most directly comparable GAAP measure or measures." Regulation G, 17 C.F.R. §244.100(a).

[64] 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. "Paragraphs 6 and 7 of FASB Interpretation No. 45 exclude certain guarantee contracts from the recognition and measurements provisions of FASB Interpretation No. 45." *See* Off-Balance Sheet Release.

3. certain derivative instruments[66]; and

4. variable interests.[67]

Unlike the Proposed Rules, the Final 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."[68] In implementing this standard, the SEC rejected the more demanding standard set forth in the

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[65] *See* FASB Interpretation No. 5 (discussion of contingent gains and losses).

[66] 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).

[67] *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").

[68] *See* Off-Balance Sheet Release. Consistent with the 1989 Interpretive Release, the Final 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.

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."[69] 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.[70] 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.

[69] *Id.*; *see also* SEC Release No. 33-9098, *Proposed Rule: Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies* (May 10, 2002). 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." *See* Off-Balance Sheet Release. 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. *Id.*

[70] See Off-Balance Sheet Release. Former SEC Commissioner Edward H. Fleischman has stated that the "reasonably likely" standard means a 40% or more probability of occurrence. *See Feischman Addresses MD&A Issues Before Southern Securities* Institute, THE SEC TODAY, Vol. 91-51 (March 15, 1991).

The disclosure of off-balance sheet arrangements must now be presented in a separate section of MD&A.[71] 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

4. the potential material risks arising from the off-balance sheet arrangement.[72]

Sharpened attention is also now drawn to internal or external events: (1) that can trigger contingent and off-balance sheet liabilities, as well as (2) adverse factors such as credit rating downgrades that may result in the company's inability to obtain or retain its off-balance sheet arrangements.[73]

[71] *See* 17 C.F.R. § 229.303(a)(5).

[72] *See* Off-Balance Sheet Release, at 14-16.

[73] *See* Off-Balance Sheet Release.

In all cases, disclosure is only required "to the extent necessary to an understanding of a registrant's off-balance sheet arrangements."[74] 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.[75]

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-

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[74] *Id.* at 14.

[75] *Id.* (emphasis added).

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 receivables 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"[76]) to show in a new tabular format the amounts of payments due under certain contractual obligations for specified time periods.[77] The

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[76]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.*

[77] *See* Off-Balance Sheet Release, *supra* 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. *See* 17 C.F.R. § 229.303(a)(5); Off-Balance Sheet Release. A company may "disaggregate the specified categories of

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."[78] The tabular disclosure format is also expected to improve investors' ability to consistently compare the financial results of different registrants.[79] The table must appear in all annual reports but does not have to be in quarterly filings unless material changes in categories outside of the ordinary course of business occurred during the quarter.

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contractual obligations using other categories suitable to its business," provided that the table discloses all of the information required by the defined categories. *Id.* For a discussion of the technical definitions of these terms see EXHIBIT 1 - GLOSSARY OF KEY TERMS AND CONCEPTS.

[78] *See* Off-Balance Sheet Release, at 17.

[79] *Id.*

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:[80]

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-

[80] 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.

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.[81]

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 <u>not</u> generally cause disclosure of "routine transactions" such as employment agreements, leases, licenses, or employee pension plans.[82] Additionally, contingent liabilities (stemming from litigation, arbitration, or regulatory matters) are <u>not</u> required off-balance sheet disclosures <u>unless</u> such liabilities are otherwise material under other sections of Item 303.[83]

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

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[81] *See* 17 C.F.R. § 229.303(a)(5)(ii)(D).

[82] *See* Off-Balance Sheet Release ("We agree that certain modification of the proposed definition [of Off-Balance Sheet Release] are necessary to eliminate disclosure of routine arrangements that could obscure more meaningful information.")

[83] *Id.* ("We are not adopting a disclosure requirement for contingent liabilities and commitments.")

statements.[84] It may be difficult, however, to comply with the SEC admonition that the impact of cross-referencing does not diminish the quality of the discussion of off-balance sheet arrangements.

Finally, in compliance with the Paperwork Reduction Act,[85] the Off-Balance Sheet Release indicated the SEC's analysis that the amended disclosure requirements will increase a registrant's annual compliance costs by approximately $5,000.[86] To the surprise of no one, the actual costs (legal and accounting) would appear to be magnitudes higher.

IV. PRACTICE AND CONCERNS UNDER THE 2003 RULES.

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

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[84] *See* Off-Balance Sheet Release (instructions to paragraph (c) of Item 303).

[85] 44 U.S.C. § 3501 *et. seq.* The amendments to Regulation S-K enacted by the Final Rule contain "Collection of Information" requirements within the meaning of the Paperwork Reduction Act. *Id.*; *see also* Off-Balance Sheet Release.

[86] *See* Off-Balance Sheet Release, *supra*.

to a 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 where 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 disclosure analysis about such transactions. Some transactions will then 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) analyze 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.[87]

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.[88] Companies must prepare

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[87] *See* Off-Balance Sheet Release.

[88] *Id.*

and employ assumptions that are "objectively reasonable"[89] 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

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[89] *See* 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 SEC Release No. 33-6835).

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.[90] 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 <u>had</u> been satisfied and disclosure should have been made.

The 2003 Rules also require registrants to disclose "potential <u>material</u> risks" arising from off-balance sheet arrangements (emphasis added). Many issuers already (and more will) incorporate their Form 10-K Risk Factors into

[90] 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 Act do not provide a "good faith" or "best of knowledge" standard, so even

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 registrant's litigation exposure. Properly-framed cautions will secure protection for the registrant about disclosure of forward-looking information in accordance with the Safe Harbor Rules.

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

reasonable processes may not protect such officers from violating the certification standards.

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 over-ruled 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 <u>prior</u> 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. 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.[91]

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[91] Such questionnaires will also facilitate disclosure of a registrant's related-party transactions as encouraged by the SEC. *See* SEC Release No. 33-8056, *supra*.

Some issuers, in response to Sarbanes-Oxley (as well as to the personal CEO and CFO certifications required under Sections 302 and 906 of such Act[92]) 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 and their involvement in ongoing disclosure analyses.

Most of the foregoing analysis 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

[92] The Sarbanes-Oxley Act of 2002 §§302, 906.

experience) compared to larger issuers, or may only have a single financial officer. Chief Financial Officers of such 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)[93] requires mid-cap issuers to disclose more information about smaller contracts than their larger 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

[93] Although the SEC has advised against using quantitative figures as a dispositive indicator of materiality, such figures are often used by issuers

information that can be of real assistance to their larger competitors and exacerbate the competitive handicap of mid-cap companies.

V. 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

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as "rules of thumb" driving the materiality analysis. *See* SAB No. 99, *Materiality* (Nov. 24, 1999).

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 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.

EXHIBIT 1

GLOSSARY OF KEY TERMS AND CONCEPTS[94]

Asset Securitizations. In an Asset Securitization transaction, a company sells (either directly or indirectly) to a third party, certain assets of the company, such as its receivables. One or more special purpose entities that are bankruptcy-remote are usually utilized in such sales. In many instances, the ultimate acquiring entity then issues securities to investors, and the proceeds are used to pay the original selling company for the assets sold.

Business Combination. A "Business Combination" occurs when an entity acquires net assets that constitute a business or acquires equity interests of one or more other entities and obtains control over that entity or entities.[95]

Capital Lease. A "Capital Lease" is a Lease which, at its inception, meets one or more of the following four criteria: (1) the Lease transfers ownership of the property to the lessee by the end of the lease term; (2) the Lease contains an option to purchase the leased property at a price which is significantly lower than the fair market value of the property; (3) the Lease term is equal to 75 percent or more of the estimated economic life of the leased property, provided that

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[94] Although this EXHIBIT 1 is intended to provide in one place a collection of terms relating to MD&A, some of the more technical definitions set forth in SEC or accounting resources are expressly limited "for purposes of" that particular resource. Advisors are encouraged to review the underlying resources to assess any limitations accompanying a particular definition.

[95] *See* FASB Statement No. 41, *Business Combinations* (June, 2001).

the beginning of the lease term does not fall within the last 25 percent of the total estimated economic life of the leased property; and (4) the present value at the beginning of the Lease term of minimum lease payments equals or exceeds 90 percent of the excess fair market value of the leased property over any related investment tax credit retained by the lessor and expected to be realized by the lessor, provided that the beginning of the Lease term does not fall within the last 25 percent of the total estimated economic life of the leased property.[96]

Capital Lease Obligation. "Capital Lease Obligation" means a payment obligation under a Capital Lease.[97]

Capital Resources. Required MD&A Disclosure including: (1) the registrant's material commitments for capital expenditures as of the end of the latest fiscal period, and indicating the general purpose of such commitments and the anticipated source of funds needed to fulfill such commitments; and (2) a description of any known material trends, favorable or unfavorable, in the registrant's capital resources.[98]

Commitment Date. The "Commitment Date" is the date the company is committed to in an Exit Plan by management having the appropriate level of authority.[99]

Contingency. A "Contingency" is an existing condition, situation, or set of circumstances involving possible gain or loss.[100]

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[96] *See* FASB Statement No. 13, *Accounting for Leases* (November, 1976).

[97] *See* Regulation S-K, 17 C.F.R. § 229.303(a)(5)(ii).

[98] *See* Regulation S-K, 17 C.F.R. § 229.303(a)(d).

[99] *See* SAB No. 100, *Restructuring and Impairment Charges* (November 24, 1999).

[100] *See* FASB Statement No. 5, *Accounting for Contingencies* (March, 1975).

Critical Accounting Policies. "Critical Accounting Policies" are those that management believes are most critical to the preparation of the issuer's financial statements.

Derivative Instruments. "Derivative Instruments" are generally financial instruments whose values are primarily determined by the performance of underlying assets or indices including interest rates, foreign exchange rates, and equity or commodity prices. The technical definition of "Derivative Instrument" requires that a financial instrument: (1) have one or more Underlyings, one or more Notional Amounts or payment provisions of both; (2) require either no initial net investment or an initial net investment that is smaller than would be expected for other types of contracts that would be expected to have a similar response to changes in market factors; and (3) its terms require or permit net settlement by a means outside the contract.[101] Common formats of derivatives include futures, forwards, swaps, and options.

Disposal. "Disposal" means the disposal of a long-lived asset of an entity to be disposed of by sale or otherwise (such as by abandonment, in an exchange for a similar productive long-lived asset, or in a distribution to owners in a spinoff).[102]

Exit Activity. An "Exit Activity" means an action taken by a business in connection with the abandonment or relocation

[101] *See* FASB Statement No. 133, *Accounting for Derivative Instruments and Pledging Activities* (June, 1998).

[102] *See* FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (August, 2001).

of business operations. An Exit Activity includes but is not limited to a Restructuring.[103]

Exit Cost. A cost that results from a plan to exit an activity pursuant to a qualified Exit Plan and: (1) is not associated with or does not benefit activities that will be continued; (2) is not associated with or is not incurred to generate revenues after the commitment date; and (3) is either: (a) incremental to other costs incurred in the company's conduct of its activities prior to the Commitment Date and will be incurred as a direct result of the Exit Plan; or (b) will be incurred under a contractual obligation that existed prior to the commitment date and will either continue after the Exit Plan is completed with no economic benefit to the company or be a penalty to cancel the contractual obligation.[104]

Exit Plan. An "Exit Plan" is a plan adopted, and committed to, by a company in connection with an Exit Activity that identifies all significant actions to be taken. The Exit Plan must specifically identify all significant actions to be taken to complete the exit plan and the period of time taken to complete the Exit Plan must indicate that significant changes to such plan are not likely. The Exit Plan must have been rigorously developed and thoroughly supported.[105]

Foreign Issuer. "Foreign Issuer" means any issuer which is a foreign government, a national of any foreign country or a

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[103] *See* FASB No. 146, *Accounting for Costs Associated with Exit of Disposal Activities* (June, 2002).

[104] *See* SAB No. 100, *Restructuring and Impairment Charges* (November 24, 1999) (referencing Emerging Issue Task Force Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity*).

[105] *Id.*

corporation or other organization incorporated or organized under the laws of any foreign country.[106]

Foreign Private Issuer. "Foreign Private Issuer" means any Foreign Issuer other than a foreign government except an issuer meeting the following conditions: (1) more than 50 percent of the issuer's outstanding voting securities are directly or indirectly held of record by residents of the United States; and (2) any of the following: (a) the majority of the executive officers are U.S. citizens or residents; (b) more than 50 percent of the assets of the issuer are located in the U.S.; or (c) the business of the issuer is administered principally in the U.S.[107]

Forward-Looking Information. "Forward-looking information" means voluntary disclosures anticipating a future trend or event or anticipating a less predictable impact of a known event, trend or uncertainty. This is to be distinguished from presently-known data that will impact upon future operating results which may be required to be disclosed.[108]

GAAP. "GAAP" means generally accepted accounting principles in the United States.

Guarantee. A "Guarantee" falling under the definition of Off-Balance Sheet Arrangement, means any obligation under a guarantee contract that has any of the following characteristics: (a) contracts that contingently require the guarantor to make payments to the guaranteed party based on changes in an Underlying that is related to an asset, a liability or an equity security of the guaranteed party; (b)

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[106] *See* SEC Rule 3b-4(b).

[107] *See* SEC Rule 3b-4(c).

[108] *See* Regulation S-K, 17 C.F.R. § 229.303 (instruction (7) to paragraph 303(a)).

Performance Guarantees; (c) indemnification agreements that contingently require the indemnifying party to make payments to the indemnified party (guaranteed party) based on changes in an Underlying that is related to an asset, a liability or an equity security of the indemnified party; or (d) indirect guarantees of the indebtedness of others, which arise under an agreement that obligates one entity to transfer funds to a second entity upon the occurrence of specified events, under conditions whereby (i) the funds become legally available to creditors of the second entity and (ii) those creditors may enforce the second entity's claims against the first entity under the agreement (*e.g.*, Keepwell Agreements).[109]

Notwithstanding the foregoing, the following guarantees contracts are excluded from the definition of Off-Balance Sheet Arrangement: (a) guarantees issued by insurance and reinsurance companies and accounted for under specialized accounting principles for those companies; (b) a lessee's guarantee of the residual value of leased property in a capital lease; (c) contingent rents; (d) vendor rebates; (e) guarantees whose existence prevents the guarantor from recognizing a sale or the earnings from a sale; (f) product warranties; (g) guarantees that are accounted for as Derivatives; (h) contingent consideration in a Business Combination; (i) guarantees for which the guarantor's obligations would be reported as an equity item (rather than a liability); (j) certain guarantees in connection with a lease restructuring; (k) guarantees issued between either parents and their subsidiaries or corporations under common control; (l) a parent's guarantee of a subsidiary's debt to a third party; and

[109] *See* 17 C.F.R. § 229.303(a)(4)(ii)(A) (referencing FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Others* (November, 2002)).

(m) a subsidiary's guarantee of the debt owed to a third party by either its parent or another subsidiary of that parent.[110]

Keepwell Agreement. "Keepwell Agreements" include any agreement or undertaking under which a Company is, or would be, obligated to provide or arrange for the provision of funds of property to an affiliate or third party.[111]

Lease. A "Lease" is an agreement conveying the right to use property, plant or equipment (land and/or depreciable assets) usually for a stated period of time.[112]

Liquidity. "Liquidity" means the ability of an enterprise to generate adequate amounts of cash to meet the enterprise's need for cash. Liquidity is generally discussed on both a long-term and short-term basis, and should be discussed in the context of the registrant's own business or businesses.[113]

Long-Term Debt Obligation. "Long-Term Debt Obligation" means a payment obligation under long-term borrowings.[114]

Loss Contingency. "Loss Contingency" means an existing condition, situation, or set of circumstances involving uncertainty as to a possible loss.[115]

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[110] *Id.* (referencing the exclusions found in paragraphs 6 and 7 of FASB Interpretation No. 45.)

[111] Off-Balance Sheet Release, at n. 77.

[112] *See* FASB Statement No. 13, *Accounting for Leases* (November, 1976).

[113] *See* Regulation S-K*,* 17 C.F.R. §229.303(a)(1).

[114] *See* 17 C.F.R. § 229.303(a)(5)(ii) (referencing FASB Statement No. 47, *Disclosure of Long-Term Obligations* (March 1981)).

[115] FASB Statement No. 5, *Accounting for Loss Contingencies*; SAB No. 92.

Material. The concept of materiality has been given numerous, and sometimes conflicting, definitions by courts and commentators, often based upon context. A fact is generally considered "Material" if there is a substantial likelihood that the fact would have been viewed by a reasonable investor as having significantly altered the totality of information made available. One must consider both an item's quantitative and qualitative factors in assessing an item's materiality. While quantitative "rules of thumb" (*e.g.*, five to ten percent of net income) may assist in any initial assessment of materiality, these measures are <u>not</u> dispositive. Every assessment of materiality necessarily considers all of the surrounding facts and circumstances.[116]

Non-GAAP Financial Measure. "Non-GAAP Financial Measure" is a numerical measure of a registrant's historical or future financial performance, financial position, or cash flows that: (1) excludes amounts, or is subject to adjustments that have the effect of excluding amounts, that are included in the most directly comparable measure calculated and presented in accordance with GAAP in the statement of income, balance sheet, or statement of cash flows (or equivalent statements) of the issuer; or (2) includes amounts, or is subject to adjustments that have the effect of including amounts, that have the effect of including amounts, that are excluded from the most directly comparable measure so calculated and presented.

Notional Amount. A "Notional Amount" is a number of currency units, shares, bushels, pounds, or other units specified in the contract.[117]

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[116] SAB No. 99, *Materiality* (Nov. 24, 1999).

[117] FASB Standard No. 133, *Accounting for Derivative Instruments and Pledging Activities* (June, 1998).

Off-Balance Sheet Arrangement. "Off-Balance Sheet Arrangement" generally means any transaction, agreement or other arrangement to which an entity unconsolidated with the registrant is a party, the effects and risks of which are not fully transparent to the investor. The technical definition of Off-Balance Sheet Arrangement under the SEC regulations encompasses: (1) obligations under certain Guarantee contracts; (2) a retained or contingent interest in assets transferred to an unconsolidated entity or similar arrangement that serves as credit, liquidity or market risk support to such entity for such assets; (3) certain obligations under Derivative Instruments; and (4) any obligation arising out of a Variable Interest in an unconsolidated entity that is held by, and material to, the issuer.[118] Off-Balance Sheet arrangements do not include contingent liabilities related to litigation, arbitration, or regulatory actions unless such activity is otherwise disclosable.

Operating Lease. "Operating Lease" means any Lease other than a Capital Lease.[119]

Operating Lease Obligation. "Operating Lease Obligation" means a payment obligation under a Operating Lease.[120]

Performance Guarantee. A "Performance Guarantee" includes a contract that contingently requires the guarantor to make payments to the guaranteed party based on another entity's failure to perform under an obligating agreement.[121]

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[118] See Regulation S-K, 17 C.F.R. §229.303(a)(4).

[119] *See* FASB Statement No. 13, *Accounting for Leases* (November, 1976).

[120] *Id*.

[121] *See* Off-Balance Sheet Release (citing paragraph 3(b) of FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Others* (November, 2002)).

Purchase Obligation. "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.[122]

Restructuring. "Restructuring" means a program that is planned or controlled by management and materially changes either: (1) the scope of a business undertaken by an enterprise; or (2) the manner in which that business is conducted. A Restructuring includes the sale or termination of a line of business, the closure of business activities in a particular location, the relocation of business activities from one location to another, changes in management structure, and a fundamental reorganization that affects the nature and focus of operations.[123]

Restructuring Charge. "Restructuring Charge" means charges typically resulting from the consolidation and/or relocation of operations, or the abandonment of operations or productive assets.[124]

Results of Operations. "Results of Operations" mean: (1) any unusual or infrequent events or transactions or any significant economic changes that materially affected the amount of reported income from continuing operations; (2) any known trends or uncertainties that have had (or that the registrant reasonably expects will have) a material favorable

[122] *See* 17 C.F.R. §229.303(a)(5)(ii)(D).

[123] FASB Statement No. 146, *Accounting for Costs Associated with Exit Disposed Activities*, (June, 2002) (quoting IAS 37, *Provisions, Contingent Liabilities, and Contingent Assets*).

[124] SAB No. 100, *Restructuring and Impairment Charges* (November 24, 1999).

or unfavorable impact on net sales or revenues or income from continuing operations; (3) to the extent that the financial statements disclose material increases in net sales or revenues, the extent to which such increases are attributable to increases in prices or to increases in the volume or amount of goods or services being sold or to the introduction of new products or services; and (4) the impact of inflation and changing prices on net sales and revenues and on income from continuing operations.[125]

Revenue Recognition. Revenue should not be recognized until it is realized or realizable and earned. Revenue is generally realized or realizable and earned when: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services have been rendered; (3) the seller's price to the buyer is fixed or determinable; and (4) collectibility is reasonably assured.[126]

Routine Transactions. "Routine Transactions" include employment agreements, leases, licenses, and employee pension plans.

Small Business Issuer. A "Small Business Issuer" is any entity that: (1) has 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. An entity is not a Small Business Issuer the aggregate market value of its outstanding equity securities held by non-affiliates in $25,000,000 or more.

Standby Letter of Credit. A "Standby Letter of Credit" is an irrevocable commitment on the part of a bank to make

[125] *See* Regulation S-K, 17 C.F.R. §229.303(a)(3).

[126] SAB No. 101, *Restructuring and Impairment Charges* (November 24, 1999).

payment to a designated beneficiary if the bank's customer defaults on an obligation.

Statutory Safe Harbors. "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.[127]

Underlying. An "Underlying" is a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable.[128]

Variable Interest. A "Variable Interest" is a contractual, ownership, or other pecuniary interest in an entity that changes with changes in the entity's net asset value.[129]

[127] *See* 15 U.S.C. §§77z-2 and 78v-5.

[128] *See* FASB Standard No. 133, *Accounting for Derivative Instruments and Hedging Activities* (June, 1998).

[129] Off-Balance Sheet Release (quoting FASB Interpretation No. 46).

EXHIBIT 2

A BRIEF HISTORY OF MD&A - PART II: SOURCES OF GUIDANCE FOR MD&A PREPARATION[130]

I. Statutes

Item	Description
Securities Act of 1933, 15 U.S.C. § 77a *et seq*.	Statute addressing the primary issuance of securities.
Securities Exchange Act of 1934, 15 U.S.C. § 78a *et seq*.	Statute addressing the secondary market place

II. Regulations

Item	Description
Regulation S-B, 17 C.F.R. §228.10 *et. seq.*	Source of disclosure requirements for **Small Business Issuers**
Regulation S-K, 17 C.F.R. § 229.10 *et seq.*	Standard instructions for preparing MD&A section of SEC filings.

[130] Technical terms and concepts placed in boldface are further explained and defined in EXHIBIT 1, Glossary of Key Terms and Concepts. Although this EXHIBIT 2 highlights most of the primary resources governing MD&A Disclosure, it is not exhaustive. Advisors are encouraged to review other resources for MD&A guidance, including SEC Audit Risk Alert Letters, Statements of Position of the American Institute of Certified Public Accountants, and various speeches and publications prepared by SEC Staff.

Regulation S-X, 17 C.F.R. § 210.1-01 *et seq.*	Requirements for the form and content of financial statements required to be filed as part of registration statements and reports.
Regulation G, 17 C.F.R. § 244 *et seq.*	Requirements for disclosure of **Non-GAAP Financial Measures**.

III. SEC Releases

Item	**Date**	**Description**
SEC Release No. 33-8182, *Final Rule: Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations*.	January 22, 2003	Final rule concerning the disclosure of "Off-Balance Sheet Arrangements." Amended Regulations S-K and S-B and Forms 20-F and 40-F.
SEC Release No. 33-8176, *Final Rule: Conditions for Use of Non-GAAP Financial Measures*.[131]	January 22, 2003	Final rule concerning specific requirements for disclosure where company uses **Non-GAAP Financial Measures** such as EBIDTA. Enacted Regulation G.

[131] On June 13, 2003, Staff members of the SEC Division of Corporate Finance issued answers to 33 frequently asked questions regarding the use of **Non-GAAP Financial Measures.** *See* SEC Division of Corporate Finance *Frequently Asked Questions Regarding the Use of Non-GAAP Financial Measures.* (June 13, 2003) *available at* http://www.sec.gov/divisions/corpfin/faqs/nongaapfaq.htm In standard

Item	Date	Description
SEC Release No. 33-8098, *Proposed Rule: Disclosure in Management's Discussion and Analysis About the Application of Critical Accounting Policies*	May 10, 2002	Proposed rule requiring "plain English" disclosure concerning the methodology, assumptions, and decision-making process underlying any "critical" accounting estimates, and disclosure regarding the process underlying the initial adoption of a registrant's accounting policy.
SEC Release No. 33-8056, *Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations*.	January 22, 2002	Release 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

practice, the answers represented the views of the Division of Corporate Finance and not the SEC. *Id*.

Item	Date	Description
SEC Release No. 33-8040, *Cautionary Advice Regarding Disclosure About Critical Accounting Policies*.	December 12, 2001	Release cautioning registrants to explain their decision-making process and be able to defend their choice of **Critical Accounting Policies**.
SEC Release No. 33-6835, *Management's Discussion and Analysis of Financial Condition and Results of Operations*	May 18, 1989	Seminal release articulating goals of MD&A and SEC's expectations with respect to MD&A disclosures.
SEC Release No. 33-6711, *Concept Release on Management's Discussion and Analysis of Financial Condition and Operations*	April 24, 1987	Discussion of proposals submitted by the then Big "7" accounting firms for improved MD&A disclosure.
SEC Release No. 33-6349, *Management's Discussion and Analysis of Financial Condition and Results of Operations*	September 28, 1981	Provides analysis of MD&A sections filed during first year of MD&A and provides sample MD&A disclosures.

Item	Date	Description
SEC Release No. 33-6231, *Amendments to Annual Report Form, Related Forms, Rules, Regulations, and Guides; Integration of Securities Act Disclosure System*	September 25, 1980	Enactment of Item 11 of Regulation S-K implementing MD&A section of SEC filings.

IV. Staff Accounting Bulletins

Item	Date	Description
SEC Staff Accounting Bulletin No. 102 – Selected Loan Loss Allowance Methodology and Documentation Issues	July 6, 2001	Staff guidance regarding loan and lease losses in accordance with GAAP.
SEC Staff Accounting Bulletin No. 101 – Revenue Recognition in Financial Statements	December 3, 1999	Staff guidance regarding **Revenue Recognition** in financial statements.

SEC Staff Accounting Bulletin No. 100 – Restructuring and Impairment Charges	August 12, 1999	Staff guidance regarding accounting for and disclosure of expenses commonly reported in connection with **Exit Activities** and **Business Combinations**.
SEC Staff Accounting Bulletin No. 99 – Materiality	November 24, 1999	Staff guidance regarding certain quantitative benchmarks to assess **Materiality** in preparing and auditing financial statements.
SEC Staff Accounting Bulletin No. 92 – Loss Contingencies	June 8, 1993	Staff guidance regarding accounting and disclosure relating to **Loss Contingencies**.

V. Financial Accounting Standards Board Statements

Item	**Date**	**Description**
FASB Statement No. 5, Accounting for Contingencies	March, 1975	Establishes standards of financial accounting and reporting for **Loss Contingencies**.
FASB Statement No. 13, Accounting for Leases	November, 1976	Establishes standards of financial accounting and reporting for **Leases**.

Item	Date	Description
FASB Statement No. 57, Related Party Disclosures	March, 1982	Establishes requirements for related party disclosures.
FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities	June, 1998	Establishes standards for accounting for **Derivative Instruments**.
FASB Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets	August, 2001	Establishes standards for accounting for the impairment or **Disposal** of long-lived assets.
FASB Statement No. 146, Accounting for Costs Associated with Exit or Disposal Activities	June, 2002	Establishes standards for accounting for costs associated with **Exit Activities** or **Disposal** Activities.

VI. Financial Accounting Standards Board Interpretations

Item	Date	Description
FASB Interpretation No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others	November, 2002	Provides definition and exclusions for **Guarantees** falling under Regulation S-K's definition of **Off-Balance Sheet Release**
FASB Interpretation No, 46, Consolidation of Variable Interest Entities	January, 2003	Provides the concept of **Variable Interest** falling under Regulation S-K's definition of **Off-Balance Sheet Release**

VII. Notable Enforcement Actions

In re Edison Schools, Inc., Exchange Act Release No. 34-45925 (May 14, 2002)	MD&A violation where Edison did not disclose that a portion of its reported revenues included payments that did not reach Edison and were made by school districts to teachers and other providers of services in Edison's schools. SEC further observed that Edison lacked "adequate system of internal controls" to ensure proper disclosure.

SEC v. Dean L. Buntock et al., Civ. Action No. 02C 2180, Litigation Release No. 17435 (N.D. Ill., March 26, 2002)	Federal civil action against former high-ranking officers of Waste Management who falsified the company's earnings through the use of non-GAAP financial measures. Inadequate MD&A disclosures by the company helped support the misrepresentation.
In re BankAmerica Corp., Administrative Proceeding File No. 3-10541, Exchange Act Release No. 44613 (July 30, 2001)	SEC finds violation where strategic alliance with various D.E. Shaw entities was incorrectly described as a loan rather than an equity investment and where MD&A failed to disclose the risks associated with the alliance.
In re Sunbeam Corporation, Administrative Proceeding File No. 3-10481, Securities Act Release No. 7976, Exchange Act Release No. 44305 (May 15, 2001)	MD&A violations where company engaged in a variety of questionable accounting techniques that should have been disclosed in MD&A as material "infrequent items."
In re Sony Corporation, SEC Litigation Release No. 15832 (August 5, 1998)	SEC found inadequate disclosures of known negative results and trends in issuer's MD&A disclosures. This is a rare SEC action brought against reporting **Foreign Private Issuers**.

In re Advanced Micro Devices, Inc., Exchange Act Release No. 37730 (September 26, 1996)	MD&A violation where disclosure indicated that company was independently designing the microcode for its 486 microprocessor. In reality, company engineers had been provided with Intel Corporation's copyrighted 386 microcode to speed up development.
In re Gibson Greetings, Inc., SEC Exchange Release No. 34-36357, S.E.C. Docket 4 (October 11, 1995)	SEC concluded that Gibson Greetings violated MD&A by using deferral accounting for derivative transaction even though it failed to qualify for derivative accounting. The SEC found that the company's CFO and treasurer were at fault for the company's violations because they were familiar with the derivative transactions.
In re Philip A. Fitzpatrick and Gerry R. Ginsberg ("First Capital Holdings Corp., Inc."), Exchange Act Release No. 34-34865 (October 20, 1994)	MD&A violation where failure to disclose uncertainties relating to company's reinsurance agreements and their impact upon the company's **Liquidity**.
In re America West Airlines, Inc., Exchange Act Release No. 34-34047 (May 12, 1994)	MD&A violation where company failed to disclose uncertainties regarding its ability to comply with financial covenants in its credit agreement.

In re Salant Corporation and Martin F. Tynan, Exchange Act Release 34-34046, 56 S.E.C. docket 1779 (May 12, 1994)	MD&A disclosure violation where company failed to disclose in MD&A "known uncertainties arising from the declining economic condition of the company." Where company had amended its credit agreement to remove certain financial covenants, taken loans against trade payables, and failed to pay certain vendors, the SEC concluded that management was fully aware of material uncertainties affecting the financial condition of the company.