

**Report and Recommendations Pursuant to Section 401(c)  
of the Sarbanes-Oxley Act of 2002 On Arrangements with  
Off-Balance Sheet Implications, Special Purpose Entities,  
and Transparency of Filings by Issuers**

**Submitted to the President of the United States, the Committee on  
Banking, Housing, and Urban Affairs of the United States Senate and  
the Committee on Financial Services of the United States House of  
Representatives**

**OFFICE OF THE CHIEF ACCOUNTANT  
OFFICE OF ECONOMIC ANALYSIS  
DIVISION OF CORPORATION FINANCE**

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**

This is a report by the Staff of the U.S. Securities and Exchange Commission. The Commission has expressed no view regarding the analysis, findings, or conclusions contained herein.

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## ABBREVIATIONS

|                    |   |
|--------------------|---|
| ABO                | Accumulated Benefit Obligation  |
| APBO               | Accumulated Postretirement Benefit Obligations  |
| Act                | The Sarbanes Oxley Act of 2002  |
| AICPA              | American Institute of Certified Public Accountants  |
| AIMR               | Association for Investment Management and Research (currently known as the Certified Financial Analyst Institute) |
| APB                | Accounting Principles Board   |
| ARB                | Accounting Research Bulletin  |
| Board              | Financial Accounting Standards Board  |
| CFA Institute      | Certified Financial Analyst Institute (formerly known as the Association for Investment Management and Research)  |
| Commission         | United States Securities and Exchange Commission  |
| DIG                | Derivatives Implementation Group  |
| EDGAR              | Electronic Data Gathering, Analysis, and Retrieval system   |
| EITF               | Emerging Issues Task Force  |
| ERISA              | Employee Retirement Income Security Act of 1974   |
| FASB               | Financial Accounting Standards Board  |
| FR                 | Final Reporting Release   |
| Interpretation No. | FASB Interpretation Number  |
| GAAP               | Generally Accepted Accounting Principles  |
| GSE                | Government Sponsored Enterprise   |
| IASB               | International Accounting Standards Board  |
| IOSCO              | International Organization of Securities Commissions  |
| LIBOR              | London Inter-bank Offering Rate   |
| MD&A               | Management's Discussion and Analysis of Financial Position and Results of Operations                              |
| OBS                | Off-Balance Sheet   |
| OPEB               | Other Post-Employment Benefits  |
| PBO                | Projected Benefit Obligation  |
| QSPE               | Qualifying Special Purpose Entity   |
| SAB                | Staff Accounting Bulletin   |
| Sarbanes Oxley Act | The Sarbanes Oxley Act of 2002  |
| SEC                | United States Securities and Exchange Commission  |
| SFAC               | Statement of Financial Accounting Concepts  |
| SFAS               | Statement of Financial Accounting Standards   |
| SOP                | Statement of Position   |
| SPE                | Special Purpose Entity  |
| Staff              | Staff of the United States Securities and Exchange Commission   |
| VaR                | Value at Risk   |
| VIE                | Variable Interest Entity  |

# Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers

## EXECUTIVE SUMMARY

In 2001 and 2002, a spate of major corporate accounting scandals came to light that exposed weaknesses in corporate governance, audit practices, and financial reporting. Congress responded by passing the Sarbanes-Oxley Act of 2002 (the “Sarbanes-Oxley Act” or “Act”),<sup>1</sup> the most significant piece of securities legislation since the 1930s. Among the many provisions of the Act, Section 401(c) mandates that the Securities and Exchange Commission (“SEC” or “Commission”) conduct a study of filings by issuers (the “Study”) and issue a report (the “Report”) that addresses two primary questions: (1) the extent of off-balance sheet (“OBS”) arrangements, including the use of special purpose entities (“SPEs”), and (2) whether current financial statements of issuers transparently reflect the economics of off-balance sheet arrangements. To answer these questions, the staff of the Commission (the “Staff”) conducted an empirical analysis of the filings of issuers as well as a qualitative analysis of pertinent U.S. Generally Accepted Accounting Principles (“GAAP”) and Commission disclosure rules. The mandate also asks for recommendations, if any. In this Report, which is intended to fulfill the statutory mandate, the Staff describes the Study, reports its findings and provides recommendations.

For purposes of the Study and Report, the Staff takes a relatively expansive approach to the scope and meaning of the term “off-balance sheet.” The Staff examines a variety of business arrangements that may be viewed as having off-balance sheet implications and that are deemed important from a policy perspective. The arrangements examined in the Study include investments in the equity of other entities, transfers of financial assets (where there is continuing involvement), certain retirement arrangements, leases, contingent obligations and guarantees, derivatives, and other contractual obligations—with an emphasis on the use of special purpose entities where relevant. The Staff broadly concludes that significant progress has been made in several areas since the passage of the Act, but that there remains room for improvement in the financial reporting of several types of arrangements with off-balance sheet implications. The Staff also believes that reducing the complexity of the financial reporting requirements should increase transparency and understanding.

The Study was performed by analyzing data collected from the filings of a sample of 200 issuers, including the notes to the financial statements, and Management’s

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<sup>1</sup>The Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 2002.

Discussion and Analysis of Financial Position and Results of Operations (“MD&A”).<sup>2</sup> The Staff determined that a sample size of 200 was sufficient to construct a representative sample of the population of active U.S. issuers.<sup>3</sup> Given the possibility that the use of arrangements with off-balance sheet implications, as well as special purpose entities, might be disproportionately concentrated in the very largest issuers, a “stratified” sampling approach was adopted such that the sample would consist of the 100 largest issuers (in terms of market capitalization)<sup>4</sup> and 100 additional issuers, randomly selected.<sup>5</sup>

The Staff reports findings on the extent to which issuers report the existence of certain business arrangements with off-balance sheet implications, how such arrangements are presented on issuer balance sheets, and the transparency of the supporting disclosures in the financial reports. The empirical findings and estimates are limited by what is actually reported and/or disclosed in issuers’ financial reports. The Staff was not in a position to address whether and to what extent there may be other arrangements that are not reflected in the financial reports. The empirical portion of the Study is largely descriptive in nature.

In addition to the empirical work, the Report is also informed by the Staff’s experience in reviewing periodic financial statements filed with the Commission, which provides it with information about the application of accounting and disclosure standards. In particular, the qualitative analysis of the content and application of pertinent accounting standards relies in part on the collective experience of the Staff. Further, the Report is informed by the Staff’s experience in dealing with standard setters and international regulators that are grappling with comparable issues. For example, both the Financial Accounting Standards Board (“FASB”) and the International Accounting Standards Board (“IASB”) have dealt with (and continue to consider) the accounting for each of the topics addressed in this Report, and the Technical Committee of the International Organization of Securities Commissions (“IOSCO”) has recently released its Report on Strengthening Capital Markets Against Financial Fraud, which, among other things, discusses whether additional disclosures related to the use of SPEs are warranted.

In excess of 100 Staff members directly contributed to the Study and Report through participation in project planning, methodology design, data collection and analysis, research, critical analyses of standards and rules, and the drafting, editing, and review of the Report. Primarily, this included Staff from the Office of the Chief Accountant, the Office of Economic Analysis and the Division of Corporation Finance.

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<sup>2</sup>Management’s Discussion and Analysis of Financial Condition and Results of Operations is required by Item 303 of Regulation S-K, Items 303(a), (b) and (c) of Regulation S-B, Item 5 of Form 20-F and Paragraphs 11 and 12 of General Instruction B of Form 40F.

<sup>3</sup>In statistical terms, the sample size is sufficient to test for a 20% difference from the sample mean at 95% significance and with 90% power.

<sup>4</sup>This is with certain exceptions, as explained below.

<sup>5</sup>See Section II for more details on the sample selection methodology.

In many cases, when considering the appropriateness of accounting for various transactions, the focus is on the standards themselves and recommendations tend to focus on what changes the FASB, as the accounting standard-setter in the U.S., should consider. However, the Staff believes that to focus only on the FASB activities is too narrow, as the FASB is only one part of the financial reporting framework. Thus, in formulating its recommendations, the Staff considered potential improvements that could be made to improve transparency by various participants in the financial reporting process.

The Staff identified several key initiatives to improve transparency in reporting, as follows:

- i. Discourage transactions and transaction structures primarily motivated by accounting and reporting concerns, rather than economics. The Staff believes that use of transaction structuring to achieve accounting and reporting goals that do not conform to the economic substance of the arrangements reduces transparency in financial reporting. As discussed below, many of the areas dealing with off-balance sheet arrangements involve significant use of accounting-motivated structured transactions.
- ii. Expand the use of objectives-oriented standards, which would have the desirable effect of reducing complexity in accounting standards. The Staff's previous report on objectives-oriented standards<sup>6</sup> described many of the benefits of such standards, as well as the risks inherent in accounting standards that rely to a significant extent on rules and bright lines. The Staff continues to support the recommendations in its prior study.
- iii. Improve the consistency and relevance of disclosures that supplement the basic financial statements. In many cases, the Staff does not believe issuer disclosures are as informative as they could be. Nowhere is this clearer than in regards to financial instruments disclosures. While new standards might help in this area, substantial progress can be made through attention of issuers in improving disclosures under existing standards.
- iv. Improve communication focus in financial reporting. The Staff believes that many issuers interpret financial reporting narrowly, and regard technical compliance with the requirements as satisfactory. However, if investors and other users are misled or have insufficient information to understand the activities of the issuer, such "compliance" does not serve the purpose of financial disclosure. Moreover, such a mindset puts the burden on regulators and standard-setters to drive all improvements in reporting. The Staff believes that if issuers focus on clear and transparent communication with investors in preparing financial statements, both accounting and disclosures will improve.

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<sup>6</sup>Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System ("Objectives-Oriented Accounting Standards Study").

In addition, the Report includes several standard-setting recommendations that would help further these initiatives.

- a. The Staff recommends that the FASB continue its work on the accounting guidance that determines whether an issuer would consolidate other entities. While it may be too early to fully understand the effects of recent improvements in consolidation guidance for SPEs, the consolidation guidance continues to be complex and decisions regarding consolidation greatly affect which items are on the balance sheet.
- b. The Staff recommends the accounting guidance for defined-benefit pension plans and other postretirement benefit plans be reconsidered. Under the current accounting guidance (circa 1985), the trusts that administer these plans, which are conceptually similar to SPEs, are exempt from consolidation by the issuers that sponsor them, effectively resulting in the netting of assets and liabilities on the balance sheet. In addition, issuers have the option to delay recognition of certain gains and losses related to the retirement obligations and the assets used to fund these obligations. An extrapolation of the findings from the sample of issuers in the Study to the approximate population of active U.S. issuers suggests that there may be approximately \$535 billion in retirement obligations that are not recognized on issuer balance sheets.
- c. The Staff recommends that the accounting guidance for leases be reconsidered. The current accounting for leases takes an “all or nothing” approach to recognizing leases on the balance sheet. This results in a clustering of lease arrangements such that their terms approach, but do not cross, the “bright lines” in the accounting guidance that would require the lease to be recognized on the balance sheet. An extrapolation of the findings from the sample of issuers in the Study to the approximate population of active U.S. issuers suggests that there may be approximately \$1.25 trillion in non-cancelable future cash obligations committed under operating leases that are not recognized on issuer balance sheets, but are instead disclosed in the notes to the financial statements.<sup>7</sup>
- d. The Staff recommends the continued exploration of the feasibility of reporting all financial instruments at fair value. Supporters of greater use of fair values on the balance sheet argue that the most useful information is that which reflects the current values of assets and obligations. Fair value accounting for all financial instruments also would appear to have benefits in terms of reduced complexity (for example, by eliminating the need for hedge accounting and its attendant documentation and effectiveness testing requirements, in many instances), more understandability, and less motivation to structure transactions so as to achieve certain accounting treatments. Of course, some have expressed significant concerns with requiring fair value accounting for all financial instruments, such as the potential manipulability and degree of difficulty in auditing some fair values. However, in light of the potential benefits, the Staff

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<sup>7</sup>This figure is not discounted to its present value, as would be the case if these cash flows were recognized as a liability on issuer balance sheets.



believes that methods should be sought to eliminate the obstacles to this treatment.

- e. The Staff believes that, in general, disclosures in the filings of issuers need to be better organized and integrated. More useful and consistent disclosure requirements could be achieved if a framework were developed that clearly and concisely set forth the objectives and limitations of the notes to the financial statements. In addition, the Staff hopes to work with the FASB, users, preparers, and others to improve disclosures for financial instruments, so that information is organized, streamlined, and provides adequate specificity and detail, without overburdening preparers and auditors.

While the Staff concludes in this Report that there remains room for improvement in the transparency of financial reporting related to the balance sheet, it also wishes to acknowledge that much has been accomplished since the passage of the Sarbanes-Oxley Act in terms of improving the financial reporting of arrangements with off-balance sheet implications.<sup>8</sup> This includes, among other things, additional guidance from the FASB—for example, Interpretation No. 46(R), Consolidation of Variable Interest Entities (revised December 2003)—an interpretation of ARB No. 51—which is intended to address some of the concerns with the failure of issuers to consolidate certain special purpose entities under earlier guidance.<sup>9</sup> The FASB has also promulgated new guidance in several other areas, including the accounting for guarantees in Interpretation No. 45 and distinguishing liabilities from equity in SFAS No. 150. Further improvements come from regulatory requirements promulgated by the Commission that an issuer explain its off-balance sheet arrangements in a separately captioned subsection of its MD&A.<sup>10</sup> While not directly related to the topics addressed in this Report, the Staff also notes the substantial improvement in transparency that will result from the implementation of SFAS No. 123R “Share-Based Payment”, which requires accounting for stock options based on their fair values.

Underpinning this Report is the Staff’s focus on “full and fair disclosure.” The Staff believes that investors—and the market as a whole—are best served by financial information that is presented fully and clearly. For example, the Staff believes that investors will benefit from an income statement that reflects changes in asset values so long as the sources of those changes are disclosed, and the manner in which those values are determined (*i.e.*, what measurement attribute is used and what assumptions underlie the value) is understandable. What presents difficulties for investors, as well as the market as a whole, is a lack of information about potential positive and negative cash flows. Thus, while some participants in the financial reporting process favor accounting standards that enable the presentation of consistent or smooth income statement figures,

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<sup>8</sup>For a more complete list of improvements in financial reporting since the Act see Section I.C.4.

<sup>9</sup>See Section IV infra. for discussion.

<sup>10</sup>See Disclosure in Management’s Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations Release No. 33-8182 (January 28, 2003) (“FR-67”). This rule was promulgated by the Commission in January 2003 in response to Section 401(a) of the Act.

the Staff believes that transparent balance sheets are very important and that investors are better served by seeing any volatility that exists, along with explanations for why such volatility exists. To that end, it seems desirable to the Staff for standard setters to focus on balance sheet measures and to consider transparent ways in which to address concerns about showing volatility in the income statement.

Finally, it is important that both regulation and standard setting keep pace with business changes in the private sector, which are extremely fast paced. That being said, the Staff appreciates the extraordinary resource demands that have been imposed on preparers and auditors as a result of the Sarbanes-Oxley Act coupled with the various other efforts at improving financial reporting, auditing, and standard setting that have followed in its wake. Nonetheless, the Staff believes that the issues raised in this Report should be addressed to improve the transparency of the balance sheet in particular and of financial reporting in general.

## I. Introduction

### A. How the Study and Report Fulfill the Statutory Mandate

#### 1. The Statutory Mandate

The mandate for this Report comes from the Sarbanes-Oxley Act of 2002, which introduced a broad array of reforms to the U.S. financial reporting system.<sup>11</sup> The Act called for increased oversight of auditors of public companies through the creation of the Public Company Accounting Oversight Board.<sup>12</sup> It directed the Commission to establish rules prohibiting auditors from providing certain non-audit services to audit clients<sup>13</sup> and requiring management and auditor reporting on the effectiveness of public companies' internal controls.<sup>14</sup> It increased penalties for violations of securities laws and required certification of financial results by key corporate officers.<sup>15</sup> Through these and other provisions, the Act called for improvement in the system of checks and balances that govern the production of financial information provided to investors.

The Act also mandated that the Commission conduct a Study of off-balance sheet transactions and the use of special-purpose entities. Specifically, Section 401(c)(1) of the Act requires the Commission to: “complete a study of filings by issuers and their disclosures to determine—

(A) the extent of off-balance sheet transactions, including assets, liabilities, leases, losses, and the use of special purpose entities; and

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<sup>11</sup>See the Sarbanes-Oxley Act.

<sup>12</sup>See sections 101-109 of the Act.

<sup>13</sup>See section 201 of the Act.

<sup>14</sup>See section 404 of the Act.

<sup>15</sup>See sections 901 to 906 of the Act.

(B) whether generally accepted accounting rules result in financial statements of issuers reflecting the economics of such off-balance sheet transactions to investors in a transparent fashion.”

In addition, Section 401(c)(2) requires the Commission to: “submit a report to the President, the Committee on Banking, Housing, and Urban Affairs of the Senate, and the Committee on Financial Services of the House of Representatives, setting forth—

(A) the amount or an estimate of the amount of off-balance sheet transactions, including assets, liabilities, leases, and losses of, and the use of special purpose entities by, issuers filing periodic reports pursuant to section 13 or 15 of the Securities Exchange Act of 1934;

(B) the extent to which special purpose entities are used to facilitate off-balance sheet transactions;

(C) whether generally accepted accounting principles or the rules of the Commission result in financial statements of issuers reflecting the economics of such transactions to investors in a transparent fashion;

(D) whether generally accepted accounting principles specifically result in the consolidation of special purpose entities sponsored by an issuer in cases in which the issuer has the majority of the risks and rewards of the special purpose entity; and

(E) any recommendations of the Commission for improving the transparency and quality of reporting off-balance sheet transactions in the financial statements and disclosures required to be filed by an issuer with the Commission.”

In order to fulfill the mandate and produce this Report, the Staff has characterized the terms “off-balance sheet transaction,” “economics” of an arrangement, and “transparency” of financial reporting. When used in other contexts, these terms may have different definitions or meanings.

In recent times, following the accounting scandals exposed in 2001 and subsequently, the term “off-balance sheet” has sometimes carried the connotation of something underhanded, or at least less than fully transparent. The insinuation is that something that should be on the balance sheet is not, and that the reporting issuer has designed the transaction or arrangement to produce that result. However, questions about whether items should be reflected on the balance sheet do not arise only when there is an attempt to deceive financial statement users. Many legitimate transactions generate such questions, and there are, of course, bounds as to what should be included on a balance sheet. It is this broader, more-inclusive question of the proper bounds of what should be included on the balance sheet that draws the Staff’s attention in this Report. The common characteristic of the arrangements addressed in this Report is that they create or involve a situation in which there may be a legal or economic nexus between the issuer and risks, rewards, rights or obligations not reflected (or not fully-reflected) on the balance sheet.

Sections 401(c)(1)(B) and 401(c)(2)(C) both use the term “economics,” with the latter section asking “whether generally accepted accounting principles or the rules of the

Commission result in financial statements of issuers reflecting the economics of such transactions to investors in a transparent fashion.”<sup>16</sup> For purposes of this Report, when the Staff refers to the “economics” of an arrangement, the reference is meant to speak generally to the risks, rewards, rights, and obligations associated with the arrangement, rather than a formal categorization.

The words “transparent” or “transparency” appear in sections 401(c)(1)(B), 401(c)(2)(C) and 401(c)(2)(E), with the final subsection asking for “any recommendations of the Commission for improving the transparency and quality of reporting off-balance sheet transactions in the financial statements and disclosures required to be filed by an issuer with the Commission.”<sup>17</sup> The Staff believes transparency can best be gauged in terms of the informational needs of investors, creditors and other users of financial statements. For purposes of this Report, the Staff characterizes “transparent” financial reporting as reporting that provides investors and other users of financial statements with appropriate information to assess the material risks, rewards, rights, and obligations associated with arrangements. The Staff notes that transparency is not always improved with the provision of more information.<sup>18</sup> Thus, while some might argue that the greatest transparency would come from putting all things on the balance sheet, thereby eliminating “off-balance sheet” arrangements entirely, the Staff believes that putting too many things on the balance sheet could result in less understanding of the differences between the rights and obligations associated with each of the items reported.

## **2. The Structure of this Report**

The Report is arranged topically, analyzing the accounting and reporting for various types of arrangements in turn. This structure allows the Staff to provide the requested information for various types of arrangements in an integrated manner that is intended to facilitate understanding.

By way of background, the next sub-section presents a short primer summarizing the financial reporting framework, including the basic accounting concepts necessary to understand the issues discussed in the Report. Those who are familiar with the financial reporting framework may skip this section of the Report with no loss of continuity. The remainder of the introduction provides a discussion of the historical context of the Study and Report, including, among other things, a discussion of certain arrangements involving Enron.

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<sup>16</sup>Emphasis added.

<sup>17</sup>Emphasis added.

<sup>18</sup>For example, as noted in the December 29, 2003 Release No. 33-2950 Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations:

MD&A must specifically focus on known material events and uncertainties that would cause reported financial information not to be necessarily indicative of future operating performance or of future financial condition. Companies must determine, based on their own particular facts and circumstances, whether disclosure of a particular matter is required in MD&A. However, the effectiveness of MD&A decreases with the accumulation of unnecessary detail or duplicative or uninformative disclosure that obscures material information.

Section II of the Report—entitled “Study Methodology”—addresses methodological issues including the construction of a stratified sample, the data collection process, descriptive statistics on the sample and a description of the technique for extrapolating to the population.

Section III of the Report—entitled “Arrangements with Potential Off-Balance Sheet Implications”—addresses particular types of arrangements with potential off-balance sheet implications. Section III covers investments in the equity of other entities, transfers of financial assets with continuing involvement, retirement arrangements, leases, contingent liabilities and guarantees, derivatives, and other contractual obligations. Each of the sub-sections includes the following:

- i.) A description of the transactions or reporting issues being addressed combined with a discussion of the related accounting and financial reporting requirements;
- ii.) A discussion of the potential off-balance sheet questions that arise from the arrangements and a discussion of why standard setters have made the decisions currently reflected in the accounting guidance; and
- iii.) A presentation and discussion of the empirical data gathered from the Study of filings by issuers to provide information regarding the percentage of issuers reporting the arrangements discussed in the Report, and how these arrangements are recognized on issuer balance sheets and in notes to the financial statements.

The discussions of each area are intended to be illustrative. The Staff focuses on different ways that the arrangements in question could be analyzed in terms of what assets or liabilities would be recorded. Sections 401(c)(1)(A), (2)(A) and (2)(B) of the Act require a study of “the extent of” off-balance sheet transactions. Where the data were obtainable, this portion of the mandate is answered in the subsections of Section III titled “Empirical Findings from Study of Filings by Issuers.”

Sections 401(c)(1)(B) and (2)(C) of the Act require a study of whether generally accepted accounting principles and the rules of the Commission result in financial statements of issuers “reflecting the economics of such off-balance sheet transactions to investors in a transparent fashion.” The Staff addresses this question for each of the substantive accounting areas addressed in Section III in the subsections entitled “Off-Balance Sheet Issues in Accounting for [...]”

Section IV addresses certain post-Sarbanes Oxley improvements to the financial reporting regime as they relate to off-balance sheet arrangements. This section includes a discussion of FASB Interpretation No. 46(R), which was meant to achieve more consistent application of consolidation policies for special purpose entities. Section 401(c)(2)(D) of the Act inquires as to “whether generally accepted accounting principles specifically result in the consolidation of special purpose entities sponsored by an issuer in cases in which the issuer has the majority of the risks and rewards of the special purpose entity.” This can simply be answered in the affirmative in that Interpretation No. 46(R) essentially requires this.<sup>19</sup> However, as is discussed in Section IV, the

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<sup>19</sup>See Section IV for additional information on Interpretation No. 46(R).

determination of which party has “the majority of the risks and rewards of the special purpose entity” may involve complex judgments in some circumstances.

Section 401(c)(2)(E) of the Act calls for recommendations, if any, for “improving the transparency and quality of reporting off-balance sheet transactions” in financial statements. Section V discusses several goals toward which all those involved in the financial reporting community should work. The discussion explains the goal and its benefits to financial reporting, and explains how various constituents in the capital markets can help to achieve the goals. Section VI provides recommendations for changes in accounting and reporting requirements that would further the initiatives discussed in Section V. The recommendations in Sections V and VI do not, in all cases, follow only from the analysis of the various types of transactions. That is, the Staff draws as well from its own experiences in dealing with issuer financial statements on a daily basis.

## **B. The Financial Reporting Framework**

The Commission has responsibilities under the securities laws to specify acceptable standards for the preparation of financial statements.<sup>20</sup> However, the Commission has for virtually its entire existence looked to the private sector for assistance in this task. Currently, the body that the Commission looks to for the setting of financial reporting standards is the FASB.<sup>21</sup> The FASB has promulgated accounting standards in many areas, and has also created a conceptual framework for accounting and financial reporting that it uses in setting accounting standards. This framework specifies that the objective of financial reporting is to provide information useful to investors and creditors in their decision-making processes.<sup>22</sup>

Filings by issuers include four main financial statements: the balance sheet, the income statement, the cash flow statement, and the statement of changes in equity.<sup>23</sup> Each financial statement provides different types of information, but they are interrelated in that they “reflect different aspects of the same transactions or other events affecting an entity,” as well as complementary in that “none is likely to serve only a single purpose or provide all the financial statement information that is useful for a particular kind of assessment or decision.”<sup>24</sup> A complete set of financial statements also includes notes, which disclose quantitative and qualitative information not in the basic four financial statements. Public filings may also be required to include additional information,

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<sup>20</sup>See, for example, sections 7, 19(a) and Schedule A, items (25) and (26) of the Securities Act of 1933, 15 U.S.C. 77g, 77s(a), 77aa(25) and (26); sections 3(b), 12(b) and 13(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(b), 78l(b) and 78m(b); sections 5(b), 14, 15 and 20 of the Public Utility Holding Company Act of 1935, 15 U.S.C. 79e(b), 79n, 79o and 79t; sections 8, 30(e), 31 and 38(a) of the Investment Company Act of 1940, 15 U.S.C. 80a-8, 80a-29(e), 80a-30 and 80a-37(a).

<sup>21</sup>See Release No. 33-8221 (April 25, 2003), Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter.

<sup>22</sup>Statement of Financial Accounting Concept No. 1, Objectives of Financial Reporting by Business Enterprises, November 1978, paragraph 32.

<sup>23</sup>SFAC No. 5, paragraphs 39-41 and 55-57.

<sup>24</sup>SFAC No. 5, paragraph 23, see also paragraph 24.

including information about the company’s business, the risk factors it faces, and a discussion of its financial condition and results of operations.

## 1. The Balance Sheet

Given the topic of this Report, our main focus is on the balance sheet. The balance sheet portrays an issuer’s financial position at a point in time. Its basic components include:

- Assets, which are “probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events”;<sup>25</sup>
- Liabilities, which are “probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events”;<sup>26</sup> and
- Equity, which is “the residual interests in the assets of an entity that remains after deducting its liabilities.”<sup>27</sup>

While the above definitions appear straightforward, many questions and issues arise in determining which items should be reflected on the balance sheet. Additionally, questions arise regarding whether certain items that are included in the balance sheet should be reported as liabilities or as equity.

Perhaps the most pervasive question is whether, in deciding which assets and liabilities to include in the balance sheet, one should look to those assets and liabilities legally controlled by an issuer, or to those assets and liabilities that expose an issuer to risks and rewards. In most simple structures, these two approaches to analyzing the question produce similar answers as to whether or not to consolidate. However, more complex structures have developed in business practice for which these two different philosophies produce different answers.

Determining the contents of the balance sheet using a control approach generally makes sense if one is interested in what value company management can generate from the resources that it manages. That is, a control approach is compatible with a “stewardship” view of the financial statements. On the other hand, a risks and rewards analysis makes sense to those who see the financial statements as a way to understand how various events might affect the value of their holdings in the entity. Current GAAP generally relies on a control approach to determine which items appear in the balance sheet. Thus, even when a majority of the risks and rewards of an asset belong to other parties, the controlling entity will record the asset on its books. Furthermore, an issuer that owns a controlling voting interest in another entity will generally consolidate that other entity, even if its controlling interest represents a minority of the total capital invested.

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<sup>25</sup>SFAC No. 6, paragraph 25.

<sup>26</sup>Id., paragraph 35.

<sup>27</sup>Id., paragraph 49.

While the focus on control has been generally consistent, there are various analyses that are used to identify the controlling party. The common indicator of control is a legal analysis regarding the ability to direct the use of the asset in question or, in a consolidation situation, voting control over the entity in question. However, there are some instances in which a legal control analysis has been found lacking, and therefore is not used. The decision of whether to consolidate certain SPEs is one such area. Even before the Enron and other scandals, many had realized that looking for the more common indicators of control does not work well in regard to SPEs, mainly because so many SPEs have all of their significant activities “pre-programmed” at their formation, such that voting control is rendered rather irrelevant.<sup>28</sup> Under recent accounting guidance for SPEs, a risks and rewards analysis is performed in order to get at which party, if any, should consolidate the SPE.

Another issue that pervasively affects which assets and liabilities are included in the balance sheet is whether to record assets and liabilities individually in the financial statements, or to net them. This is particularly important in that most contracts provide both counterparties with rights that could be considered assets, while simultaneously subjecting them to obligations that could be considered liabilities. Pension obligations, when recognized, are generally reported net of assets set aside to fund them,<sup>29</sup> while other obligations for which funds are set aside generally are reported on a “gross” basis—that is, both the obligation and the funds set aside are separately reported in the balance sheet. In contrast, transfers of financial assets may be reported on either a gross or net basis, depending on a myriad of factors. Similar to questions of control vs. risk and rewards, both gross and net reporting can provide information that is useful to investors. For example, in the partial transfer of a financial asset, a gross reporting approach may signal to investors that an issuer still owns the entire asset, and has merely agreed, through a separate contract, to forward a portion of the payments received to another party, in return for the payments received from that other party. Net reporting, however, lets investors know that the issuer is really no longer exposed to the full change in value of the financial asset, because a portion of the related risks and rewards has passed to the purchaser.

## **2. Other Basic Financial Statements**

The other three basic financial statements describe, each in its own way, the changes in various balance sheet items from one period to the next. We discuss each in turn.

The income statement reflects the issuer’s revenues and expenses, gains and losses, and, thus, is intended to capture “the extent to which and the ways in which the equity of an entity increased or decreased from all sources other than transactions with

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<sup>28</sup>See, for example, page 82 of the Commission’s 2000 Report to Congress, which comments that “existing [consolidation] standards do not adequately address circumstances involving entities with specific limits on their powers, also referred to as SPEs. The FASB is urged to continue its efforts to provide guidance concerning these entities.”

<sup>29</sup>See discussion in Section III.



owners during a period.”<sup>30</sup> Over the years, tremendous controversy about what should be reported in the income statement has arisen. In large part, the controversy can be traced to the fact that net income (often expressed as a per share measure) has been focused on more than any other single characteristic in evaluating performance. As such, the decision to change accounting standards in a way that would result in more volatility being reported has often prompted controversy.

Due to the complementary and integrated nature of the balance sheet and income statement, choosing the accounting treatment for one statement has implications for the other.<sup>31</sup> One of the most critical and timely examples to illustrate such conflicts relates to recent standards that require the recognition of more assets and liabilities on the balance sheet at their fair values. Moving to fair values on the balance sheet requires that a decision also be made regarding whether the unrealized changes in these fair values are reported on the income statement. Unrealized gains and losses related to assets and liabilities are those that occur while an issuer holds the asset or liability, as opposed to realized gains and losses that occur when an asset or liability is sold or settled.

Proponents of the “all inclusive” approach to defining net income would argue that it is appropriate to include both realized and unrealized gains and losses in net income because this information enables users to better predict future earnings or cash flows. However, others point out that recording unrealized gains and losses in the income statement may lead to increased earnings volatility such that earnings become less predictive of future earnings or cash flows. The alternative to reporting unrealized gains and losses as part of net income is to report these changes in “other comprehensive income,” which most often appears in the statement of shareholder equity, until the gain or loss is realized through sale of the asset or settlement of the liability.

The statement of changes in equity reflects the ways in which assets and liabilities have changed due to transactions with owners during the period, such as declarations of dividends, issuances of stock options, exchanges of shares in mergers and acquisitions, and items that are classified as “other comprehensive income,” as discussed above.<sup>32</sup>

The cash flow statement reflects “an entity’s cash receipts classified by major sources and its cash payments classified by major uses during a period.”<sup>33</sup> This statement

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<sup>30</sup>SFAC No. 5, paragraph 30. In truth, there are several transactions that meet the criteria to be included in the income statement, but have nonetheless been excluded from net income, and instead categorized as “other comprehensive income”.

<sup>31</sup>Historically, the relative focus of standard setters on the balance sheet versus the income statement (or vice versa) has varied. The balance sheet was emphasized in the early part of the 20<sup>th</sup> Century (and before), in part because creditors had little reliable information available to them. Liquidation values and conservatism were of central importance. By the late 1930s, the focus shifted to a shareholder orientation, the income statement and value in use rather than liquidation value. Hendriksen, Elden S., 1982, Accounting Theory, Irwin, Homewood, Illinois, 257.

<sup>32</sup>With the exception of the changes in the value of international subsidiaries that result from translating their financial statements into U.S. dollars, these issues are discussed in detail in Section III.

<sup>33</sup>Id., paragraph 52.

groups the inflows and outflows of cash into three broad categories: operating cash flows, investing cash flows, and financing cash flows.

Operating cash flows include cash received from customers, cash spent on materials and labor, cash paid for utilities, insurance, executive salaries, and many other types of operating items. When the operating section of the cash flow statement is presented based on categories such as these, it is known as a “direct method” cash flow statement. The FASB noted that “[t]he principal advantage of the direct method is that it shows operating cash receipts and payments [and that] [k]nowledge of the specific sources of operating cash receipts and the purposes for which operating cash payments were made in past periods may be useful in estimating future operating cash flows.”<sup>34</sup>

Another option, known as the “indirect method,” allows issuers to prepare this section by reconciling net income to operating cash flow. Using this method involves adjusting net income for non-cash items, such as depreciation and changes in certain current assets or liabilities. For example, issuers would adjust net income for changes in accounts receivable (which indicate a difference between accrual basis revenue and cash received from customers) or changes in accounts payable (which indicate a difference between accrual basis expenses and cash received to providers of goods and services). The FASB noted that “[t]he principal advantage of the indirect method is that it focuses on the differences between net income and net cash flow from operating activities.”<sup>35</sup>

When the FASB promulgated SFAS No. 95, The Statement of Cash Flows, it required presentation of the indirect method in all cases, and expressed a preference that the direct method<sup>36</sup> also be presented, but did not require its use. Most issuers do not present direct method cash flow statements.<sup>37</sup>

The other two sections of the cash flow statement report investing cash flows and financing cash flows. Investing cash flows include cash inflows and outflows related to purchases or sales of property, plant and equipment, investments in equity or debt of other entities, and other types of investments. Financing cash flows include cash inflows from raising capital through issuing stock or debt, cash outflows to repay mortgages and other liabilities, cash paid for dividends, and the like.

### **3. Notes to the Financial Statements, MD&A, and Other Disclosures**

The basic financial statements alone often do not provide sufficient information for investment decisions. The FASB’s concept statements note that: “[s]ome useful information is better provided by financial statements and some is better provided, or can only be provided, by notes to financial statements or by supplementary information or

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<sup>34</sup>SFAS No. 95, paragraph 107.

<sup>35</sup>SFAS No. 95, paragraph 108.

<sup>36</sup>SFAS No. 95, paragraph 119.

<sup>37</sup>The Staff agrees with the FASB’s preference and encourages issuers to voluntarily present their cash flow statements using the direct method.

other means of financial reporting.”<sup>38</sup> These disclosures in the notes to the financial statements are intended to provide information that balance sheets, income statements, and cash flow statements cannot (or do not) provide.

In addition, although the notes provide much information that is not provided in the basic financial statements, they generally do not provide an explanation of the business activities underlying the numbers. Recognizing that such information may be as important to investors as the information in the financial statements and notes, the Commission requires issuers to include a section called Management’s Discussion and Analysis of Financial Position and Results of Operations in many filings. MD&A requires a discussion of significant events, trends, and uncertainties, explanations of key financial statement figures, disclosures regarding events reasonably likely to affect the issuer’s operations or liquidity in the near future and other information that provides context to the financial statements. As noted in FR 67:

The disclosure in MD&A is of paramount importance in increasing the transparency of a company's financial performance and providing investors with the disclosure necessary to evaluate a company and to make informed investment decisions. MD&A also provides a unique opportunity for management to provide investors with an understanding of its view of the financial performance and condition of the company, an appreciation of what the financial statements show and do not show, as well as important trends and risks that have shaped the past or are reasonably likely to shape the future.

Because of the importance of the notes to the financial statements and other disclosures, including MD&A, in providing information that is not provided by the basic financial statements themselves, questions of whether items should or should not be included on the balance sheet and whether sufficient transparency in reporting has been achieved must be assessed in light of the presence and role of these other reporting tools.

## **C. Historical Context of the Study and Report**

### **1. Enron**

While the Act does not discuss why off-balance sheet arrangements and SPEs are identified for special attention, looking back at the scandals that preceded the passage of the Act appears instructive. At the beginning of 2001, Enron Corp. enjoyed a market capitalization that exceeded \$60 billion, ranked as the seventh largest corporation in the world by revenue,<sup>39</sup> and had won Fortune magazine’s award as the ‘most innovative company in the United States’ six years running.<sup>40</sup> Yet, toward the end of 2001, Enron

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<sup>38</sup>SFAC No. 5, Recognition and Measurement in Financial Statements of Business Enterprises, (Dec. 1984), paragraph 7.

<sup>39</sup>Second Interim Report of Neal Batson, Court Appointed Examiner (“Second Interim Batson Report”), In re: Enron Corp., et al., Jan. 21, 2003, page 5.

<sup>40</sup>The award was won in 1996 through 2001. See Christopher L. Culp and Hanke, Steve H., “Empire of the Sun: An Economic Interpretation of Enron’s Energy Business,” Policy Analysis, Cato Project on Corporate Governance, Audit and Tax Reform, Feb. 20, 2003, page 2.

collapsed within a matter of months, filing for bankruptcy protection under Chapter 11. Its collapse constituted the largest corporate bankruptcy up to that point in time.

This event acted as a catalyst—especially after it was rapidly followed by other high-profile business and financial reporting failures, including those at Worldcom and Adelphia—and raised many questions about corporate governance, the audit process, and financial reporting in general. It eventually was reported that aspects of Enron’s business were built on non-substantive trades and related-party transactions with no valid business purpose. There were multiple violations of the company’s code of conduct, some of which were specifically approved by the Board of Directors.<sup>41</sup> Compounding all of this, it quickly became apparent that Enron’s financial reports had not revealed the company’s true economic position to the market. Upon closer scrutiny, it also appeared the use of and accounting for OBS arrangements and SPEs had hidden the risks that played an important role in its rapid collapse.<sup>42</sup> The Enron scandal, along with other financial reporting failures (several of which also involved OBS transactions and SPEs), preceded the wave of reforms that included passage of the Act.

While it is beyond the scope of this Report to look in detail at Enron’s transactions, a brief description of a few transactions may serve to illustrate the lack of transparency that can result from some off-balance sheet arrangements. Enron’s transactions have been examined in detail by others. For the examples provided below, the Staff relies solely on the Powers Report and the Second Interim Batson Report, both of which are publicly available.

Enron’s court appointed bankruptcy examiner, Neal Batson, preliminarily concluded that “through the pervasive use of structured finance techniques involving SPEs and aggressive accounting practices, Enron so engineered its reported financial position and results of operations that its financial statements bore little resemblance to its actual financial condition or performance.”<sup>43</sup> The impact of these “techniques” was profound. For 2000, barring the use of these techniques, Enron’s reported debt would have been \$22.1 billion rather than \$10.2 billion.<sup>44</sup>

On November 19, 2001, Enron filed its third quarter financial statements and reported debt on its balance sheet of approximately \$13 billion. Yet, on the same day, at a meeting designed to help relieve its liquidity crisis, Enron informed its bankers that its debt was approximately \$38 billion; the difference of \$25 billion was explained as being either off-balance sheet or on the balance sheet as something other than debt. Batson notes that approximately \$14 billion of this off-balance sheet debt was “incurred through structured finance transactions involving the use of SPEs.”<sup>45</sup>

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<sup>41</sup>See, for example, Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp. William C. Powers, Jr. Chair (Feb. 1, 2002) (“Powers Report”), page 3.

<sup>42</sup>See Second Interim Batson Report; see also Powers Report.

<sup>43</sup>Second Interim Batson Report, page 15.

<sup>44</sup>Id., page 3.

<sup>45</sup>Id., page 9-10.

Similarly, a report by a Special Investigative Committee on Enron—*i.e.*, the Powers Report—found, among other things, that transactions with certain SPEs “allowed Enron to conceal from the market very large losses resulting from Enron’s merchant investments by creating an appearance that those investments were hedged.”<sup>46</sup> We rely on the Powers Report for the following example of an arrangement combining the use of SPEs with derivatives to reduce transparency.

Enron had invested in a “high-tech” stock—Rhythms NetConnections, Inc.<sup>47</sup> The investment had grown approximately 30-fold in value. Enron reflected this investment on the balance sheet at its (estimated) fair value,<sup>48</sup> and recognized the increases in value in the income statement. Theoretically, a decrease in value, if it occurred, would also flow through the income statement. While there was concern that the value of the investment might fall, Enron was not in a position to sell the shares due to a lock-up agreement.<sup>49</sup> Further, as the Powers Report explains, “[g]iven the size of Enron’s position, the relative illiquidity of Rhythms stock, and the lack of comparable securities in the market, it would have been virtually impossible (or prohibitively expensive) to hedge Rhythms commercially.”<sup>50</sup>

Enron resolved this dilemma by entering into a “hedging” transaction with an SPE that was designed (from an accounting perspective) to permit Enron to offset losses associated with any potential decrease in the value of Rhythms NetConnections shares.<sup>51</sup> Enron received, from an SPE that had no other operations, a put option on Rhythms NetConnections shares which appeared to protect Enron from decreases in the value of those shares.<sup>52</sup> However, Enron provided the SPE with a large quantity of restricted Enron stock, which the SPE would use to cover its obligations to Enron.<sup>53</sup> As a consequence of this arrangement, the SPE would not be able to meet its obligations under the derivatives contract if the value of Enron shares decreased (sufficiently) at the same time as the value of Rhythms NetConnections shares did.<sup>54</sup>

This transaction was one of many that highlighted problems with the then-existing accounting guidance on the consolidation of SPEs. In the most egregious uses of SPEs, most objective observers would have concluded that the “sponsor” of the SPE really was in control of its actions, either through voting provisions, economic compulsion, or, most likely, because the SPE’s activities were set forth upon its formation, and were entirely, or almost entirely, performed for the benefit of the sponsor. The accounting guidance at

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<sup>46</sup>Powers Report, page 4.

<sup>47</sup>Id., page 77.

<sup>48</sup>Id.

<sup>49</sup>Id.

<sup>50</sup>Id., page 78.

<sup>51</sup>Id.

<sup>52</sup>Id., page 80 and 81.

<sup>53</sup>Id., page 80.

<sup>54</sup>Id., page 82.

the time, however, generally focused on voting control to determine whether all entities, including SPEs, should be consolidated. By giving an independent third party who had made a “substantive” investment (3% of the value of the assets of the SPE was generally considered substantive) voting control of the SPE, a sponsor could generally avoid consolidation, despite the fact that the activities of the SPE could not be substantively changed by the “controlling” investor. Recognizing this as a problem, the FASB, subsequent to the passage of the Act, issued new guidance, Interpretation No. 46(R), regarding the consolidation of SPEs.<sup>55</sup> Interpretation No. 46(R) is discussed in Section IV.

Another structuring technique used by Enron, again combining the use of SPEs and derivatives, appears to have been designed to create the impression of operating cash flows while disguising debt financing. The Staff relies on the Second Interim Batson Report for this example, which refers to these particular transactions as “prepay” arrangements.<sup>56</sup> A typical Enron “prepay” involved three parties: an Enron affiliate, an investment bank, and a conduit entity formed at the direction of the investment bank. More specifically, a prepay had three component parts:

- i.) The investment bank paid the conduit entity up-front in exchange for the conduit entity’s future deliveries of a commodity at periodic intervals;
- ii.) The conduit entity paid the Enron affiliate up-front for future deliveries of a commodity; and
- iii.) Enron promised to buy a commodity from the investment bank in the future, at amount in excess of the amounts paid by the investment bank in step (i).<sup>57</sup>

The circular nature of delivery and payments with respect to the commodities had the effect of eliminating any material risk or any potential gain with respect to the changes in the price of the underlying commodity. Each party’s apparent assumption of price risk was illusory. With the elimination of price risk, “prepays” were effectively debt. In other words, the conduit entity was an alter ego of the investment bank. Therefore, the transaction was essentially between two parties—Enron and the investment bank. The investment bank was making a large payment to Enron in exchange for Enron’s promise to pay the bank an amount in excess of what Enron received in the initial prepayment.

Each aspect of this arrangement, if considered separately, appears to have a different economic intent than the economics of the transactions when analyzed together. For example, cash today in exchange for a forward contract on oil and gas appears to be nothing more than a common derivatives transaction. However, taking the totality of the arrangement, the individual futures contracts have the effect of canceling price risk, leaving money given today for a promise of money returned tomorrow as the economic

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<sup>55</sup>Interpretation No. 46(R), Consolidation of Variable Interest Entities

<sup>56</sup>See Second Interim Batson Report, pages 58-67 and at Appendix E of that Report.

<sup>57</sup>Id., page 64.

essence of the arrangement—i.e., a loan, and loan accounting would have been the appropriate accounting to apply to this series of transactions.

Enron’s accounting, however, inappropriately focused on its constituent parts. Thus, the cash received by Enron in Step (ii) above was not recorded as cash flow from financing (as would be appropriate for loan proceeds), but as cash flow from operations<sup>58</sup> (on the argument that it was associated with the forward contract on the oil and gas). With respect to the balance sheet, Enron also failed to treat the liability associated with Step iii—the promised future payments to the investment bank—as a debt liability. Instead, the liability was recorded as a risk management liability.<sup>59</sup> Thus, these prepay transactions allowed Enron to hide debt,<sup>60</sup> lower key financial ratios followed by analysts,<sup>61</sup> and provide the illusion of cash flow from operations.<sup>62</sup>

This structure also highlights what is referred to by accountants as the “unit of account” problem. The economics of a transaction may look quite different depending on how broadly or narrowly one defines the boundaries of the transaction. That is, a particular contract may appear to have certain economic characteristics when viewed in isolation—and may be given a certain accounting treatment that corresponds to those economic characteristics—but if understood as a piece of a larger agreed-upon transaction may actually have quite different economics, and be properly accorded different accounting treatment. Thus, determining the actual bounds of a transaction is fundamental to understanding both the underlying economics and the proper accounting treatment. Determining these bounds has been and will remain an ongoing challenge to standard setters, auditors, and regulators.<sup>63</sup>

## 2. The Standard Setting Environment

The series of financial reporting scandals indicated to many that the system of corporate governance and financial reporting was in need of repair. In response to these scandals, the Sarbanes-Oxley Act called for improvement in the checks-and-balances that govern the production of financial information provided to investors. In addition, various enforcement actions served notice on bad actors that they would be discovered and dealt with for their misrepresentations. But, for some, a question remained as to whether these immediate legislative and enforcement responses completely addressed all of the causes of these financial scandals. In particular, many asked whether, beyond the bad actors, the

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<sup>58</sup>Id., page 59.

<sup>59</sup>Id.

<sup>60</sup>Id.

<sup>61</sup>Id., page 61.

<sup>62</sup>Id.

<sup>63</sup>See, for example, SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity, paragraphs 14 and A25-A29; EITF Issue No. 00-21, Accounting for Revenue Arrangements with Multiple Deliverables, and Derivatives Implementation Group Issue K1, Determining Whether Separate Transactions Should Be Viewed as a Unit.

accounting standards themselves might have played some role in facilitating or even encouraging the bad behavior.

In a static world, one might expect standard setters and regulatory agencies to examine each type of arrangement, determine how information about that arrangement could best be communicated, and create standards that require specific financial reporting treatments. Experience, however, suggests that such an approach to standard setting lags behind the requirements of the marketplace and, ultimately, results in rules-based guidance that lacks conceptual coherence. The volume of different arrangements that must be analyzed under this approach—and the unexpected variants in these arrangements—present substantial challenges. The fact is that we live in a world of accelerating technological change, financial innovation, and globalization with rapidly shifting competitive dynamics and regulatory action. Moreover, there is a constant interaction among these forces, with each stimulating further change in the others. In such a dynamic world, standard setters cannot possibly anticipate—and pre-determine precise accounting rules for—every transactional innovation.

In light of these concerns, the Act mandated a study be conducted by the Commission regarding the current form of U.S. accounting standards. More specifically, section 108(d) of the Act called upon the Commission to conduct a study on the adoption of “principles-based” accounting standards by the United States financial reporting system.<sup>64</sup> This report has been completed and submitted to Congress on July 30, 2003.

In this study, the Staff noted several shortcomings of what are often denoted as “rules-based” standards. Such standards often:<sup>65</sup>

- Contain numerous bright-line tests, which ultimately can be misused by financial engineers as a roadmap to comply with the letter but not the spirit of standards;
- Further a need and demand for voluminously detailed implementation guidance on the application of the standard, creating complexity in and uncertainty about the application of the standard; and
- Contain numerous exceptions to the principles purportedly underlying the standards, resulting in inconsistencies in accounting treatment of transactions and events with similar economic substance.

The Staff recommended a continued movement in the direction of (what the Staff referred to as) “objectives-oriented” accounting standards. Objectives-oriented standards are those which:<sup>66</sup>

- Clearly state the accounting objective of the standard, with the objective incorporated in the standard;
- Minimize the use of exceptions from the standard;

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<sup>64</sup>See Objectives-Oriented Accounting Standards Study.

<sup>65</sup>Id.

<sup>66</sup>Id.



- Avoid use of percentage tests (“bright-lines”) that allow financial engineers to achieve technical compliance with the standard while evading the intent of the standard;
- Are based on an internally consistent and consistently applied conceptual framework; and
- Provide sufficient detail and structure so that the standard is operational and can be applied on a consistent basis.

The study also notes that objectives-oriented standards have the potential to more quickly adapt to today’s faster paced business environment better than rules-based standards for (at least) two reasons:<sup>67</sup>

First, standard setters should be able to move faster to address emerging practice issues under an objectives-oriented regime. It is easier to come to an agreement on a principle than on a highly detailed rule, even if the principle is substantive and relatively specific in nature. It also takes more time to develop and provide extensive implementation guidance on a wide variety of hypothetical scenarios, as required by the rules-based approach.

Second, by its very nature, a standard setting body cannot respond as quickly to changes in the environment as can the professionals directly involved in the marketplace. Because, when properly constructed, objectives-oriented accounting standards are solidly based on a conceptual framework, yet cabined by the specific, substantive objectives embodied in each standard, they provide for a framework within which the application of professional judgment can be exercised. As such, managers and accountants should be able to draw upon the objectives of the standard so that their accounting decisions better capture economic reality in response to market developments. This should render objectives-oriented accounting standards more durable once they are in place than are rules-based standards. The latter tend to be in greater need of constant tinkering by standard setters to reflect changes in the environment than do objectives-oriented standards.

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<sup>67</sup>Id. (footnotes deleted from quotation).

Finally, the study also notes that significant hurdles exist to creating objectives-oriented standards. Indeed, the bright lines, numerous exceptions, and voluminous interpretive guidance that many see as problems with rules-based standards are characteristics of many parts of U.S. GAAP precisely because constituents requested that the FASB and other standard-setters include them in the guidance. The development of objectives-oriented standards is continuously challenged by the constant requests received by standard-setters that they provide new interpretive guidance and exceptions to the principles underlying the accounting standards.

In addition, standard-setters must contend with the fact that just about any proposed change will be unpopular with at least a segment of preparers, auditors and other participants, including users. Even the improvements to the accounting guidance identified in Section I.C.4 below—that have happened since the passage of the Sarbanes-Oxley Act—generated significant debate, and these changes were made during a period in which the FASB, the Commission and others were being actively encouraged to make such improvements. The expectation that proposals for change will generate controversy should not stop standard-setters from taking up a project in a needed area, but standard-setters must nonetheless factor this into its processes and agenda decisions, ensuring that sufficient opportunity for deliberation, comment, discussion, and dialogue will exist. In addition, where new standards will result in the need for significant changes to internal controls and financial reporting systems, adequate implementation time must also be built into the process.

### **3. Accounting Motivated Transaction Structuring**

Standard-setting is rendered difficult not only by the fast-paced business environment, but also by the fact that the transactions themselves evolve in reaction to the standards. As soon as a new standard is issued, questions immediately arise regarding whether specific structures are within the scope of the new guidance, how interactions between the new standard and existing standards should be addressed, and whether more detail on the new guidance can or should be provided. Indeed, in many instances, the issuance (or even expectation) of a new standard triggers a search to determine techniques to structure and/or restructure transactions to avoid reporting the very information sought by the new standard.

For example, when the FASB issued a standard in 1976 that required some lease obligations to be recorded on the balance sheet as liabilities,<sup>68</sup> many lessees immediately began to restructure their leases to avoid recognizing liabilities. Their efforts were aided by parties who sought to profit from offering their expertise in structuring leases in ways that provided “preferable” accounting. Such structuring tends to reduce transparency. Indeed, oftentimes that is its point.

When we refer to accounting-motivated structured transactions, we are speaking of those transactions that are structured in an attempt to achieve reporting results that are not consistent with the economics of the transaction, and thereby impair the transparency

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<sup>68</sup>SFAS No. 13, Accounting for Leases.

of financial reports.<sup>69</sup> Standard setters have sometimes responded to structuring efforts by refining and expanding the standards. However, this process can be a never-ending circle, where restructuring of contracts and the creation of innovative new financial structures lead to revisions in GAAP, which are then followed by the creation of additional financial structures. As a result, the rules themselves come to provide a roadmap for avoiding their intent, as issuers adjust arrangements to fall just outside the scope of a particular accounting treatment.

Although this dynamic has long been recognized by regulators and standard setters, there have been sweeping innovations in capital markets during recent years that have substantially increased the potential (and in many cases, the expectation) for issuers to engage in this type of structuring. With dramatically lowered transaction costs due to technological and financial innovations, it has become economically feasible to isolate, price and trade rights to specified streams of cash flows. This ability to un-bundle risk and return, re-bundle it into new instruments, and sell these new instruments in the marketplace has revolutionized capital markets. Economists sometimes refer to this availability of a full range of financial alternatives as the “completion” of financial markets (although markets remain far from fully complete).<sup>70</sup>

Progress in the “completion” of financial markets has undeniable benefits, allowing issuers to enhance liquidity, better manage risk exposure, and reduce borrowing costs, while permitting investors to invest in instruments or entities best suited to their investment preferences and risk tolerance. Nevertheless, as noted above, the very complexity and flexibility inherent in these new financial tools and practices renders the goal of transparency substantially more difficult to achieve. These innovative financial instruments provide a new set of tools to those who would attempt to hide their exposure to risk, or otherwise manipulate their financial statements. As one author who writes about derivative markets states:<sup>71</sup>

it is generally possible to create a given payoff in multiple ways. The construction of a given financial product from other products is sometimes called financial engineering. ... [B]ecause there are multiple ways to create a payoff, ... regulatory arbitrage ... [in which the author includes the circumvention of accounting rules] can be difficult to stop.

The propensity of certain issuers to combine engineered transactions with aggressive accounting interpretations in order to obtain “desirable” accounting results

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<sup>69</sup>Thus, we do not mean to include situations where, for example, an issuer increases its sales efforts at the end of a period to generate revenue. In that situation, the reporting of revenue would generally mirror the economics if additional sales are generated. Such situations may, however, result in the need for explanatory disclosures, particularly in MD&A.

<sup>70</sup>See, for example, Mario Draghi, Giavazzi, Francesco, and Merton, Robert C. Transparency, Risk Management and International Financial Fragility NBER Working Paper 9806, June 2003 (“[t]he role of swaps and other privately negotiated derivative instruments is to complete financial markets, thus increasing the ability of individuals, financial institutions, corporations and governments to manage risk.”)

<sup>71</sup>McDonald, Robert L. Derivatives Markets (2003), pages 3 and 4.

poses difficult challenges to auditors, standard setters, and regulators, and reduces investor understanding.

#### **4. Improvements in the Financial Reporting Regime Since the Passage of the Sarbanes-Oxley Act**

There have been a number of significant events in the financial reporting system since the passage of the Sarbanes-Oxley Act. Among others, these have included:

##### Accounting Developments:

- Consolidation of Variable Interest Entities (revised December 2003)—an interpretation of ARB No. 51 (“Interpretation No. 46(R)”)<sup>72</sup>, which requires a “risks and rewards” approach to the consolidation of “variable interest entities” as opposed to an approach based on control by ownership or legal authority, addressing, among other things, some of the concerns with the failure of issuers under earlier guidance to consolidate certain special purpose entities;
- Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others (“Interpretation No. 45”), which requires the recognition of liabilities for obligations undertaken upon issuing certain guarantees, as well as other disclosures;<sup>73</sup>
- Share-Based Payment, SFAS No. 123(R), which requires a fair-value based method of accounting for stock options and other equity instruments used to purchase goods and services, including employee services, eliminating the previous accounting guidance that allowed compensation paid in a particular form to go unreported in the financial statements;<sup>74</sup>
- Employers’ Disclosures about Pensions and Other Postretirement Benefits—An Amendment of FASB Statements No. 87, 88, and 106, SFAS No. 132(R), which revised employers’ disclosures about pension plans and other postretirement benefit plans;<sup>75</sup>
- Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equities, SFAS No. 150, which established standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity;<sup>76</sup>

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<sup>72</sup>More specifically, the FASB issued Interpretation No. 46 in January 2003 and 46(R)—the revised interpretation—in December 2003.

<sup>73</sup>The FASB issued Interpretation No. 45 in November 2002.

<sup>74</sup>This Statement, revised in 2004, was a revision of FASB Statement No. 123, Accounting for Stock-Based Compensation. It superseded APB Opinion No. 25, Accounting for Stock Issued to Employees, and its related implementation guidance.

<sup>75</sup>This was revised in December 2003.

<sup>76</sup>This was issued by the FASB in May 2003.

- Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System, which is a Staff study that recommended that accounting standards should be developed using an “objectives-oriented” approach;<sup>77</sup> and
- The FASB Response to SEC Study on the Adoption of a Principles-Based Accounting System,<sup>78</sup> in which the FASB indicated its general agreement with the Staff’s recommendations regarding objectives-oriented accounting standards;

Regulatory and Other Developments:

- Disclosure in Management’s Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations (“FR 67”),<sup>79</sup> which requires an issuer to explain its off-balance sheet arrangements in a separately captioned subsection of its MD&A and to provide an overview of certain known contractual obligations in a tabular format;<sup>80</sup>
- Interpretation: Commission Guidance Regarding Management’s Discussion and Analysis of Financial Condition and Results of Operations (“FR 72”),<sup>81</sup> which explains how MD&A can provide more meaningful disclosure in a number of areas, including its overall presentation and focus, with general emphasis on the discussion and analysis of known trends, demands, commitments, events and uncertainties, and specific guidance on disclosures about liquidity, capital resources and critical accounting estimates;
- Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date,<sup>82</sup> which adds certain disclosure requirements for public companies regarding material changes in financial condition or operations, including (among other things) disclosures if an issuer becomes directly or contingently liable for an obligation that arises out of an off-balance sheet arrangement or if a triggering event occurs causing an issuer obligation under an off-balance sheet arrangement to increase or be accelerated, or its contingent obligation under an off-balance sheet arrangement to become a direct on-balance sheet financial obligation;
- Summary by the Division of Corporation Finance of Significant Issues Addressed in the Review of the Periodic Reports of the Fortune 500 Companies,<sup>83</sup> in which

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<sup>77</sup>The Staff study on the adoption of objectives-oriented accounting standards was published by the Commission in July 2003.

<sup>78</sup>This was released by FASB in July 2004.

<sup>79</sup>This rule was promulgated by the Commission in January 2003 in response to Section 401(a) of the Act.

<sup>80</sup>Much of the language and many of the concepts in FR 67 are consistent with the language and concepts embodied in the Commission’s January 2002 statement, which discussed the desirability of enhance disclosure in MD&A of off-balance sheet arrangements.

<sup>81</sup>FR 72 was promulgated by the Commission in December 2003.

<sup>82</sup>This rule, which was proposed prior to the passage of the Act, is also responsive to the current disclosure goals of Section 409 of the Sarbanes-Oxley Act.

<sup>83</sup>This document is dated February 27, 2003, as modified.

the Division focused on disclosures that appeared to be critical to an understanding of each company's financial position and results, but which, at least on their face, seemed to depart significantly from either GAAP or Commission rules, or to be materially deficient in explanation or clarity; this document included a discussion of the Division's comments to issuers on off-balance sheet arrangements, including securitized financial assets;

- Certification of Disclosure in Companies' Quarterly and Annual Report, as directed in part by Section 302(a) of the Act, adopted rules to require, among other things, that an issuer's principal executive and financial officers each certify: the financial and other information contained in the issuer's quarterly and annual reports; that they are responsible for establishing, maintaining and regularly evaluating the effectiveness of the issuer's internal controls; that they have made certain disclosures to the issuer's auditors and the audit committee of the board of directors about the issuer's internal controls; and that they have included information in the issuer's quarterly and annual reports about their evaluation and whether there have been significant changes in the issuer's internal controls or in other factors that could significantly affect internal controls subsequent to the evaluation;<sup>84</sup>
- Management's Report on Internal Controls Over Financial Reporting and Certification Disclosure in Exchange Act Periodic Reports, which, as directed by Section 404 of the Act, adopted rules requiring, among other things, that companies subject to the reporting requirements of the Securities Exchange Act of 1934, other than registered investment companies, include in their annual reports a report of management on the company's internal control over financial reporting;<sup>85</sup>
- Standards Relating to Listed Company Audit Committees, which, as directed by Section 301 of the Act, adopted a new rule to direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the audit committee requirements mandated by the Act, relating to the independence of audit committee members; the audit committee's responsibility to select and oversee the issuer's independent accountant; procedures for handling complaints regarding the issuer's accounting practices; the authority of the audit committee to engage advisors; and funding for the independent auditor and any outside advisors engaged by the audit committee;<sup>86</sup>
- Strengthening the Commission's Requirements Regarding Auditor Independence, which, consistent with the direction of Section 208(a) of the Act, adopted amendments to existing requirements regarding auditor independence to enhance

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<sup>84</sup>The effective date for these rules was August 29, 2002. Release Nos. 33-8124; 34-46427.

<sup>85</sup>The effective date for these rules was August 14, 2003. Release Nos. 33-8238; 34-47986.

<sup>86</sup>The effective date for this rule was April 25, 2003. Release Nos. 33-8220; 34-47654.

the independence of accountants that audit and review financial statements and prepare attestation reports filed with the Commission; and

- Proposed Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities, Office of the Comptroller of the Currency, Treasury; Office of Thrift Supervision, Treasury; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; and Securities and Exchange Commission, which, among other things, provided that financial institutions should have effective policies and procedures in place to identify those complex structured finance transactions that may involve heightened legal and reputation risk, to ensure that the transactions receive enhanced scrutiny by the institution, and to ensure that the institution does not participate in illegal or inappropriate transactions.<sup>87</sup>

To the extent possible, we consider the effects of these recent changes in financial reporting throughout this Report. In addition, as part of the Study the Staff collected data about the initial implementation of Interpretation No. 46(R) and FR 67. The Staff presents these empirical findings in Section IV.

## **II. Study Methodology**

This section presents the methodology for the Study, including 1) methodological issues related to the construction of a representative sample of filings by issuers appropriate to the questions addressed in the Study, and 2) the process by which the sample findings are extrapolated to estimate the extent of arrangements with off-balance sheet implications for the population. Descriptive statistics relating to the sample are also presented in this section.

Certain characteristics common to many arrangements with off-balance sheet implications were identified that could complicate the selection of a sample for the Study. The prevalence of off-balance sheet arrangements may vary across issuers and is apt to be correlated with size. Indeed, a disproportionate amount of certain off-balance-sheet arrangements may occur in a small number of issuers.<sup>88</sup> Thus, in order to construct a sample that will be representative of the population, it is important to stratify<sup>89</sup> the sample

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<sup>87</sup>On May 19, 2004, the Agencies requested public comment on a proposed Interagency statement. (69 FR 28980, May 19, 2004)

<sup>88</sup>For example, see Credit Suisse First Boston Equity Research FIN 46: New Rule Could Surprise Investors, page 6 (June 24, 2003).

<sup>89</sup>The principle of stratification is to partition the population so that the units within a particular stratum are similar in terms of the variable being measured. Then, even though the strata may differ markedly from each other in terms of other measures, a stratified sample with the appropriate number of units in each stratum will tend to be representative of the population as a whole. Then, the formula for the variance of the estimator of the population mean with stratified sampling is a function of within-stratum variance terms. In other words, the population estimate will be most precise if the population is partitioned into strata such that within each stratum the units are similar. This point will underlie much of the analysis below.

to ensure that the influence of different sized firms is appropriately captured in the Staff estimates of the extent of off-balance sheet arrangements.<sup>90</sup>

The Staff determined that a sample of  $n=94$  issuers would satisfy the required levels of power and hypothesis sensitivity for a stated level of significance.<sup>91, 92</sup> To ensure observations from the largest issuers are included, the Staff constructed the sample to include the 100 largest issuers (as measured by market capitalization) and randomly selected an additional 100 issuers from the rest of the population. This results in a total sample of  $n=200$  observations within 2 strata. Thus, the Study sample is composed of two sub-samples: 100 large issuers<sup>93</sup> (the “large issuer sub-sample”) and 100 randomly selected issuers from the rest of the population (the “random issuer sub-sample”).<sup>94</sup> This

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<sup>90</sup>For a given total sample size  $n$ , one may choose how to allocate observations among the  $L$  strata. In the absence of other information about the variances of a specified measure of interest across strata, a reasonable initial choice may be to assume equal sample sizes for the strata. In this case, however, the variance of the measure of interest in the stratum of largest issuers is likely to be very different from the variance of the stratum of the smallest issuers for the distribution of total assets. In addition, the costs of including additional observations differ substantially across strata. To construct an estimate that accounts for this, the Staff first determined the stratum size allocations across the population that minimizes the variance of the population estimate. Note that these estimates are dependent on the underlying assumed parameter values. This method allowed the Staff to determine the appropriate strata sizes given the importance of size and the importance of requiring that specific issuers be included in the sample.

<sup>91</sup>The Staff follows the discussion of the stratification principle and optimal allocation in Chapter 11 of Sampling, Steven K. Thompson, Wiley Interscience (2002) and also referred to Chapter 4 of Sampling Techniques, William G. Cochran, Wiley (1977). The Staff used size (as measured by total assets) as the stratification variable and then used the Compustat universe to estimate the optimal allocation of the sample across strata to minimize the variance of the estimator and determine the appropriate sample size for the study. This calculation depends on population variance so we use the natural log of total assets, which is approximately normal, as the basis of the population distribution. The first two moments of the distribution were used to establish the total sample size appropriate to ensuring the designated levels of power and precision. The other variables in the study are assumed to be distributed like the natural log of total assets. To the extent that other variables have distributions similar to the distribution of the natural log of total assets, the above analysis is appropriate. Where possible, the Staff made conservative assumptions in order to preserve the statistical integrity of the sampling method.

<sup>92</sup>The Staff chose to construct a sample large enough to ensure that the power of the tests is no lower than 90% with an  $\alpha$  level of significance of 5% throughout. More powerful tests and/or higher levels of significance would require larger sample sizes. To establish the level of sensitivity of the hypotheses we would expect from tests based on our sample, the sample sizes were determined assuming the difference between the null and alternative hypotheses is 20%. The subsequent power calculations require a sample of at least  $N=94$  to satisfy these conditions.

<sup>93</sup>With certain exceptions as discussed below.

<sup>94</sup>As discussed above, the sample size that would be sufficiently representative to make inferences for the total population subject to the required power, level of significance and hypothesis is less than 100. To accommodate the prevalence of the variables of interest in the 100 largest issuers, a (much larger) total sample of  $n=200$ , composed of 2 strata of 100 issuers each was constructed. The 2 strata are composed of the 100 largest issuers and a random sample of size 100 from the rest of the population. This over-sampling ensures the statistical validity of the results throughout. In addition, over-sampling large issuers allowed statistically supportable observations to be made about these large issuers, which is a goal of the Study. This is particularly relevant because the variables of interest may be more prevalent in the larger issuers. The importance of large issuers to the Study was considered to justify the additional cost of collecting information from all of the largest 100 issuers.



stratification method results in a sample that is sufficiently large to ensure the validity of the statistical results subject to the specified power, hypothesis sensitivity, and significance level requirements. In fact, this sampling method accommodates variation across issuers and the importance of including the largest issuers in the Study.

The actual sample issuers in the large issuer sub-sample were selected based on U.S. market capitalization as of December 31, 2003.<sup>95</sup> The random sample of issuers was selected using a random number generator to identify issuers from a list of all issuers on the Commission's Electronic Data Gathering, Analysis, and Retrieval ("EDGAR") system.<sup>96</sup> As noted above, the final sample that passed all the screening criteria and for which data was successfully collected includes a total of 200 issuers. The tables below describe the characteristics of the sample as well as each sub-sample, in terms of securities registered with the Commission, size, industry membership, fiscal year-ends, and the forms used by each issuer for their annual filings with the Commission.

Table II(A)(1) describes the securities registered with the Commission by our sample of issuers. Approximately 93% of the sample issuers report common stock registered with the Commission, and this average includes 100% of the large issuer sub-sample. In contrast, only 6% of the sample issuers had registered preferred stock with the Commission. Slightly more, almost 13% had registered debt securities.

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<sup>95</sup>Fannie Mae and Freddie Mac were excluded from the population and sample, even though they would otherwise fall into the ranks of the top 100 issuers. This was done given the relatively unique features of these two extremely large Government Sponsored Entities ("GSEs"). Two market indices (which would otherwise fall into the ranks of the top 100 issuers) were also excluded from the sample because their assets are predominantly the securities of other issuers that are eligible for the study. Two foreign private issuers (which would otherwise fall into the ranks of the top 100 issuers) were also excluded from the sample. Such issuers file 20-F annual reports and are not included in the study because foreign private issuers have a one-year lag before they are required to implement some of the pertinent new standards.

<sup>96</sup>Upon initial selection, the issuer was subjected to a screening to ascertain its viability as a participant in the Study. If it was determined that an issuer was not a viable participant, the issuer was dropped and another selected from the original list. Issuers were excluded if they were registered under the Investment Act or if they were foreign private issuers. Issuers were also excluded if they did not have current financial statements, notes to the financial statements, and MD&A disclosures available via annual filings (*i.e.*, forms 10-K or 10KSB) and quarterly filings (*i.e.*, form 10-Q or 10QSB), as the pertinent data would not be available for such issuers. The selection and screening process was performed for a total of 276 issuers to obtain a sample of 100 issuers that met all the requirements for membership in the sample.

|   | Full Sample<br>(n=200)<br>(%) | Sub-Samples                     |                                  |
|---|-------------------------------|---------------------------------|----------------------------------|
|   |                               | Large Issuers<br>(n=100)<br>(%) | Random Issuers<br>(n=100)<br>(%) |
| Issuers with Registered Common Stock    | 93                            | 100                             | 86                               |
| Issuers with Registered Preferred Stock | 6                             | 6                               | 6                                |
| Issuers with Registered Debt Securities | 12.5                          | 23                              | 2                                |

<sup>a</sup> These data were collected from the cover page of each issuer's 10-K or 10KSB filing, which designates securities registered under Sections 12(b) and 12(g) of the Securities Act of 1934. Additional types of securities (e.g., registered preferred stock rights, trust preferred securities, and partnership units) are not reported in this table. Some issuers not included in the categories above may have securities that are exempt from registration.

Table II(A)(2) describes the size of the issuers in the sample, in terms of U.S. market capitalization, total assets, and total liabilities. The sample includes issuers with a total equity market capitalization of \$7.75 trillion. For comparison, the total U.S. equity market capitalization for all issuers listed on the New York Stock Exchange (“NYSE”) and the National Association of Securities Dealers Automated Quotations (“NASDAQ”) as of December 31, 2003 was approximately \$15 trillion.<sup>97</sup> The market capitalization of the large issuer sub-sample is approximately 75 times that of the random issuer sub-sample.

|  | Full Sample<br>(n=200)<br>(million) | Sub-Samples                           |  |
|--|-------------------------------------|---------------------------------------|--|
|  |                                     | Large Issuers<br>(n=100)<br>(million) | Random Issuers<br>(n=100)<br>(million) |
| U. S. Market Capitalization of Common Stock <sup>a</sup> | \$7,771,753                         | \$7,670,538                           | \$101,215                              |
| Total Assets <sup>b</sup>                                | \$12,418,041                        | \$12,242,146                          | \$175,895                              |
| Total Liabilities <sup>b</sup>                           | \$10,219,198                        | \$10,089,973                          | \$129,225                              |

<sup>a</sup> These data were collected directly from the NYSE and the NASDAQ, for issuers traded on those exchanges. These values do not include market capitalizations of issuers in the sample that were not traded on these two exchanges, however, this omission is estimated to affect the total market capitalization for the random issuer sub-sample by less than 1%.

<sup>b</sup> These data were collected from the face of the balance sheet in the 10-K or 10KSB filing.

Total assets for the sample issuers are \$12.4 trillion, virtually all of which relate to the large issuers. Total assets for the large issuer sub-sample are almost 70 times as large as total assets for the random issuer sub-sample. Total liabilities for the sample are \$10.2 trillion, virtually all of which relate to the large issuer sub-sample. Total liabilities for the large issuer sub-sample are approaching 90 times as large as total liabilities for the random issuer sub-sample.

<sup>97</sup>U.S. market capitalization figures for all issuers on the NYSE and the NASDAQ were obtained directly from these markets as of December 31, 2003.

Table II(A)(3) describes the industry membership of the issuers in the sample. Note that our sample has a relatively large representation of manufacturing issuers and finance, insurance, and real estate issuers. These relative emphases are largely consistent in the sub-samples.

| <b>TABLE II(A)(3): Industry Membership of Issuers in Sample<sup>a</sup></b> |                               |                                 |                                  |
|---|-------------------------------|---------------------------------|----------------------------------|
|   | Full Sample<br>(n=200)<br>(%) | Sub-Samples                     |                                  |
|   |                               | Large Issuers<br>(n=100)<br>(%) | Random Issuers<br>(n=100)<br>(%) |
| Mining, Oil & Gas, and Construction   | 3.5                           | 1                               | 6                                |
| Manufacturing   | 38.5                          | 50                              | 27                               |
| Transportation, Communication, Electric, Gas, & Sanitary Services           | 11.5                          | 9                               | 14                               |
| Wholesale & Retail Trade  | 6.5                           | 8                               | 5                                |
| Finance, Insurance, & Real Estate   | 24                            | 24                              | 24                               |
| Services  | 15                            | 8                               | 22                               |
| Non-Classifiable  | 1                             | 0                               | 2                                |

<sup>a</sup> These data were collected from the cover page of each issuer's 10-K or 10KSB filing.

Table II(A)(4) describes the year-ends of the issuers in the sample. The majority of issuers in our sample had December 31 year-ends.

| <b>TABLE II(A)(4): Year Ends of Issuers in Sample<sup>a</sup></b> |                               |                                 |                                  |
|---|-------------------------------|---------------------------------|----------------------------------|
|   | Full Sample<br>(n=200)<br>(%) | Sub-Samples                     |                                  |
|   |                               | Large Issuers<br>(n=100)<br>(%) | Random Issuers<br>(n=100)<br>(%) |
| June-November 2003 Year End                                       | 17                            | 16                              | 18                               |
| December 2003 Year End  | 75                            | 77                              | 73                               |
| January-May 2004 Year End   | 8                             | 7                               | 9                                |

<sup>a</sup> These data were collected from the cover page of each issuer's 10-K or 10KSB filing.

Table II(A)(5) describes the distribution of the sample in terms of issuers that file Form 10-K vs. Form 10KSB. Small business issuers may file form 10KSB instead of form 10-K. Form 10-K was filed by 87% of the sample issuers and form 10KSB was filed by the remaining 13%.

|                           | Full Sample<br>(n=200)<br>(%) | Sub-Samples                     |                                  |
|---------------------------|-------------------------------|---------------------------------|----------------------------------|
|                           |                               | Large Issuers<br>(n=100)<br>(%) | Random Issuers<br>(n=100)<br>(%) |
| Issuers filing Form 10-K  | 87                            | 100                             | 74                               |
| Issuers filing Form 10KSB | 13                            | 0                               | 26                               |

<sup>a</sup> These data were collected from the cover page of each issuer's 10-K or 10KSB filing.

For each issuer in the sample, data was collected from the 10-K or 10KSB filing corresponding to the fiscal year-ends described in Table II(A)(4) above.<sup>98</sup> The Staff focused on collecting data that facilitated the measurement of the extent of off-balance sheet arrangements, both in terms of the extent of issuers involved in such arrangements and any related dollar amounts.

The Staff extrapolates the findings from the sample to estimate amounts for the approximate population of active U.S. issuers. The Staff estimates the population of active U.S. issuers to be approximately 10,100.<sup>99</sup> Subtracting the 100 issuers in the large issuer sub-sample results in 10,000 issuers in the population that are represented by the random issuer sub-sample. The Staff performs extrapolations by multiplying amounts from the random issuer sub-sample by a factor of 100 (i.e., 10,000 issuers in the population divided by 100 issuers in the random issuer sub-sample) and adding amounts from the large issuer sub-sample. If the extrapolated amounts are percentages, this calculation is performed using the absolute counts in each sub-sample, after which the total is divided by 10,100.

### **III. ARRANGEMENTS WITH POTENTIAL OFF-BALANCE SHEET IMPLICATIONS**

#### **A. Investments in the Equity of Other Entities**

##### **1. Nature of Arrangements and Financial Reporting Requirements**

Issuers regularly invest in the equity of other entities. An issuer may invest for the short term or the long term, for income or capital appreciation, or for strategic

<sup>98</sup> As discussed in Section IV, some data related to the implementation of FASB Interpretation No. 46(R) was also collected from the 10-Q or 10QSB filings of each issuer for the quarter that included May 15, 2004, which would include information about the full adoption of Interpretation No. 46(R) for many of the issuers in the sample.

<sup>99</sup>The estimate of the approximate number of active U.S. issuers in the population (not including international issuers filing form 20-F or issuers under the Investment Act) is based on the Staff's judgment. The actual number of active issuers is constantly changing. Some issuers discontinue filing because they no longer meet the reporting requirements, while others are delinquent in their filings and still others choose to file voluntarily. The estimate of 10,100 (versus the round number 10,000) is not meant to imply a high level of precision, but, as noted above, is based on the Staff's judgment, and also is chosen to render the extrapolation calculations straightforward and easily understood by the reader.

purposes, such as expanding its product offerings into new territory, integrating the other entity's products or technology with its own, or diversifying its business. Investments may be purely passive in nature, or may provide the issuer with some level of influence, or even control, over the other entity. The accounting for investments in other entities differs based on the level of the investor's involvement with the other entity.

**a. Investments Giving Rise to Neither Influence Nor Control**

Investments that give rise to neither influence nor control are common. These investments are equivalent in nature to those an individual might hold in an investment portfolio. Assuming the investment is in publicly traded equity, SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities, provides the relevant accounting guidance for these investments. SFAS No. 115 requires the investment to be re-measured and presented on the issuer's balance sheet at its fair value.<sup>100</sup> The requirement to report these investments at fair value (*i.e.*, "mark to market") raises the issue of how to account for changes in these fair values (market fluctuations) that occur during the period the issuer owns the stock of the other entity. Historically, the accounting for these "unrealized holding gains and losses" has been the subject of much debate.<sup>101</sup>

During development of SFAS No. 115 there was some objection to recognizing the effects of changes in the market price of investments held (*i.e.*, recognizing the effects of market volatility) in an issuer's earnings. Those expressing objections argued that these unrealized holding gains and losses are different in character from income and expense items that arise from past transactions with other parties. As such, some argued (and still believe) that the gains and losses are only "potential" gains and losses, rather than gains and losses that have already occurred, and therefore do not belong in an issuer's earnings.

In light of these views, the standard provides for alternative treatments of the unrealized holding gains and losses. If the "purpose" of the investment is for "trading,"<sup>102</sup> unrealized holding gains and losses must be recognized in earnings each period. Investments held for other than trading purposes that do not provide the holder

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<sup>100</sup>See SFAS No. 115, paragraphs 3 and 12.

<sup>101</sup>A realized gain or loss occurs if the issuer actually sells the shares; an unrealized holding gain or loss occurs when the price of the shares increases or decreases, but the issuer continues to hold the shares. Once the investment has been liquidated and any gain or loss realized, there is no longer a question as to recognition of that gain or loss.

<sup>102</sup>Paragraph 12(a) of SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities, states that "Securities that are bought and held principally for the purpose of selling them in the near term (thus held for only a short period of time) shall be classified as trading securities. Trading generally reflects active and frequent buying and selling, and trading securities are generally used with the objective of generating profits on short-term differences in price."

with either significant influence or control are classified as “available for sale,”<sup>103</sup> in which case the investment is still recorded at fair value, but unrealized holding gains and losses are excluded from earnings until the investment is ultimately sold and the gain or loss is realized.<sup>104</sup> In the meantime, unrealized holding gains and losses are recorded in the “other comprehensive income” section of the shareholder’s equity section of the balance sheet.

As noted above, these investments are only “marked to market” each period if the equity instruments are publicly-traded. If the instruments are not publicly traded, the investment is accounted for under the cost method.<sup>105</sup> Under the cost method, changes in value (*i.e.*, unrealized gains and losses) are not recognized in earnings until the investment is sold. However, if the value of the investment declines (*i.e.*, the investment is impaired) and this decline is “other than temporary,” a loss should be recognized.<sup>106</sup> Determining whether a loss is “other than temporary” is a judgmental assessment, based on the relevant facts and circumstances.

In addition to the accounting described above, SFAS No. 115 requires disclosures regarding investments where the issuer has neither significant influence nor control, including, but not limited to:

- Gross unrealized holding gains and gross unrealized holding losses (separately reported) for investments classified as “available for sale;”
- Proceeds from the sale of “available for sale” securities; gross realized gains and gross realized losses on those sales;
- Gross gains and gross losses included in net income related to transfers of securities from “available for sale” to “trading” categories; and
- Detailed information regarding the gains and losses included in other comprehensive income and net income.

#### **b. Investments Giving Rise to Influence but Not Control**

An issuer’s investment in another entity may give rise to “significant influence” over the other entity. The term “significant influence” refers to the ability of an issuer to impact the other entity’s operating and financial policies. Such ability to exercise influence may be attained, for example, through ownership of voting stock of the other entity,<sup>107</sup> board representation, participation in policy making processes, or technological

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<sup>103</sup>Paragraph 12(b) of SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities, states that “Investments not classified as trading securities (nor as held-to-maturity securities) shall be classified as available-for-sale securities.”

<sup>104</sup>SFAS No. 115, Paragraph 16.

<sup>105</sup>See APB No. 18, paragraph 6a.

<sup>106</sup>See SFAS No. 115, paragraph 16 and APB Opinion No. 18, paragraph 19h.

<sup>107</sup>Paragraph 17 of APB No. 18 includes a presumption that an issuer has “significant influence” over another entity if the issuer owns more than 20% but no more than 50% of the voting stock of that entity. However, the determination of whether an investor has significant influence often requires judgment.

dependency. If an investment in the equity of another entity affords the issuer the ability to exercise “significant” influence over operating and financial policies of the other entity, APB No. 18, The Equity Method of Accounting for Investments in Common Stock, requires that the issuer follow the “equity method” of accounting for this investment. If, instead, an investment does not afford the issuer the ability to exercise significant influence, the cost or fair value methods are used. Under the equity method, the investment is recognized on the issuer’s balance sheet at its initial cost, adjusted over time for the issuer’s share of changes in the other entity’s changes in net assets (i.e., assets less liabilities). The issuer’s share of the other entity’s net income (loss) is recognized as an increase (decrease) in the investment. Dividends received by the issuer from the other entity are treated as a reduction of the investment. By way of these mechanics, the equity method attempts to reflect an issuer’s share in the other entity’s equity, and changes therein, in the issuer’s investment in the other entity recognized as an asset on the issuer’s balance sheet. As with other unconsolidated investments, impairment losses are recognized if the value of the investment declines below its carrying value and the decline is deemed “other than temporary.”

APB No. 18 has its own set of disclosure requirements, including:

- Name of the entity whose shares the issuer owns;
- Particulars of the issuer’s accounting policies under the equity method;
- Value of each investment based on current quoted market prices, if available; and
- Summarized financial information about assets, liabilities, and result of operations of the other entities, if the investment is “significant.”

In addition to the requirements of APB 18, Rule 3-09 of the Commission’s Regulation S-X requires that issuers file as part of their annual report on Form 10-K the separate financial statements of investments in entities accounted for under the equity method, if they meet the definition of a “significant subsidiary” under Regulation S-X 1-02.<sup>108</sup> Presenting these separate financial statements of the other entity is intended to provide added information regarding investments that comprise a significant portion of an issuer’s assets, equity, or earnings.

### **c. Investments Giving Rise to Control**

If an issuer controls another entity such that the issuer can direct the other entity’s operations, ARB No. 51, Consolidated Financial Statements, requires the issuer to “consolidate” that other entity.<sup>109</sup> When consolidation is required, the issuer no longer

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<sup>108</sup>See 17 CFR 210.1-02(w) for definition of a significant subsidiary.

<sup>109</sup>ARB No. 51, paragraph 1, states that “consolidated statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies.” SFAS No. 94, Consolidation of All Majority Owned Subsidiaries, eliminated certain exceptions to the general rule under ARB No. 51 that majority owned entities should be consolidated. These exceptions had allowed certain controlled entities that were foreign, “non-homogeneous”, and where there were significant non-controlling

presents information about its investment in the other entity in terms of a “one-line” investment account on the balance sheet, but rather, the assets and liabilities of the other entity are combined with (or added to) the assets and liabilities of the issuer, and the combined amounts are presented on the issuer’s consolidated financial statements. For example, the cash of the other entity is combined with the issuer’s cash; the equipment of the other entity is combined with the issuer’s equipment; the debt of the other entity is combined with the issuer’s debt; and so on. Likewise, the consolidated income statement combines the revenues and expenses of the other entity with those of the issuer.

One of the important benefits of consolidating entities controlled by the investor is similar reporting for all of the assets, liabilities, equity and operating results of the issuer and entities under the issuer’s direction. If entities are consolidated, an issuer cannot simply transfer an asset or liability to another entity that it controls and remove that asset or liability from its balance sheet. Issuers might be motivated to make such transfers by a desire to move poorly performing assets off the balance sheet or a desire to reduce the debt outstanding on the balance sheet to improve the appearance of the issuer’s financial position and liquidity. However, if the other entity is consolidated by the issuer, these assets and liabilities will be reflected on the consolidated balance sheet, regardless of which entity (the issuer or a controlled entity) legally “owns” them. Indeed, a part of the rationale for the consolidation standard was to prevent substantial obligations and/or losses from being “hidden” in unconsolidated controlled entities.

In most instances, the balance sheet of an issuer that consolidates another entity would reflect the same net assets (i.e., assets less liabilities) as if the investment in the stock of that entity had been accounted for using the equity method of accounting. However, under the equity method of accounting the issuer “nets” the assets and liabilities of the other entity and reports them on one line on the balance sheet. Similarly, the income statement of an issuer that consolidates another entity would generally reflect the same net income as if that entity had been accounted for using the equity method. Again, the difference lies in the level of detail provided to the user of the financial statements.

There are no specific disclosures related to consolidated entities. Rather, disclosures are provided related to the assets and liabilities of the consolidated entities just as they are for the issuer’s own assets and liabilities.

## **2. Off-Balance Sheet Issues in Accounting for Investments**

The fact that so many different accounting treatments exist for these investments certainly raises the question of whether each is necessary. Of course, multiple methods are appropriate if each is used to reflect substantively different circumstances. In analyzing the accounting for investments in other entities, the sub-section immediately below begins by considering the guidance for determining which approach to use. Since the largest difference in accounting, especially as it relates to whether assets or liabilities

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shareholders (minority interests). The exception in ARB No. 51 for temporarily controlled entities was eliminated through the issuance of SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets.



are on or off the balance sheet, is between consolidation and any of the other methods, we begin with the consolidation guidance.

### **a. Consolidation**

As discussed above, the accounting guidance generally relies on the concept of control to determine which entities to consolidate. Using control as the criterion for consolidation has been the generally accepted standard for decades, and the standard-setters have gradually eliminated exceptions to this general rule over time.<sup>110</sup> This approach provides consistency, and is a concept the Staff believes users can readily understand, even if determining whether control exists is sometimes a difficult question.<sup>111</sup>

Even before the Enron and other scandals, standard-setters had concluded that an approach focused on legal or voting control was often not effective in addressing the question of consolidation of special purpose entities. The nature of many SPEs is that they are designed so that all of their significant activities are “pre-programmed” or built into the operating structure of the entity at formation, such that voting control is irrelevant. The FASB recently issued an interpretation of the general consolidation rule under ARB No. 51 (i.e., Interpretation No. 46(R)) which seeks to identify the party that effectively controls the entity through an analysis of the risks and rewards of the SPE.<sup>112</sup> The addition of Interpretation No. 46(R) to the consolidation guidance has improved the guidance for assessing consolidation of SPEs.

Since the issuance of Interpretation No. 46(R), an investor must determine whether the investee is a Variable Interest Entity or a Voting Interest Entity. This determines which consolidation approach—voting control or risks and rewards—is used in evaluating whether the other entity needs to be consolidated. Once an issuer identifies an entity that is required to be analyzed under the risks and rewards approach, additional analysis is required to measure the exposure to risks and rewards of the entity. We discuss Interpretation No. 46(R) in more detail in Section IV of this Report.

### **b. Unconsolidated Investments**

As discussed above, investments in the equity of another entity that do not provide the issuer with control are accounted for using four different methods. In general, the Staff believes that the number of potential methods for these investments should be reduced, as the different methods do not always correspond to investments with

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<sup>110</sup>See SFAS No. 94, paragraph 9 and paragraph C2.a of SFAS No. 144.

<sup>111</sup>Including: when minority shareholders have significant participatory rights (EITF 96-16, Investor’s Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights), and where control may exist due to contractual relationships rather than ownership (EITF 97-2, Application of FASB Statement No. 94 and APB No. 16 to Physician Practice Management Entities and Certain Other Entities with Contractual Management Arrangements).

<sup>112</sup>As noted previously, Interpretation No. 46(R), discussed in detail in Section IV of this Report, addresses the accounting for Variable Interest Entities, which are generally understood to include the subset of entities typically referred to as SPEs.

differing economics. Some support the equity method by arguing that significant influence over another entity is a trigger that should change the accounting. Others suggest that equity method investments should be reported at fair value. Still others argue that fair value should not be used when that value is not evident from public market transactions. Although all of these views have merit, the Staff nonetheless believes that exploring the approach of recording all investments in other entities that do not result in consolidation at fair value is warranted.

The benefits of reducing the number of alternative accounting treatments for unconsolidated investments would include: 1) increased transparency for financial statement users, 2) reduced complexity for financial statement preparers, 3) reduced likelihood that investments with similar underlying economic characteristics are presented differently in the financial statements, and 4) reduced incentives to structure investments in an effort to achieve a particular accounting treatment. For example, an issuer investing in another entity that is likely to incur losses in the short term may currently have an incentive to structure its investment to avoid the equity method,<sup>113</sup> because it would require the investor to recognize its share of these losses.

### **3. Empirical Findings from Study of Filings by Issuers**

In this section the Staff presents empirical findings from the Study of filings by issuers related to investments in other entities. The Staff also extrapolates from these findings to estimate amounts related to the approximate population of active U.S. issuers.

Table III(A)(1) describes the percentage of issuers reporting investments in the equity of other entities. Almost 96% of the sample issuers present financial reports that consolidate one or more other entities. As indicated in the table, approximately 50% of the sample issuers report equity-method investments, and approximately 36% report cost-method investments. Approximately 58% and 18% of the sample issuers report investments categorized as “available for sale” and “trading”, respectively.<sup>114</sup> An extrapolation of the findings from the sample to the approximate population of active U.S. issuers suggests that approximately 24% of the population of issuers report equity-method investments, approximately 17% report cost method investments, approximately 37% report available-for-sale investments and approximately 6% report trading investments.

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<sup>113</sup> See, for example, EITF Issue No. 02-14, Whether an Investor Should Apply the Equity Method of Accounting to Investments Other Than Common Stock.

<sup>114</sup> Two-thirds of those issuers reporting trading investments are large banks, financial institutions, insurance companies, and the like.

| Categorized by Accounting Treatment <sup>a</sup>                  | Full Sample<br>(n=200)<br>(%) | Sub-Samples                     |                                  | Estimate for Population<br>(N=10,100)<br>(%) |
|---|-------------------------------|---------------------------------|----------------------------------|--|
|   |                               | Large Issuers<br>(n=100)<br>(%) | Random Issuers<br>(n=100)<br>(%) |  |
| Issuers presenting consolidated financial statements <sup>b</sup> | 95.5                          | 100                             | 91                               | 91.1   |
| Issuers reporting equity method investments <sup>c</sup>          | 50.5                          | 78                              | 23                               | 23.5   |
| Issuers reporting cost method investments <sup>c</sup>            | 36                            | 55                              | 17                               | 17.4   |
| Issuers reporting available-for-sale investments <sup>c</sup>     | 58                            | 79                              | 37                               | 37.4   |
| Issuers reporting trading investments <sup>c</sup>                | 17.5                          | 29                              | 6                                | 6.2  |

<sup>a</sup> These categories are not mutually exclusive.  
<sup>b</sup> Determined by observation of the face of the balance sheet; issuers presenting consolidated financial statements will include the term “Consolidated” in the titles of each statement.  
<sup>c</sup> Determined by examining the notes to the financial statements of issuers that report “Investments” to ascertain whether these investments are accounted for as “trading,” “available for sale,” “cost method,” or “equity method investments.”

Table III(A)(2) presents reported amounts related to equity method investments, where such amounts can be determined. As discussed above, the amount presented on the balance sheet for equity method investments represents the issuer’s interest in the net assets of the other entity. For our sample of issuers, the total value on the balance sheet for equity-method investments is reported at approximately \$146 billion. A total of almost \$18 billion in income related to equity method investments is reported on the sample issuers’ income statements.

|  | Full Sample<br>(n=200)<br>( <i>millions</i> ) | Sub-Samples                                     |  | Estimate for Population<br>(N=10,100)<br>( <i>millions</i> ) |
|--|---|---|--|--|
|  |   | Large Issuers<br>(n=100)<br>( <i>millions</i> ) | Random Issuers<br>(n=100)<br>( <i>millions</i> ) |  |
| Equity method investments reported on issuer balance sheet <sup>a</sup>                        | \$145,914                                     | \$143,318                                       | \$2,596  | \$402,918  |
| Income (loss) from equity method investments reported on issuer income statements <sup>a</sup> | \$17,664                                      | \$17,462  | \$202  | \$37,662   |

<sup>a</sup> These data were collected from the notes to the financial statements and supplemental exhibits.

It is important to note that disclosure of the amount on the balance sheet related to equity method investments may not be required, absent other factors that make the

information material to investors. For example, if the investment does not meet certain requirements that designate it as “significant,”<sup>115</sup> the amount reported for the investment may be combined with other items on the balance sheet and presented as “other assets” with no further breakdown of the other asset categories required. In this case, investors may not be able to determine the existence of some equity method investments (or other types of investments) from the issuer’s filing.

If the investment is “significant,” disclosures about the financial position and operating results of the other entity may be required in the notes to the financial statements or in supplemental exhibits. The Staff notes that, due to the varying placement of the disclosures and the different levels of disclosures required, it may sometimes be difficult for investors to fully comprehend the extent of an issuer’s involvement with equity method investments and to compare such involvements across issuers. As a result, the Staff acknowledges that the values reported in Table III(A)(2) may be understated.

In reviewing the sample data, the Staff notes that fair values of equity method investments are not disclosed in many cases.<sup>116</sup> Where fair values were reported, the Staff notes that there is little, if any, correlation among the fair values, the value reported on the issuer’s balance sheet under the equity method, and the underlying equity in the other entity.

## **B. Transfers of Financial Assets with Continuing Involvement**

### **1. Nature of Arrangements and Financial Reporting Requirements**

Issuers often transfer financial assets (e.g., customer receivables, notes, mortgages, bonds) to other parties. In this subsection, we discuss the “derecognition” of financial assets; that is, when is it appropriate for an issuer to consider financial assets to be sold, and remove them from the balance sheet. If the transfer is treated as a sale (i.e., if it receives “sale accounting”), the issuer would record the receipt of cash, remove (i.e., “derecognize”) the assets from its balance sheet, and report any gain or loss in the income statement. If a transfer of financial assets does not qualify for sale accounting, it is instead accounted for as a borrowing. In these cases, the issuer transferring the assets would record the receipt of cash, but would not remove the assets from its balance sheet, and would not report any gain or loss in the income statement. Further, the issuer transferring the assets would recognize a liability for the full amount of cash received from the other party.

In a simple example, consider an issuer selling \$1 million in customer receivables to a finance company without recourse or further obligation on either party’s part. The issuer receives cash today and its customers’ future payments are sent to the finance

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<sup>115</sup>See Regulation S-X Rules 3-09 and 4-08(g).

<sup>116</sup>Paragraph 20(b) of APB No. 18 indicates that the “For those investments in common stock for which a quoted market price is available, aggregate value of each identified investment based on the quoted market price usually should be disclosed.”

company. In this case the finance company bears all the risk and, assuming no fraud or other irregularities, the issuer is not required to reimburse the finance company if its customers default. In this case, since the issuer surrenders all rights and retains no obligations associated with ownership of the receivables, the transfer would typically be treated as a sale.

In other arrangements, the issuer may continue to be involved with the transferred assets. For example, an issuer might transfer customer receivables to a finance company for cash, but accept an obligation to reimburse the finance company in the event that the issuer's customers default. Consider a transfer of \$1 million in customer receivables similar to that above, except that the issuer guarantees up to \$10,000 of the amounts transferred. Such a transfer would typically still be treated as a sale, since the continuing obligation to which the issuer is exposed is relatively small, and does not result in the issuer continuing to control the transferred assets..

The transaction looks less like a sale as the continuing involvement increases. Indeed, in some cases, a transfer of financial assets with extensive continuing involvement might be economically indistinguishable from a borrowing secured by the "sold" assets. Consider a similar transfer of \$1 million in customer receivables where the issuer guarantees 100% of the amounts transferred, such that the issuer must reimburse the finance company for any and all customer defaults. This transaction clearly has economic similarities to a secured borrowing since the issuer has received cash today and is obligated to remit cash to the finance company in the future, regardless of whether or not its customers pay.

SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, provides the guidance for determining whether all, or any portion of, a transfer of financial assets should be accounted for as a sale, in cases where there is continuing involvement. SFAS No. 140 focuses on the concept of "control" of the transferred financial assets; if control is deemed to be relinquished, the transaction is treated as a sale. However, SFAS No. 140 does not impose a "sale" or "no sale" determination for the entire transaction. Instead, what has been dubbed a "financial components" approach is taken, such that the issuer continues to record as an asset any portion of the original asset that it continues to control after the transfer, and removes from its balance sheet the portion that it no longer controls. Thus, if control over only a portion of the assets has been given up, an issuer would account for only that portion as sold. The issuer would continue to include in its financial statements any portion of the assets it did not sell and recognize any other assets or liabilities related to its continuing involvement with the portion of the assets sold.

In our example above where the issuer guaranteed up to \$10,000 of the amounts transferred, assuming that sale accounting were appropriate, the issuer would recognize the receipt of the cash, remove the customer receivables from its balance sheet, and recognize a liability related to the \$10,000 guarantee. If, in addition to the guarantee, the issuer retained an undivided interest in 20% of the receivables, then the issuer would recognize the receipt of the cash, remove only 80% of the receivables' carrying value

from its balance sheet, and recognize a liability related to the \$10,000 guarantee.<sup>117</sup> In the example above where the issuer guaranteed 100% of the amounts transferred, it is likely that the transfer of the customer receivables would not receive sale accounting. In this circumstance, as described above, a liability will be recorded to reflect the issuer's obligation to repay the full amount received to the finance company.

It is noteworthy that, under this approach, transfer of control remains the key criterion (as opposed to, say, some measure of risks and rewards), albeit applied to each component of the transaction. In this context, transfer of control is generally considered to have occurred for accounting purposes if:<sup>118</sup>

- The assets have been “isolated” from the issuer transferring the assets<sup>119</sup> (that is, put presumptively beyond the reach of the issuer or its creditors even in bankruptcy);
- The purchaser<sup>120</sup> is not restricted from selling the assets or using them as collateral for a loan; and
- The issuer transferring the assets does not continue to maintain effective control over the assets by keeping a right or obligation to repurchase or redeem the assets before their maturity.

Transfers of financial assets often take more complex forms than the simple scenarios discussed above. For example, financial assets are often transferred into a special purpose entity, which issues securities or commercial paper in order to fund the purchase of the financial assets. If the SPE issues securities, the transaction is commonly described as a “securitization” of those financial assets.<sup>121</sup> If the transaction involves the transfer of mortgage loans and a related guarantee (such as one from a government-sponsored agency), it is referred to as a “guaranteed mortgage securitization.” If the SPE issues commercial paper, it might be referred to as a commercial paper conduit.

There are several reasons why issuers engage in these more complex transactions, such as to enhance liquidity, manage risks, and/or to obtain lower-cost funding. In order to achieve lower-cost funding, issuers generally maintain at least some level of continuing involvement in the transferred assets that provides protection (*i.e.*, from credit, interest rate, or other risks) to the purchasers of the securities or commercial paper issued by the SPE. For example, a seller may provide credit enhancement through over-collateralization of the assets sold. In a common type of over-collateralization, the seller

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<sup>117</sup>This would assume that all the criteria to qualify for sale accounting in paragraph 9 of SFAS No. 140 have been met.

<sup>118</sup>See SFAS No. 140, paragraph 9.

<sup>119</sup>This is a facts and circumstances determination, and often requires the advice of outside attorneys.

<sup>120</sup>When the purchaser is a QSPE (as is discussed below), this criteria applies to restrictions on the QSPE's interest holder.

<sup>121</sup>Paragraph 364 of SFAS No. 140, defines a securitization as “the process by which financial assets are transformed into securities.”

would sell assets worth, say, \$100 for \$90, while retaining the right to the last \$10 collected on those assets. Other types of continuing involvement include derivative transactions with the SPE,<sup>122</sup> cash reserve accounts,<sup>123</sup> guarantees,<sup>124</sup> and/or servicing obligations for the underlying assets. In the context of a securitization, the assets and liabilities related to an issuer's continuing involvement in the transferred assets are often referred to as "retained interests." Both the economics and the structural forms of these contracts have evolved rapidly in recent years, in order to take advantage of opportunities in financial markets and, at times, to achieve specific accounting results.

When an SPE is involved, in addition to determining whether or not sale accounting is appropriate, there is also a need to determine whether the transferor is required to consolidate the SPE for accounting purposes. If an issuer transfers financial assets to an SPE in a transaction qualifying for sale accounting, but the SPE is consolidated, the sale accounting allowed by SFAS No. 140 would be effectively negated. That is, the issuer would recognize the outstanding portion of the assets transferred on its consolidated balance sheet, as well as a liability reflecting the SPE's obligation to its debt-holders.

In order to facilitate sale accounting in securitization transactions, the accounting guidance includes an exception to the consolidation requirements for certain SPE's commonly used in securitization transactions. In many cases the SPE in a securitization transaction can be described as being on "auto-pilot"—*i.e.*, it merely collects cash flows on the financial assets and pays those cash flows to investors, but does nothing else, such that, in essence, no one controls or needs to control the operations of the entity. In such cases, since all decisions are preprogrammed by the legal documents that create the SPE, it has been argued that there is no need for any party to be deemed to control the entity—and thus, no justification for consolidation. The FASB denoted this type of SPE as a "qualifying" SPE or "QSPE" to differentiate it from other SPEs.<sup>125</sup>

SFAS No. 140 also requires the following disclosures (among others):<sup>126</sup>

- Total outstanding amounts of securitized assets, the portion that has been derecognized, and the portion that continues to be recognized on the balance sheet (*e.g.*, as retained interests); and
- Amounts of, delinquencies on, and net credit losses related to securitized assets plus any other assets the issuer manages with them;

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<sup>122</sup>See discussion on derivatives in Section III(F).

<sup>123</sup>A cash reserve account is a form of credit protection provided by the seller and is typically funded from a portion of the seller's proceeds from the securitization transaction. Losses of principal and/or interest in the entity generally would be borne first by the cash reserve account up to the amount funded in such account, thus providing a form of credit enhancement to the third-party investors.

<sup>124</sup>See discussion on guarantees in Section III(E).

<sup>125</sup>See SFAS No. 140, paragraph 46 and Interpretation No. 46(R), paragraph 4(c).

<sup>126</sup>See SFAS No. 140, paragraph 17 a complete list of the disclosure requirements.

In addition, SFAS No. 140 requires the following disclosures for each securitization asset type (such as credit card receivables, mortgage loans or automobile loans):

- The characteristics of the securitization—that is, a description of the issuer’s continuing involvement with the securitized assets and the amount of gain or loss on sale;
- Cash flows between the issuer and the SPE;
- The issuer’s accounting policies for initially and subsequently measuring any retained interests;
- Key assumptions in measuring the fair value of the retained interests; and
- Sensitivity analysis showing the effects of changes in the key measurement assumptions.

The Commission’s Financial Reporting Release No. 67 (known as FR 67) mandated by section 401(a) of the Act, also requires additional disclosures in the Off-Balance Sheet section of MD&A regarding certain off-balance sheet arrangements. FR 67 requires issuers to provide disclosures about securitization transactions that involve transfers to an unconsolidated entity with the issuer having retained or contingent interests in the unconsolidated entity. Disclosure is required to the extent necessary to provide an understanding of the issuer’s material off-balance sheet arrangements as well as the material effects of those arrangements. For securitization transactions these disclosures may include:

- Nature and business purpose of the arrangement, including a description of the retained or contingent interests in assets transferred that serve as credit, liquidity, or market risk support for the assets;
- Importance of the arrangement to liquidity, capital resources, market risk or credit risk support, or other benefits;
- The financial impact of the arrangements and the issuer’s exposure to risk as a result of the arrangements (e.g., retained interests or contingent liabilities); and
- Known events, demands, commitments, trends or uncertainties that affect the availability or benefits of such arrangements.

## **2. Off-Balance Sheet Issues in Accounting for Transfers of Financial Assets**

During the development of the guidance related to transfers of financial assets, the FASB noted that transfers of financial assets in which the seller has some continuing involvement (either with the transferred assets or with the purchaser) had grown significantly in volume, variety, and complexity.<sup>127</sup> With this in mind, the FASB set out

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<sup>127</sup>See SFAS No. 140, paragraph 116.



to develop an approach that would be more responsive to developments in the financial markets. The financial components approach was designed to be consistent with the way market participants deal with financial assets, recognizing that the financial marketplace can contractually separate and repackage the cash flows associated with financial assets in many ways. The financial components approach was also designed to reflect the economic consequences of contractual provisions underlying the financial assets and liabilities, and conform to the FASB's conceptual framework.

Application of the financial components approach may be challenging, as many of these transactions (e.g., securitizations) can be complex and highly structured. For example, it is often necessary to obtain legal opinions from attorneys with specific expertise in these transactions. Additionally, determining the fair value of the various components of the transaction, including any retained interests, requires the exercise of judgment and may also involve subjective estimations, raising questions about the preciseness of both the fair values and of gains or losses recorded upon the sale of the financial assets. Nevertheless, the financial components approach, in general, provides a consistent approach to derecognition, and is a substantial improvement from the incomplete and sometimes inconsistent guidance that existed before that approach was adopted. The financial components approach is also more flexible than an "all or nothing" approach that would look at each instrument only as whole.<sup>128</sup>

As discussed above, an alternative to using control as a basis for determining which assets to record is a "risks and rewards" approach. Those who support a risks and rewards approach to derecognition often suggest that an approach that focuses on control of the financial assets makes it possible to have economically similar transactions treated differently for accounting purposes. For example, consider an issuer selling customer receivables and specifying in the sale agreement that it could, at some later date, select from among those receivables a small portion to repurchase at a fixed price. Since any individual receivable could be repurchased under this provision, according to SFAS No. 140 the issuer is deemed to have retained control over the entire pool of assets, even though the issuer might not participate significantly in the risks and rewards associated with the asset pool. As a consequence of this retained control, this transfer would not qualify for sale accounting under SFAS No. 140.

Although there is debate about whether the guidance in SFAS No. 140 is effective, much of the controversy is caused not by the standards themselves, but by transaction structuring. Issuers often structure transfers in order to achieve or avoid sale accounting, trigger or avoid the recognition of losses (or gains), or change the measurement attribute applied to the recorded assets and liabilities. The Staff believes, based on its reviews of issuer filings, that the most frequent structuring goal is to achieve sale treatment without consolidation of any related SPEs. While economic motivations for most asset transfers exist, some transfers of financial assets appear to be significantly, primarily, or even solely entered into with accounting motivations in mind.

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<sup>128</sup>In contrast, lease accounting, discussed in Section III.D, takes such an "all or nothing" approach.

Some of this structuring has been undertaken by using QSPEs in situations that appear to the Staff to be beyond those originally contemplated by the FASB. The FASB originally intended a QSPE to be merely a pass-through entity to essentially serve as custodian of the underlying financial assets,<sup>129</sup> and attempted to define it in such a way as to ensure that this was the case. There are restrictions on the types of assets that an SPE can hold while remaining “qualified,” and when it is acceptable for the QSPE to dispose of certain non-cash financial assets.<sup>130</sup> Although the limitations on the activities of QSPEs do not permit the QSPE to manage the assets on its balance sheet, there are few explicit limitations on managing the balance sheet liabilities.<sup>131</sup> That is, in structures where the QSPE holds longer term assets and funds the purchase of such assets through the issuance of shorter term interests to investors, decisions have to be made regarding the nature of the new interests to be issued when the original short term interests mature. In practice, these decisions are made by the issuer transferring the financial assets. Accountants and auditors have concluded that the SPE – despite such management of liabilities -- is a QSPE under SFAS No. 140, and is therefore exempt from consolidation. These and other interpretations of the QSPE guidance have expanded the activities of QSPEs beyond the simple pass-through entities originally envisioned by the FASB.<sup>132</sup>

Despite persistent work by the FASB<sup>133</sup> and the Commission, the Staff considers the accounting for sales of financial assets to be in need of improvement. Indeed, the FASB already has several projects on its agenda relating to transfers of financial assets. However, this area is challenging to standard setters, in large part because financial structures are virtually limitless and continue to evolve at a rapid pace. However, because the areas in need of improvement in their accounting stem mainly from structured transactions that have accounting motivations, improvement in transparency and comparability across issuers can perhaps most directly and quickly be accomplished by eliminating the use of such structured transactions.

### **3. Empirical Findings from Study of Filings by Issuers**

In this section the Staff presents empirical findings from the Study of filings by issuers related to transfers of financial assets. The Staff also extrapolates from these findings to estimate amounts related to the approximate population of active U.S. issuers.

Table III(B)(1) describes the percentage of issuers reporting transfers of financial assets. As indicated in the table, approximately 17% of the sample issuers report

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<sup>129</sup>See SFAS No. 140, paragraph 177.

<sup>130</sup>See SFAS No. 140, paragraph 35.

<sup>131</sup>The FASB is currently considering these and other issues as part of a project to amend SFAS No. 140.

<sup>132</sup>In acknowledging these interpretations, the Staff does not intend to signify its agreement with them.

<sup>133</sup>For example, the FASB previously amended and added to the guidance in SFAS No. 125 through the issuance of SFAS No. 140. Additionally, the FASB staff addressed 123 interpretive questions in a Special Report, A Guide to Implementation of Statement 140 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. More recently, the FASB has undertaken a project to amend the guidance in SFAS No. 140.

transfers of financial assets, mainly via securitizations, and most of these issuers are members of the large issuer sub-sample. Approximately 13% of issuers report retained interests related to these transfers and, again, most of these issuers are members of the large issuer sub-sample. An extrapolation of the findings from the sample to the approximate population of active U.S. issuers suggests that approximately 4% of the population of issuers report transfers of financial assets, and approximately 3% report retained interests from their continuing involvement with these assets.

| <b>TABLE III(B)(1): Issuers Reporting Transfers of Financial Assets</b> |                               |                                    |                                     |   |
|---|-------------------------------|------------------------------------|-------------------------------------|---|
|   | Full Sample<br>(n=200)<br>(%) | Sub-Samples                        |                                     | Estimate for<br>Population<br>(N=10,100)<br>(%) |
|   |                               | Large<br>Issuers<br>(n=100)<br>(%) | Random<br>Issuers<br>(n=100)<br>(%) |   |
| Issuers reporting transfers of financial assets <sup>a</sup>            | 17                            | 30                                 | 4                                   | 4.3   |
| Issuers reporting retained interests <sup>a</sup>                       | 13                            | 23                                 | 3                                   | 3.2   |

<sup>a</sup> These data were collected from the notes to the financial statements in the filings of issuers selected for the Study.

Table III(B)(2) presents reported amounts related to transferred financial assets. Our sample of issuers reports approximately \$791 billion in financial assets that were transferred, and moved off issuer balance sheets, but are still outstanding. In addition, our sample of issuers reported net gains of approximately \$10 billion related to the sale of financial assets during 2003. Our sample issuers report approximately \$161 billion in assets and liabilities related to the issuer's continuing involvement with these assets. An extrapolation of the findings from the sample to the approximate population of active U.S. issuers suggests that financial assets reported by the population as transferred but still outstanding are close to \$1 trillion, and that assets and liabilities reported by the population as representing their continuing involvement in these transferred assets are approximately \$186 billion.

|   | Full Sample<br>(n=200)<br>(millions) | Sub-Samples                               |  | Estimate for<br>Population<br>(N=10,100)<br>(millions) |
|---|--------------------------------------|---|--|--|
|   |                                      | Large<br>Issuers<br>(n=100)<br>(millions) | Random<br>Issuers<br>(n=100)<br>(millions) |  |
| Financial assets transferred off issuer balance sheets but still outstanding    | \$790,925                            | \$789,325                                 | \$1,600                                    | \$949,325  |
| Gain/loss on transfers of financial assets reported on issuer income statements | \$10,287                             | \$10,047                                  | \$240                                      | \$34,047   |
| Retained interests reported on issuer balance sheets                            | \$161,175                            | \$160,928                                 | \$247                                      | \$185,628  |

<sup>a</sup> These data were collected from the notes to the financial statements.

Table III(B)(3) presents reported amounts for some of the major classes of retained interests reported by our sample of issuers. Interest-only strips,<sup>134</sup> recorded as assets on the issuer's balance sheet, total approximately \$5.6 billion for the sample. Of the various types of retained interests, these are typically the most subordinate, and consequently carry the highest concentration of risk. Servicing assets,<sup>135</sup> which carry risk primarily related to prepayments, total approximately \$23 billion for the sample. The remainder of the retained interests, approximately \$133 billion, includes but is not limited to various types of more senior interests that, by their nature, are apt to carry lower risk concentrations.

| Type of Retained Interest             | Full Sample<br>(n=200)<br>(millions) | Sub-Samples                               |  | Estimate for<br>Population<br>(N=10,100)<br>(millions) |
|---------------------------------------|--------------------------------------|---|--|--|
|                                       |                                      | Large<br>Issuers<br>(n=100)<br>(millions) | Random<br>Issuers<br>(n=100)<br>(millions) |  |
| Interest-only Strip                   | \$5,628                              | \$5,540                                   | \$88                                       | \$14,340   |
| Servicing Assets                      | \$22,677                             | \$22,518                                  | \$159                                      | \$38,418   |
| Other Retained Interests <sup>b</sup> | \$132,870                            | \$132,870                                 | \$0  | \$132,870  |

<sup>a</sup> These data were collected from the notes to the financial statements.  
<sup>b</sup> These interests would include amounts representing, for example, overcollateralizations, senior or mezzanine bond interests, and seller's interests in credit card securitizations.

It appears that some issuers exclude information regarding securitization transactions from their disclosures if they did not retain a subordinate interest, such as an

<sup>134</sup>Interest-only strips are instruments that entitle the holder to a portion of the interest payments made on a pool of loans or debt securities

<sup>135</sup>Servicing assets involve the right to payments similar to an interest-only strip in return for collecting and dispersing payments made on the underlying loans.

interest-only strip, following the transactions. Further, the Staff notes that the sample issuers disclosed relatively little information regarding transactions with commercial paper conduits, such as transfers of trade receivables.

## **C. Retirement Arrangements**

### **1. Nature of Arrangements and Financial Reporting Requirements**

Many companies provide employees with retirement benefits. Cash payments under pension plans are the most common, but other benefits, such as health-care insurance, are also offered. Due in part to the magnitude of the obligations under these plans, the significance of the unfunded or underfunded status of plans, and the uncertainty inherent in measuring the obligations, the accounting for certain retirement benefits has long been controversial. However, with the aging population, concerns over the future of the social security system, and companies reducing or eliminating retirement benefits altogether, discussions regarding the accounting for employee retirement benefits occur at the highest levels within the U.S. government, corporate-America and the workforce.

There are two primary types of pension benefit plans: defined contribution and defined benefit. Under a defined contribution plan, the employer provides contributions to the plan based upon its agreements with employees and its policies, but has no further obligation to provide benefits under the plan. The future risks and rewards of these plans rest with employees, not employers. Thus, the accounting for defined contribution plans is quite straightforward and does not raise significant off-balance sheet questions; as such, the accounting for these plans is not addressed in this Report.

In contrast, under a defined benefit plan, the employer is at risk and is obligated to ensure that employees receive the predetermined benefits after retirement. An employer might simply choose to pay such benefits as they become due. However, most issuers set up a separate legal entity (usually a type of trust) to hold and manage retirement assets and make the related payments. Even when a separate entity is established to accumulate assets to fund pension benefits, the employer's obligation is not satisfied merely by making contributions to the plan. Because of its responsibility to ensure there are sufficient assets to pay plan benefits, the employer retains the risk of underperforming assets, and receives the benefit when those assets perform better than expected. Subject to certain limitations in employment law, the employer, or a representative appointed by the employer, also generally determines the plan's investments.

Based on our discussions in the previous sections, and in view of the employer's continuing involvement and risk, it might seem that a separate legal entity that is established to hold and manage pension plan assets and that is controlled by the issuer should be consolidated. If consolidated, plan assets and liabilities would be separately recognized on the issuer's balance sheet. However, defined benefit pension plans are exempt from consolidation.<sup>136</sup> Instead, the retirement plan assets and liabilities, to the

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<sup>136</sup>See, for example, Interpretation 46(R), paragraph 4(b), and SFAS No. 87, paragraphs 35-37.

extent recognized, are netted against each other, with only the net asset or net liability for each plan recognized on the issuer's balance sheet.<sup>137</sup>

It is generally accepted that any liability for pension-related costs should be recognized by the employer as its employees perform service. Pension and other retirement plan costs are determined by developing best estimates of future benefit payments, taking into account a number of factors, to the extent such factors are relevant, including the employee's age, length of service, retirement date, salary, expected trends in medical costs, expected mortality. These estimated future benefit payments are then discounted to their present value. Due to the complexities involved in estimating pension obligations, actuaries are typically involved. Given the long-term nature of pension plans, changes in the estimates and assumptions over time are expected. The accounting guidance for these plans does not require adjustments to the pension obligation as a result of changes in the estimates and assumptions to be recognized immediately.<sup>138</sup> Similarly, differences between expected and actual returns on assets need not be recognized immediately. All of these items, which are collectively referred to as pension gains and losses, may be deferred and factored into the pension obligation or asset reported on the balance sheet over future periods.

The approach to accounting for defined benefit pensions is designed to ensure that the related pension costs are recorded over the service lives of the employees and that the recorded obligation is sufficient to reflect all benefit payments obligations before they become due. However, companies are afforded discretion under the guidance as to when gains and losses are recorded during the service period, so long as they are recorded by the time the obligations become due. An issuer that does not elect to defer pension gains or losses as permitted by the accounting guidance will report a net retirement plan asset or liability that is determined based on the fair value of the assets in the plan, and the then-current best estimate of the retirement obligation. That issuer would likely report significant volatility in its pension expense, as any changes in actuarial estimates and assumptions would be immediately recognized, as would actual returns on pension plan assets. On the other hand, an issuer that elects to defer pension gains and losses would report much smoother pension expense from period to period, but would report a net retirement plan asset or liability that could be affected as much by deferrals of gains and losses as by actual changes in assets and obligations.

The FASB attempted to mitigate the effects of smoothing pension expense and reduce the amount of retirement liability that may be off-balance sheet, by instituting a "minimum liability rule."<sup>139</sup> If issuers choose to defer pension gains and losses, they

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<sup>137</sup>In part, this acknowledges the fact that under U.S. employment law, there are certain protections of retirement benefits so long as the company funds its pension plans adequately and meets other requirements. See Employee Retirement Income Security Act of 1974.

<sup>138</sup>SFAS No. 87, Employers' Accounting for Pensions and SFAS No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions, are the primary accounting standards related to accounting for retirement benefits.

<sup>139</sup>See SFAS No. 87, paragraph 36. Health-care and other postretirement benefit plans are not subject to the minimum liability rule.

must recognize a liability of at least the amount by which the accumulated benefit obligation (“ABO”), which is defined as the best estimate of the present value of future pension payments without taking into account future salary increases, exceeds the fair value of pension plan assets.<sup>140</sup> However, even with recognizing the minimum liability, a significant amount of an issuer’s pension obligation may remain off-balance sheet, since the determination of the minimum liability is based on the ABO, rather than the projected benefit obligation (“PBO”), a projection of benefit obligations which considers the effects of expected future salary increases.

Extensive disclosures are required for pensions and other postretirement benefit plans.<sup>141</sup> These disclosure requirements are intended to provide financial statement users a more complete picture of the retirement plans. More particularly, the disclosures are generally designed to accomplish three tasks. First, they provide consistent information about benefit plans, no matter what choices have been made regarding balance sheet and income statement presentation of retirement plan amounts. Second, they provide the reader with information about certain key assumptions and estimates used in the pension and postretirement benefit plan calculations. And finally, they explain whether the issuer has elected to defer any of the gains or losses and provide information about the effect of deferral.

Required disclosures include:

- A reconciliation of changes in employers’ retirement obligations from period to period, and a reconciliation of changes in fair values of retirement plan assets from period to period;
- Funded status of the plan (i.e., the extent to which the retirement obligations ((as measured by PBO for pensions and ABO for other postretirement benefit plans)) are funded with retirement assets to cover those obligations) and the amounts of retirement-related obligations that are off-balance sheet;
- Qualitative and quantitative information about how retirement plan assets are invested;
- Estimates of amounts expected to be contributed to the plan in the subsequent year and the benefits to be paid to employees in the near term;
- The amount of net periodic benefit cost recognized in earnings; and

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<sup>140</sup> However, any such increase in liability does not appear on the income statement as a loss. Rather, the “other side” of the accounting entry is also to the balance sheet, either to an intangible asset or to other comprehensive income (a component of equity).

<sup>141</sup>The accounting for other postretirement benefit plans is similar to defined benefit pension plans in that the issuer is required to estimate and recognize the obligation and related cost of providing such benefits as the employees perform services. Further, many of the same issues regarding estimation of the obligation, netting plan assets and liabilities and deferral of certain changes in plan assets and liabilities exist under other postretirement benefit plan accounting. However, other postretirement benefit plans are often not funded through the establishment of a separate legal entity.

- Key assumptions used in measurement of plan assets, liabilities and retirement cost, including the dates such measurements were determined.<sup>142</sup>

## 2. Off-Balance Sheet Issues in Accounting for Retirement Arrangements

Some investors have expressed concerns about the transparency of pension and other postretirement benefit accounting and disclosure. The CFA Institute (formerly the Association for Investment Management and Research or “AIMR”), a nonprofit membership organization for investment professionals, recently commented that, because the pension and other postretirement benefit accounting standard “fails to provide full recognition in the financial statements of the effects on the firm of the pension and postretirement benefit contracts, a huge and very costly burden has been shifted to those for whom the statements are prepared, analysts and other users.”<sup>143</sup> Accordingly, some investors have called for issuers to report actual gains and losses from changes in expected assumptions versus actual plan results by eliminating the smoothing of gains and losses currently allowed under GAAP and to separately recognize pension and other postretirement benefit plan assets and liabilities on the balance sheet. The Staff agrees that, under the current standards, the balance sheet is often not transparent as to the true funded status of pension plans and that additional clarity is necessary.

In the deliberations that led to the issuance of the retirement accounting standards that were in the mid-1980s and early-1990’s, the FASB stated that it would be preferable conceptually to recognize retirement liabilities and assets with either no delay in recognition of gains and losses in net income, or with gains and losses reported currently in other comprehensive income, but not in net income.<sup>144</sup> However, it was strongly argued by issuers that recognizing these short-term gains and losses in the income statement of the issuer may overwhelm the effects of the issuer’s continuing operations and thus would not fairly reflect the primary business activities of the issuer. Furthermore, as noted above, preparers argued that retirement plans are a long-term commitment, and that the accounting should take a similar long-term view that avoids excessive short-term volatility, so long as the obligation is recognized by the time it becomes due. Ultimately, the FASB acknowledged that not permitting the deferral of certain gains or losses would be “too great of a change from past practice” and was satisfied that the standards “as a whole represented an improvement in financial reporting.” However, the FASB also acknowledged that the issuance of such guidance was only one step toward gradual, evolutionary change.<sup>145</sup>

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<sup>142</sup>See paragraph 5 et. seq. of SFAS No. 132 Revised.

<sup>143</sup>See the CFA Institute (formerly AIMR) Comment Letter to the FASB: Re: File Reference No. 1025-200-Proposed Statement of Financial Accounting Standards: Employers’ Disclosures about Pensions and Other Postretirement Benefits, Oct. 27, 2003. See also CFA Institute (formerly AIMR) letter to the IASB: Re: Improvement of IAS 19, Employee Benefits, June 16, 2002, in which CFA Institute states that they are not in favor of smoothing pension losses and gains.

<sup>144</sup>SFAS 87, paragraph 107.

<sup>145</sup>SFAS No. 87, paragraph 107.



While the merits of the various positions can be debated, it is true that retirement plan accounting is at times inconsistent with the accounting for similar assets and liabilities. For example, there are many liabilities whose ultimate payment amount depends on future events. When the estimate of the amount to be paid changes, those other liabilities are adjusted to reflect the change in estimate. However, when estimates of the amounts of retirement benefits to be paid change, the related liability is not required to be adjusted immediately, as gains and losses may be deferred. Also, as noted previously, assets held in retirement plans are not accounted for using the guidance that would apply to such assets if not held in retirement plans. In addition, the existence of so many optional treatments is itself a difference between retirement plan accounting and the accounting for other significant assets and liabilities.

Application of the current pension and other postretirement benefit accounting guidance has raised other questions. As noted above, estimation of retirement plan liabilities depends upon multiple actuarial and other estimates and assumptions. Because of the size of retirement obligations and their sensitivity to certain assumptions, even relatively small changes in those assumptions or estimates can significantly change the estimated obligation or pension expense. The Staff has therefore focused on retirement plan assumptions in its reviews of issuer filings in the past. For example, pension plan assumptions were identified as a significant issue in the “Summary by the Division of Corporation Finance of Significant Issues Addressed in the Review of the Periodic Reports of the Fortune 500 Companies” issued in 2003. That report noted that several topics which merit improved MD&A disclosures, including information about the significant assumptions used and how they were determined, sensitivity of the financial statements to changes in assumptions, and the impact of any planned changes in assumptions. The selection of appropriate assumptions and the use of judgment in making estimates of retirement obligations would likely be as important even if the accounting guidance were changed.

### **3. Empirical Findings from Study of Filings by Issuers**

In this section the Staff presents empirical findings from the Study of filings by issuers related to retirement plans. The Staff also extrapolates from these findings to estimate amounts related to the approximate population of active U.S. issuers.

Table III(C)(1) describes the percentage of issuers reporting defined-benefit retirement plans. Approximately 48% of the sample issuers report defined-benefit pension plans, while approximately 44% report other postretirement benefit plans.<sup>146</sup> The large issuer sub-sample reports a higher incidence of these plans in that 81% (74%) of these issuers report defined-benefit pension (other postretirement benefit) plans. In contrast, in the random issuer sub-sample, only 15% (14%) of the issuers report information about defined-benefit pension (other postretirement benefit) plans. An extrapolation of the findings from the sample to the approximate population of active U.S. issuers suggests that approximately 16% of the total population of issuers report

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<sup>146</sup> Issuers may have many individual plans, but often report information on an aggregate basis.

sponsoring defined-benefit pension plans, and 15% report sponsoring other defined-benefit postretirement plans.<sup>147</sup>

| Categorized by Type of Plan <sup>b</sup>                | Full Sample<br>(n=200)<br>(%) | Sub-Samples                        |                                     | Estimate for<br>Population<br>(N=10,100)<br>(%) |
|---|-------------------------------|------------------------------------|-------------------------------------|---|
|   |                               | Large<br>Issuers<br>(n=100)<br>(%) | Random<br>Issuers<br>(n=100)<br>(%) |   |
| Issuers reporting defined-benefit pension plan(s)       | 48                            | 81                                 | 15                                  | 15.7  |
| Issuers reporting other post-retirement benefit plan(s) | 44                            | 74                                 | 14                                  | 14.6  |

<sup>a</sup> These data were collected from the notes to the financial statements in the filings of issuers selected for the Study.  
<sup>b</sup> These categories are not mutually exclusive.

Table III(C)(2) presents the reported obligations, plan assets, and funded status related to defined-benefit pension plans. These issuers report pension benefit obligations (“PBOs”) of approximately \$764 billion and plan assets set aside for pension plans of approximately \$678 billion. Defined-benefit pension plans for our sample of issuers are thus underfunded, based on this set of measurements, by approximately \$86 billion (approximately 11% of total PBO), which means that the assets set aside for the plan(s) are less than the estimated obligations related to the plan(s). In an economic sense, this “underfundedness” represents the net economic liability of an issuer related to pension plans.

<sup>147</sup>Ciesielski, J.T., “Ugly OPEBs: Surveying the S&P 500,” *The Analyst’s Accounting Observer*, November 24, 2004, reports that 14.7% of the 9,852 companies reviewed from S&P’s Research Insight database have other post-employment benefit plans (which includes other postretirement benefit plans).

**TABLE III(C)(2): Amounts Reported Related to Funded Status of Defined-benefit Pension Plans <sup>a</sup>**

|                                | Full Sample<br>(n=200)<br>( <i>millions</i> ) | Sub-Samples  |   | Estimate for<br>Population<br>(N=10,100)<br>( <i>millions</i> ) |
|--------------------------------|---|--|---|---|
|                                |   | Large<br>Issuers<br>(n=100)<br>( <i>millions</i> ) | Random<br>Issuers<br>(n=100)<br>( <i>millions</i> ) |   |
| Reported PBOs                  | \$764,497                                     | \$758,882  | \$5,615   | \$1,320,382   |
| Reported ABOs                  | \$537,522                                     | \$533,498  | \$4,024   | \$935,898   |
| Reported values of plan assets | \$678,019                                     | \$673,564  | \$4,455   | \$1,119,064   |
| Funded Status <sup>b</sup>     | \$86,478<br>(underfunded)                     | \$85,318<br>(underfunded)                          | \$1,160<br>(underfunded)                            | \$201,318<br>(underfunded)                                      |

<sup>a</sup>These data were collected from the notes to the financial statements in the filings of issuers selected for the Study.

<sup>b</sup>The funded status is calculated as the value of reported plan assets less the reported PBO.

These amounts for the sample as a whole are dominated by the large issuer sub-sample, which reports 99% of both the total reported obligation and the total value of plan assets for the sample. An extrapolation of the findings from the sample to the approximate population of active U.S. issuers suggests that defined-benefit pension plan obligations and assets reported by the population approximate \$1.320 trillion and \$1.119 trillion, respectively. This extrapolation suggests that pension plans for the population may be underfunded by approximately \$201 billion on a net basis.

Table III(C)(3) presents amounts that are reported on issuer balance sheets related to defined-benefit pension plans. The sample issuers report pension assets on the balance sheet of approximately \$181 billion and pension liabilities on the balance sheet of almost \$90 billion. Thus, issuers in the Study report a net asset position on the balance sheet for defined benefit pension plans of approximately \$91 billion. The \$177 billion difference between the liability implied by the \$86 billion underfundedness (as shown in Table III(C)(2)) and the \$91 billion net asset recognized on the balance sheet is the portion of the net pension liability that remains off-balance sheet for the sample of issuers in the Study due to the smoothing allowed by current pension accounting standards.

**TABLE III(C)(3): Amounts Reported on Issuer Balance Sheets Related to Defined-benefit Pension Plans <sup>a</sup>**

|  | Full Sample<br>(n=200)<br>(millions) | Sub-Samples                               |  | Estimate for<br>Population<br>(N=10,100)<br>(millions) |
|--|--------------------------------------|---|--|--|
|  |                                      | Large<br>Issuers<br>(n=100)<br>(millions) | Random<br>Issuers<br>(n=100)<br>(millions) |  |
| Pension asset reported on issuer balance sheets <sup>b</sup>                   | \$181,045                            | \$179,544                                 | \$1,501                                    | \$329,644  |
| Pension liability reported on issuer balance sheets                            | \$89,960                             | \$89,682                                  | \$278                                      | \$117,482  |
| Other comprehensive income reported in equity section of issuer balance sheets | \$50,181                             | \$50,134                                  | \$47                                       | \$54,834   |

<sup>a</sup> These data were collected from the notes to the financial statements in the filings of issuers selected for the Study. These items are presented on the balance sheets of issuers, but since balance sheet items are often aggregated, the detailed data can often only be obtained from the notes.

<sup>b</sup> This total includes reported prepaid pension benefits of \$172,248 (representing those retirement plans in a net asset positions and intangible assets of \$8,797. The intangible assets relate to prior service costs and exist only to offset part of the additional minimum pension liability.

An extrapolation of the findings from the sample to the approximate population of active U.S. issuers suggests that net pension assets and net pension liabilities reported on issuer balance sheets approximate \$330 billion and \$117 billion, respectively, which nets to approximately a \$213 billion asset position. The underfundedness estimated for the population and presented in Table III(C)(2) suggests that there may be a net economic liability related to defined benefit pension plans of approximately \$201 billion. Thus, these extrapolations suggest that a total of approximately \$414 billion in net pension liability may remain off-balance sheet for the approximate population of active U.S. issuers.

Table III(C)(4) presents the reported obligations, plan assets, and funded status related to other postretirement benefit plans, as well as any associated amounts reported on issuer balance sheets. The issuers in our sample report total obligations, denoted as accumulated postretirement benefit obligations (“APBOs”),<sup>148</sup> of almost \$260 billion, but they report total plan assets set aside for other postretirement benefit plans of only approximately \$42 billion (i.e., 16% funded). As a result, other postretirement benefit plans for our sample of issuers are underfunded by approximately \$217 billion (approximately 84% of the total APBO), which represents the net economic liability for these issuers related to other postretirement benefit plans. Note that other postretirement benefit plans are substantially more underfunded than defined-benefit pension plans—in fact, other postretirement benefit plans are often not funded at all. An extrapolation of the findings from the sample to the approximate population of active U.S. issuers suggests that other postretirement benefit obligations and assets reported by the population approximate \$389 billion and \$52 billion, respectively. This extrapolation

<sup>148</sup>Note that GAAP does not require the calculation of a PBO for other postretirement benefit plans; in general, such benefits are not affected by future salary increases.

suggests that other postretirement benefit plans may be underfunded by approximately \$337 billion for the population.<sup>149</sup>

**TABLE III(C)(4): Amounts Reported Related to Funded Status of Other Postretirement Benefit Plans and Amounts on Issuer Balance Sheets Related to Other Postretirement Benefit Plans<sup>a</sup>**

|   | Full Sample<br>(n=200)<br>(millions) | Sub-Samples                               |  | Estimate for<br>Population<br>(N=10,100)<br>(millions) |
|---|--------------------------------------|---|--|--|
|   |                                      | Large<br>Issuers<br>(n=100)<br>(millions) | Random<br>Issuers<br>(n=100)<br>(millions) |  |
| Reported APBOs  | \$259,865                            | \$258,560                                 | \$1,305                                    | \$389,060  |
| Reported Values of plan assets  | \$42,406                             | \$42,306                                  | \$100                                      | \$52,306   |
| Funded status <sup>b</sup>  | \$217,459<br>(underfunded)           | \$216,254<br>(underfunded)                | \$1,205<br>(underfunded)                   | \$336,754<br>(underfunded)                             |
| Other postretirement benefit plan assets reported on issuer balance sheets      | \$693                                | \$693                                     | \$0  | \$693  |
| Other postretirement benefit plan liabilities reported on issuer balance sheets | \$146,741                            | \$146,034                                 | \$707                                      | \$216,734  |

<sup>a</sup> These data were collected from the financial statements in the filings of issuers selected for the Study

<sup>b</sup> The funded status is defined as the reported value of plan assets less the reported APBO. However, not all issuers reported the funded status directly—some simply reported the value of plan assets and the APBO. Issuers directly reported total underfundedness of \$210,056 for the sample as a whole, \$208,929 for the large issuer sub-sample, and \$1,127 for the random issuer sub-sample.

Table III(C)(4) also presents amounts that are reported on issuer balance sheets related to other postretirement benefit plans. The sample issuers report net liabilities on the balance sheet related to other postretirement benefit plans of almost \$147 billion, as compared to net assets of less than \$1 billion (*i.e.*, \$693 million). The underfundedness presented in Table III(C)(4) implies that there is a net economic liability related to other postretirement benefit plans of \$217 billion. The difference between the underfundedness of \$217 billion and the \$146 billion net liability recognized on the balance sheet is approximately \$71 billion. This \$71 billion net other postretirement benefit liability remains off-balance sheet for the sample of issuers in the Study.

An extrapolation of the findings from the sample to the approximate population of active U.S. issuers suggests that the liability for other postretirement benefit plans reported on the balance sheet may be approximately \$216 billion. The underfundedness estimated for the population and presented in Table III(C)(4) suggests that there may be a net economic liability related to other postretirement benefit plans of \$337 billion. Thus,

<sup>149</sup> Ciesielski, J.T., (2004), (cited previously) reports APBO of approximately \$382 billion and plan assets of approximately \$65 billion from S&P 500 issuers with have other post-employment benefit plans (which includes other postretirement benefit plans).

these extrapolations suggest that approximately \$121 billion in other postretirement benefit liability may remain off-balance sheet for the population.<sup>150</sup> For retirement plans overall (i.e., including pension and other postretirement benefit plans), the extrapolations from the sample data suggest that liabilities of approximately \$535 billion may remain off-balance sheet.

The values reported above are all based on the amounts reported in financial statements. However, given the sensitivity of retirement obligations to various estimates and assumptions, it is important to also discuss some of these assumptions. For example, one of the most critical assumptions is the choice of discount rate used to calculate the present value of future benefit payments. Current accounting guidance specifies that issuers should select discount rates that reflect the yield on high quality bonds of duration similar to that of their projected annual benefit payments.<sup>151</sup>

Table III(C)(5) presents information about discount rates used by issuers to calculate the obligations for defined-benefit pension plans. The rates used by our sample of issuers range from approximately 5.10% to 6.75% and the average is 6.18%. The average discount rate is slightly higher for the random issuer sub-sample (at 6.26%) than for the large issuer sub-sample (at 6.18%). By way of comparison, using the Bloomberg fair value index bond yields for maturities of 10 years to 30 years, AA bond rates as of December 31, 2003 ranged from 4.7% to 5.7%.<sup>152</sup> As another point of comparison, S&P's Creditweek Corporate Industrial AA Bond Yields for maturities of 10 years to 25 years, ranged from 5.09% to 6.0%. The Staff understands that there are a variety of other indices that issuers rely on when selecting discount rates for pension calculations. However, it appears that on average issuers may be using discount rates that are at the high end.<sup>153</sup>

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<sup>150</sup>It is important to note that a portion of the amount of liability that remains off the balance sheet likely results from issuer's elections to recognize the effects of applying the new accounting guidance under SFAS No. 106, which became effective in the early 1990s, over long periods of time.

<sup>151</sup>SFAS No. 87, SFAS No. 106 as well as EITF Topic D-36 Selection of Discount Rate Used for Measuring Defined Benefit Pension Obligations and Obligations of PostRetirement Benefit Plans Other Than Pensions provide explicit instructions on how issuers should select the discount rate used to calculate their obligations.

<sup>152</sup>The Staff notes that this index is based on coupon-bearing bonds. To match maturities with precision would theoretically require rates equivalent to those of zero-coupon bonds, which rates would likely be slightly higher.

<sup>153</sup> One of the principal subjects of comment by the Division of Corporation Finance in their reviews of the annual reports filed by the Fortune 500 in 2002 was pension accounting and disclosure. One of the requested disclosures was of the assumptions, estimates, and data source used to determine the discount rate. See the Staff document Summary by the Division of Corporation Finance of Significant Issues Addressed in the Review of the Periodic Reports of the Fortune 500 Companies at <http://www.sec.gov/divisions/corpfin/fortune500rep.htm>. In addition, the Division Staff provides information and guidance to registrants on accounting and disclosure issues in various ways. For example, see the Staff document Current Accounting and Disclosure Issues in the Division of Corporation Finance at <http://www.sec.gov/divisions/corpfin/acctdis030405.pdf>, as well as the Staff document Frequently Requested Accounting and Financial Reporting Interpretations and Guidance at <http://www.sec.gov/divisions/corpfin/guidance/cfactfaq.htm>, which contain information on the selection of discount rates for pension and post retirement benefit plans.

**TABLE III(C)(5): Reported Discount Rates used in Defined-benefit Pension Calculations<sup>a</sup>**

|                      | Full Sample<br>(n=200)<br>(%) | Sub-Samples                        |                                     | Estimate for<br>Population<br>(N=10,100)<br>(%) |
|----------------------|-------------------------------|------------------------------------|-------------------------------------|---|
|                      |                               | Large<br>Issuers<br>(n=100)<br>(%) | Random<br>Issuers<br>(n=100)<br>(%) |   |
| Minimum              | 5.10 <sup>c</sup>             | 5.10 <sup>c</sup>                  | 6.00                                | NA  |
| Average <sup>b</sup> | 6.18                          | 6.18                               | 6.26                                | NA  |
| Maximum              | 6.75 <sup>d</sup>             | 6.75 <sup>d</sup>                  | 6.75                                | NA  |

<sup>a</sup> These data were collected from the notes to the financial statements in the filings of issuers selected for the Study. These items are presented on the balance sheets of issuers, but since balance sheet items are often aggregated, the detailed data can often only be obtained from the notes.

<sup>b</sup> The average is weighted by PBO and is calculated only for issuers reporting discount rates in the notes to the financial statements.

<sup>c</sup> This is the minimum reported for a U.S. defined benefit pension plan. The actual minimum of the reported discount rates for a defined benefit pension plan of 3.7% relates to a non-U.S. plan.

<sup>d</sup> This is the maximum reported for a U.S. pension plan. The actual maximum of the reported discount rates of 6.8% relates to a non-U.S. plan.

For illustrative purposes, the Staff notes that a ½% increase (e.g., from 5.5% to 6%) in the discount rate applied to a stream of annual cash flows of equal amounts for 20 years (compounded daily) would reduce the present value of that stream of cash flows by approximately 4%. While it is not possible to illustrate the effect on PBOs because the timing of payments is unknown, the Staff’s estimate of pension underfundedness may itself be understated due to the interest rates selected by issuers for discounting.

Further, the accounting measure of underfundedness represents only one method of calculating this measure. For example, the Pension Benefit Guaranty Corporation (“PBGC”) measures retirement liabilities based on the estimated cost of purchasing annuities to settle pension obligations when a company no longer can afford to maintain its plan. Thus, the discount rate used by the PBGC is based on periodical surveys of insurance companies which, in combination with a mandated mortality table, results in a present value representative of group annuity purchase prices. The 20 year select discount rate used by the PBGC as included in its fiscal year 2003 annual report was 4.40%. On the other hand, discount rates used to determine minimum funding of plan liabilities are calculated using rates either selected by a company’s actuary (ERISA Liability) based on how pension assets are invested or the current liability which is based on a statutory range of rates. The statutory range at December 31, 2003 approximated 5.90% to 6.60%.

## D. Leases

### 1. Nature of Arrangements and Financial Reporting Requirements

A lease is a contractual obligation that allows assets owned by one party to be used by another party, for specified periods of time, in return for a payment or series of payments. Assets that are commonly leased include automobiles, airplanes, buildings and other real estate, machinery, computer equipment, and many other tangible assets. An issuer may be motivated to lease, rather than purchase, an asset for many reasons, including economies of scale or scope, increased flexibility, tax advantages, improved access to capital, reduced costs of upgrading equipment, and improved risk sharing.<sup>154</sup>

SFAS No. 13, Accounting for Leases (issued in 1976), provides the basic guidance for leases.<sup>155</sup> Leases that transfer most of the benefits and responsibilities of ownership to the party using the asset may be economically similar to sales with attached financing agreements. This is recognized in SFAS No. 13, which states that “a lease that transfers substantially all of the benefits and risks incident to the ownership of property should be accounted for as the acquisition of an asset and the incurrence of an obligation by the lessee and as a sale or financing by the lessor.”<sup>156</sup> Otherwise, the lease should be accounted for as a rental contract. We concentrate on the case where an issuer is the lessee, that is, where the issuer is the party using the asset, as this is the scenario most likely to result in no elements of the lease or leased asset being on the balance sheet.

Leases can transfer control of the asset from the lessor to the lessee for as much of the asset’s life as desired, and can also transfer as many of the risks and rewards of ownership as desired. Leasing transactions can take many forms and include many different terms. Yet, despite this diversity in leasing arrangements, all leases receive one of two opposing accounting treatments; either the lease is treated as if it were a sale or as if it were a rental.

If “most” of the risks and rewards of ownership are transferred to an issuer leasing an asset, the lease is treated as a sale of the entire asset by the owner (*i.e.*, the lessor) and a purchase of an asset financed with debt by the issuer using the asset (referred to as the ‘whole-of-the-asset’ approach). This kind of lease is called a “capital lease.”<sup>157</sup> In these cases, the lessor removes the cost of the asset from its balance sheet and reports a sale of the asset for proceeds equal to the present value of the required lease payments, plus the expected remaining value of the leased asset at the end of the lease term. The issuer

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<sup>154</sup>The Equipment Leasing Association indicates that of the \$668 billion of productive assets acquired by businesses in 2003, \$208 billion, or 31 percent, was acquired through leasing. See the Equipment Leasing Association’s website: <http://www.elaonline.com/industrydata/overview.cfm>.

<sup>155</sup>Leases are defined as the right to use property, plant, or equipment for stated periods of time and can include agreements that are not nominally identified as leases. See paragraph 1 of SFAS 13, Accounting for Leases. Also see EITF Issue 01-8, Determining Whether an Arrangement Contains a Lease, which describes other arrangements than are not nominally identified as leases but may contain a lease.

<sup>156</sup>See SFAS No. 13, paragraph 60.

<sup>157</sup>Such a lease would be referred to as either a “sales-type” or “direct financing” lease for lessors.



using the asset records the asset and a related liability for the present value of the required lease payments on its balance sheet.

If the lease does not transfer sufficient risks and rewards to the lessee to be treated as a sale and purchase, it is instead treated like a rental contract. This kind of lease is called an “operating lease.” In this case, the owner of the asset retains the asset on its balance sheet and records lease rental revenue (as well as depreciation, property taxes, etc.) in its income statement on a period-by-period basis. The issuer using the asset does not record the asset, or a related liability for the future contractual rental payments, on its balance sheet, but records leasing expense in its income statement, also on a period-by-period basis.

SFAS No. 13 specifies that a lease is a capital lease if:

- The lease transfers ownership to the issuer (i.e., the lessee) using the asset by the end of the lease term; or
- The lease contains an option whereby the issuer can purchase the leased property at a price sufficiently lower than the expected fair value of the leased property at the end of the lease term; or
- The term of the lease is equal to or greater than 75% of the estimated economic life of the leased property; or
- The present value of the minimum lease payments to be made by the issuer is equal to or greater than 90% of the fair value of the leased property.<sup>158</sup>

While in the majority of cases the evaluation of whether these criteria have been met is straightforward, in certain circumstances it can be challenging, as leases sometimes contain contingent or variable payment requirements, optional term extensions, and other clauses that affect the calculations under one or more of the tests described above. However, such determinations are very important, as they can completely change the accounting for the lease.

The identification of which agreements should be accounted for as leases, and thus subject to the tests listed above, is also challenging in some situations. In order to reduce the chances of like arrangements being accounted for differently, the accounting guidance defines leases by their characteristics, not by their label. Thus, any contract, or portion of a contract, that meets the definition of a lease must be accounted for as one.<sup>159</sup> While most leases are indeed explicitly identified as such, some are not.

The accounting guidance also includes extensive disclosure requirements for leases. These requirements vary based upon the type of lease and whether the issuer is the lessor or lessee. These disclosure requirements provide investors with the following information:

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<sup>158</sup>In addition, lessors must also consider the following additional criteria: collectibility of the minimum lease payments is reasonably predictable and no important uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor under the lease. See SFAS 13, paragraphs 7 and 8.

<sup>159</sup>See, for example, EITF Issuer No. 01-8, Determining Whether an Arrangement Contains a Lease.

- General description of the nature of leasing arrangements;
- The nature, timing and amount of cash inflows and outflows associated with leases;
- The amount of lease revenues and expenses reported in the income statement each period;
- Description and amounts of leased assets by major balance sheet classification and related liabilities; and
- Amounts receivable and unearned revenues under lease agreements.<sup>160</sup>

In addition, FR 67 requires presentation of both capital and operating lease obligations in the contractual obligations table in MD&A.

## 2. Off-Balance Sheet Issues in Accounting for Leases

A lease is a particular kind of contractual obligation. As discussed in Section III.G, the most significant accounting issue with respect to most contractual obligations is whether to record the rights and obligations inherent in the contracts as assets and liabilities when neither party to the contract has performed. With respect to leases, however, the question is really how to assess whether performance has occurred. As noted above, the current lease accounting standards focus on a determination as to which party to a lease agreement has the risks and rewards of ownership of the leased asset. This, in turn, determines whether the owner is deemed to have sold the asset and whether the issuer using the asset is deemed to have purchased the asset.

As a consequence of this approach, the issuer leasing the asset will either recognize the entire leased asset on its books and a liability for all of its contractually required payments, or it will recognize no asset and no liability. The lease accounting guidance either treats the contract as if all of the performance occurs at the beginning of the lease, or as if none of it does. The intention is to treat those leases that are economically equivalent to sales as sales, and to treat other leases similar to service contracts. This approach, while a significant improvement from previous lease accounting, which rarely if ever required recognition of a capital lease, does not allow the balance sheet to show the fact that, in just about every lease, both parties have some interest in the asset, as well as some interest in one or more financial receivables or payables.<sup>161</sup>

The “all-or-nothing” nature of the guidance means that economically similar arrangements may receive different accounting—if they are just to one side or the other of the bright line test. For example, most would agree that there is little economic

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<sup>160</sup>See SFAS 13, as amended for detailed lists of disclosure requirements.

<sup>161</sup>In contrast, the model used for transfers of financial assets with continuing involvement, discussed in Section III.B, does attempt to recognize this fact, by requiring the transferor to continue to recognize those components that it continues to control, while requiring it to derecognize the components it no longer controls.

difference between a lease that commits an issuer to payments equaling 89% of an asset's fair value vs. 90% of an asset's fair value. Nonetheless, because of the bright-line nature of the lease classification tests, this small difference in economics can completely change the accounting. Conversely, economically different transactions may be treated similarly.<sup>162</sup> For example, most would agree that there is a significant economic difference between a one-month lease of a building and a 10-year lease of that building. However, if both leases qualified for operating lease treatment, they would likely both have little to no effect on the balance sheet. The extensive disclosures required for leases do provide some information about the rights and obligations inherent in operating leases.

Problems with the all-or-nothing character of the accounting have been magnified because many issuers involved in leases, taking advantage of the bright-line nature of the lease classification guidance, structure their lease arrangements to achieve whatever accounting (sales-type/capital or operating) is desired. These issuers have been aided in these endeavors by a large number of attorneys, lenders, investment banks, accountants, insurers, industry advocates, and other advisers. Indeed, lease structuring to meet various accounting, tax, and other goals, has become an industry unto itself in the last 30 years.

The significant amount of structuring of leases also makes analyzing potential changes to the lease guidance very difficult. Indeed, the current accounting guidance, which is criticized by many, would likely be held in much higher regard were it being applied to the lease arrangements that existed when it was debated and created. Changes in lease terms in response to the accounting guidance have caused undue focus on the weaknesses of the guidance. The fact that lease structuring based on the accounting guidance has become so prevalent will likely mean that there will be strong resistance to significant changes to the leasing guidance, both from preparers who have become accustomed to designing leases that achieve various reporting goals, and from other parties that assist those preparers.

### **3. Empirical Findings from Study of Filings by Issuers**

In this section, the Staff presents empirical findings from the Study of filings by issuers related to leases. The Staff also extrapolates from these findings to estimate amounts related to the approximate population of active U.S. issuers.

Table III(D)(1) describes the percentage of issuers reporting cash flows committed under operating and capital leases. Approximately 77% of issuers in the sample report information about operating leases, while approximately 31% report information about capital leases. An extrapolation of the findings from the sample to the approximate population of active U.S. issuers suggests that approximately 63% of the total population of issuers report operating leases, and 22% report capital leases.

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<sup>162</sup>See paragraph 119 of SFAC 2 which states "Greater comparability of accounting information, which most people agree is a worthwhile aim, is not to be attained by making unlike things look alike any more than by making like things look different. The moral is that in seeking comparability accountants must not disguise real differences nor create false differences."

| <b>TABLE III(D)(1): Issuers Reporting Future Cash Flows Committed under Operating and Capital Leases <sup>a</sup></b> |                               |                                 |                                  |  |
|---|-------------------------------|---------------------------------|----------------------------------|--|
| Categorized by Type of Lease  | Full Sample<br>(n=200)<br>(%) | Sub-Samples                     |                                  | Estimate for Population<br>(N=10,100)<br>(%) |
|   |                               | Large Issuers<br>(n=100)<br>(%) | Random Issuers<br>(n=100)<br>(%) |  |
| Issuers Reporting Operating Leases  | 77                            | 91                              | 63                               | 63.3   |
| Issuers Reporting Capital Leases  | 30.5                          | 39                              | 22                               | 22.2   |

<sup>a</sup> These data were collected from the contractual obligations table in the MD&A of the filings of issuers selected for the Study.  
<sup>b</sup> These categories are not mutually exclusive.

Table III(D)(2) presents the total future cash flows committed under operating and capital leases, as reported in the contractual obligation table in MD&A. Assets and liabilities related to capital leases are recorded on issuer balance sheets, but assets and liabilities related to operating leases are not.

| <b>TABLE III(D)(2): Reported Future Cash Flows Committed under Operating and Capital Leases <sup>a</sup></b> |                                      |  |   |   |
|--|--------------------------------------|--|---|---|
| Categorized by Type of Lease   | Full Sample<br>(n=200)<br>(millions) | Sub-Samples                            |   | Estimate for Population<br>(N=10,100)<br>(millions) |
|  |                                      | Large Issuers<br>(n=100)<br>(millions) | Random Issuers<br>(n=100)<br>(millions) |   |
| Undiscounted cash flows committed under operating leases   | \$205,971                            | \$195,506                              | \$10,465                                | \$1,252,006   |
| Undiscounted cash flows committed under capital leases   | \$16,095                             | \$15,802                               | \$293                                   | \$45,102  |

<sup>a</sup> These data were collected from the contractual obligations table in the off-balance sheet arrangements section of the MD&A (required by FR67) for the filings of issuers selected for the Staff Study. It is important to note that the data include only non-cancelable leases. It is also important to note that these amounts are not discounted

The undiscounted sum of the future committed cash flows related to non-cancelable operating leases for our sample issuers is approximately \$206 billion. An extrapolation of the findings from the sample to the approximate population of active U.S. issuers suggests that total (undiscounted) cash flows associated with these off-balance sheet operating leases for the population may approach \$1.25 trillion.

If these lease obligations had been reported on issuer balance sheets, the related assets and liabilities would have been required to be recognized at their present (*i.e.*, discounted) values.<sup>163</sup> The Staff did not attempt to determine the appropriate discount rates that would be used to estimate these amounts. For illustrative purposes, the

<sup>163</sup> However, if the present value exceeds the fair value, issuers would be required to measure the lease obligation using the fair value of the related asset.

discounted value of a series of five (ten) equal annual cash flows, using a discount rate of 8%, would be approximately 80% (67%) of the total undiscounted cash flows.

For comparison purposes, Table III(D)(2) also presents the total dollar amounts of cash flows committed under capital leases for the 200 issuers in the sample. As noted earlier, these leases are presented on issuer balance sheets. The undiscounted sum of the cash flows related to capital leases for our sample issuers is approximately \$16 billion. The Staff notes that the ratio of the total cash flows related to non-cancelable operating leases to capital leases is more than 12 to 1 within the sample and is estimated to be more than 25 to 1 for the population.

## **E. Contingent Obligations and Guarantees**

### **1. Nature of Arrangements and Financial Reporting Requirements**

Issuers are often involved in situations where uncertainty exists about whether an obligation to transfer cash or other assets has arisen and/or the amount that will be required to settle such obligation. Examples include:

- Where an issuer is a defendant in a lawsuit and any payment is contingent upon the outcome of a settlement or an administrative or court proceeding;
- Where an issuer provides a warranty for a product it sells and any payment is contingent on the number of products that actually become defective and qualify for benefits under the warranty; and
- Where an issuer acts as a guarantor on a loan for another entity and any payment is contingent on whether the other entity defaults.

Broadly, these kinds of situations are referred to as contingent obligations.<sup>164</sup> The difficult accounting question is what, if any, liability should be recognized before such contingencies are resolved. SFAS No. 5, Accounting for Contingencies, provides general guidance regarding the accounting for contingent obligations, although certain contingent obligations are specifically addressed in other standards.<sup>165</sup> Under SFAS No. 5, contingent obligations are treated in one of three ways depending on the circumstances. In order to conclude which treatment is applicable, an initial two-fold determination is made as to whether the loss itself is deemed “probable” to occur and whether the amount of the loss is estimable.

Recognition of a liability is required if the loss is deemed “probable” and estimable; the amount to be recognized is the most likely outcome—i.e., the individual loss amount with the highest probability. No liability is recognized on the balance sheet, but disclosures are required to inform users of the existence of the potential loss if a) the

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<sup>164</sup>Although contingencies may represent either potential assets or liabilities, the Staff focuses here on contingent obligations, as these tend to result in more reporting questions.

<sup>165</sup>For example, guidance related to the accounting for insurance is provided by SFAS No. 60 and other standards, and guidance related to the accounting for derivatives is provided by SFAS No. 133.

loss is deemed “probable,” but an amount cannot be reasonably estimated, or b) the loss is deemed “reasonably possible,” but not “probable.” Neither recognition of a liability nor disclosure is required if the probability of loss is deemed “remote.”

Consider an example where an issuer is a defendant in a lawsuit. Assume the following three possible outcomes and related probabilities of occurrence:

| Outcome                | Probability<br>(A) | Amount to be Paid<br>(B) | Probability-Weighted<br>Amount to be Paid<br>(A x B) |
|------------------------|--------------------|--------------------------|--|
| Issuer is found liable | 5 %                | \$500,000                | \$ 25,000  |
| Issuer settles         | 90 %               | \$ 50,000                | \$ 45,000  |
| Issuer wins lawsuit    | 5 %                | \$ 0                     | \$ 0   |
| Total                  | 100 %              |                          | \$70,000   |

Under SFAS No. 5, the loss would be deemed “probable,” given the 95% likelihood of a loss occurring. A liability would be recognized in the amount of \$50,000, because this amount is the most likely loss amount.

Required disclosures under SFAS No. 5 include the nature of the contingency, the range of the reasonably possible losses, and the amount recognized on the balance sheet, if any.<sup>166</sup>

SFAS No. 5 addresses uncertainty by using the probability of loss as a threshold in determining whether a liability should be recognized and for how much. In the context of SFAS No. 5, there appear to be some range of interpretations as to how high the likelihood of occurrence must be to be deemed “probable,” but by all accounts this likelihood is substantially higher than a 50%+ threshold that common parlance might assign to the term. If a liability is recognized, that liability is measured as the amount that constitutes the most likely outcome.

In contrast to the SFAS No. 5 approach, some recent accounting guidance requires that certain obligations that include contingencies be recognized at fair value. Under a fair value approach, the degree of uncertainty associated with a contingent liability is reflected in the measurement of the liability, rather than in the determination of whether a liability is recognized.

Interpretation No. 45, Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, issued in 2002 in light of the then-recent corporate scandals and passage of the Sarbanes-Oxley Act, requires certain guarantees to be initially recognized on the balance sheet at fair value.<sup>167</sup>

<sup>166</sup>Additional disclosures regarding loss contingencies may be required by Staff Accounting Bulletin Topic 5Y, Accounting and Disclosures Relating to Loss Contingencies, Statement of Position No. 94-6, Disclosure of Certain Significant Risks and Uncertainties, and Statement of Position No. 96-1, Environmental Remediation Liabilities, among others. In addition, Item 103 of Regulation S-K requires certain descriptive information to be disclosed regarding legal proceedings.

<sup>167</sup>In developing the fair value model, FASB indicated that, over the life of a guarantee, a guarantor takes the obligation to “stand ready” to honor the guarantee, and that the stand-ready obligation is not itself

One method used by issuers in determining the fair value of contingent obligations is presented by SFAC No. 7, Using Cash Flow Information and Present Value in Accounting Measurements. This method of estimating fair value is based on probability-weighted discounted cash flows consistent with the economic concept known as “expected value”.

For example, consider a simple example in which an issuer who writes a guarantee covering the default on a third-party’s debt with the following three outcomes and probabilities:

| Outcome                           | Probability<br>(A) | Amount to be Paid<br>(B) | Probability Weighted<br>Amount to be Paid<br>(A x B) |
|-----------------------------------|--------------------|--------------------------|--|
| Third party defaults entirely     | 5 %                | \$100,000                | \$ 5,000   |
| Third party defaults on ¾ of debt | 10 %               | \$ 75,000                | \$ 7,500   |
| Third party does not default      | <u>85 %</u>        | \$ 0                     | <u>\$ 0</u>  |
| Total                             | 100 %              |                          | \$12,500   |

If a contingency accounted for under the SFAS No. 5 approach had the above potential outcomes, no liability would be recognized, since the occurrence of a loss is not “probable” (i.e., a loss occurs with only 15% probability). However, under the accounting specified by Interpretation No. 45, the writer of this guarantee would recognize a liability of \$12,500, which constitutes the fair value<sup>168</sup> of the guarantee.

Notably, all types of guarantees are not included in the scope of Interpretation No. 45. Further, the requirement of Interpretation No. 45 to recognize guarantees on the balance sheet at fair value only applied to those issued or modified after December 31, 2002. However, Interpretation No. 45 introduced new disclosure requirements, which were applicable regardless of the date of the guarantee’s issuance or modification. The disclosures required in the notes to the financial statements include, but are not limited to, the following:<sup>169</sup>

- Nature of the guarantee;
- Maximum potential future payments;
- Current amount of liability on the balance sheet; and
- Certain product warranty information, including a reconciliation of changes in the liability.

The Commission’s Financial Reporting Release No. 67, mandated by section 401(a) of the Act, also requires additional disclosures in the Off-Balance Sheet section of MD&A regarding certain guarantee contracts. Disclosure is required to the extent

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contingent. The liability for the stand-ready obligation is reduced over time as the guarantee performs (that is, as it fulfills its obligation to stand ready over the life of the contract).

<sup>168</sup>The time value of money is ignored in this example.

<sup>169</sup>The required disclosures are presented in paragraphs 13-16 of Interpretation No. 45.

necessary to provide an understanding of the issuer's material off-balance sheet arrangements as well as the material effects of those arrangements. For guarantee contracts these disclosures may include:

- Nature and business purpose of the guarantee contracts;
- Importance of the guarantee contracts to liquidity, capital resources, market risk or credit risk support, or other benefits;
- The financial impact of the guarantee contracts and the issuer's exposure to risk as a result of the guarantees; and
- Known events, demands, commitments, trends or uncertainties that affect the availability or benefits of the guarantee contracts.

## **2. Off-Balance Sheet Issues in Accounting for Contingent Obligations and Guarantees**

In accounting for contingent liabilities, how uncertainty is taken into account will affect which items are reflected on the balance sheet. Although both approaches appear to generate information that would be useful to users of financial statements, differing views exist as to which treatment provides the most relevant information.

If uncertainty is taken into account in the recognition of liabilities, as is the case for contingencies accounted for under SFAS No. 5, the balance sheet will report those liabilities that are highly likely to reduce cash or other assets available for distribution to shareholders. In addition, the items on the balance sheet would be reported at the amount most likely to be paid or received. However, several issues arise from this treatment. First, while the SFAS No. 5 accounting results in the recording of a liability that reflects the most likely payment, the balance sheet reflects information about only that outcome. Information about the other potential outcomes is ignored for the purpose of recording the liability. While disclosures in the notes to the financial statements might help to provide this information, in practice those disclosures are rarely detailed enough to allow an investor to take into account multiple possible loss outcomes.

Difficulties in applying the SFAS No. 5 approach also arise because that approach requires an analysis of whether a loss is probable. Although accountants generally agree, in practice, on the percentage likelihood that is necessary to conclude that a loss is probable, determining whether the loss in a particular situation exceeds that threshold can be subjective. In addition, it may be difficult for others to independently verify management's judgments in these areas. Application issues have also arisen in regards to determining the most likely amount of a loss when a range of possible losses exists. If one amount within the range is a better estimate than any other amount, that amount should be recognized. If no amount is considered a better estimate than any other amount, the minimum amount in the range is recognized.<sup>170</sup> In practice, zero may arguably be the low point of the range in many cases, resulting in no liability being

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<sup>170</sup>FASB Interpretation No. 14, "Reasonable Estimate of the Amount of Loss".



reflected. The Staff has long believed that the application of SFAS No. 5 by issuers should be improved, and has commented on this numerous times in speeches and other venues. The needed improvements include better application of both the recognition and disclosure criteria of SFAS No. 5.

Some of the difficulties in accounting for contingencies under SFAS No. 5 are not faced in accounting for contingencies under pronouncements in which uncertainty is reflected in measurement, rather than recognition, of a liability. If uncertainty is taken into account in measuring the contingent liability, the value reflected on the balance sheet represents the value the market would assign to the contingent liability in assessing the value of the issuer; thus, information that a market participant would consider relevant is not ignored. However, the liability recorded in these situations may not actually represent a possible outcome upon ultimate resolution of the contingency.<sup>171</sup>

Reflecting uncertainty in the measurement of the liability also removes some of the pressure on the “probable” determination, and on the identification of the particular outcome that is most likely. In addition, this approach would rarely, if ever, omit a contingent obligation from the balance sheet entirely. However, if determining the probability of loss and the most likely amount of that loss, as required under SFAS No. 5, is difficult and subject to judgment, determining the probabilities of multiple potential outcomes, as required under Interpretation No. 45, may be even more difficult. Some argue that a fair value approach could result in less reliable financial statements and make auditing those statements even more challenging. Others, however, note that the fair value approach ensures that contingencies relevant to assessing an issuer’s value are at least acknowledged in a fair value approach, in contrast to the SFAS No. 5 approach, which could allow many of those contingencies to go entirely unrecognized.

### **3. Empirical Findings from Study of Filings by Issuers**

In this section, the Staff presents empirical findings from the Study of filings by issuers related to contingent obligations, including guarantees. The Staff also extrapolates from these findings to estimate amounts for the approximate population of active U.S. issuers.

Table III(E)(1) describes the percentage of issuers reporting certain contingent liabilities. As indicated in the table, approximately 64% of the sample issuers report information about some litigation contingencies in their notes to the financial statements and approximately 55% report information about guarantees. Substantially fewer, 21%, report information about environmental contingent obligations. The Staff noted during its analysis of the filings that disclosures about contingent obligations vary widely in terms of format and location in the filing. As a result, the data for contingent obligations was difficult to collect in a consistent manner across issuers.

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<sup>171</sup>In the example used previously, the three possible outcomes are losses of zero, \$75,000, and \$100,000, yet the fair value that would be recorded is \$12,500.

| Categorized by Type of Contingent Obligation <sup>b</sup> | Full Sample<br>(n=200)<br>(%) | Sub-Samples                     |                                  | Estimate for Population<br>(N=10,100)<br>(%) |
|---|-------------------------------|---------------------------------|----------------------------------|--|
|   |                               | Large Issuers<br>(n=100)<br>(%) | Random Issuers<br>(n=100)<br>(%) |  |
| Issuers reporting legal contingent obligations            | 63.5                          | 81                              | 46                               | 46.3   |
| Issuers reporting environmental contingent obligations    | 20.5                          | 31                              | 10                               | 10.2   |
| Issuers reporting guarantees                              | 54.5                          | 74                              | 35                               | 35.4   |

<sup>a</sup> These data were collected from the notes to the financial statements in the filings of issuers selected for the Study.  
<sup>b</sup> These categories are not mutually exclusive.

Table III(E)(2) describes the percentage of issuers reporting recognition of liabilities on their balance sheets for certain contingent liabilities. Less than 10% of the sample issuers report that they have recognized any amount of liability on their balance sheets for any legal contingent obligation, even though approximately 64% of the sample issuers report general information regarding legal contingent obligations. Approximately 23% of the sample issuers report that they have recognized a liability for guarantees, less than half of the 55% of issuers reporting information about the existence of guarantees. Before the implementation of Interpretation No. 45 in 2002, the Staff suspects that few of these guarantees would have been recognized as liabilities on issuer balance sheets.

| Categorized by Type of Contingent Obligation <sup>b</sup>                | Full Sample<br>(n=200)<br>(%) | Sub-Samples                     |                                  | Estimate for Population<br>(N=10,100)<br>(%) |
|--|-------------------------------|---------------------------------|----------------------------------|--|
|  |                               | Large Issuers<br>(n=100)<br>(%) | Random Issuers<br>(n=100)<br>(%) |  |
| Issuers recognizing liabilities for legal contingent obligations         | 9.5                           | 14                              | 5                                | 5.1  |
| Issuers recognizing liabilities for environmental contingent obligations | 10                            | 15                              | 5                                | 5.1  |
| Issuers recognizing liabilities for guarantees                           | 22.5                          | 35                              | 10                               | 10.2   |

<sup>a</sup> These data were collected from the notes to the financial statements in the filings of issuers selected for the Study.  
<sup>b</sup> These categories are not mutually exclusive.

The analysis of this topic so far has focused on the proportion of issuers reporting information about various types of contingent obligations. We now turn to an analysis of the amount of liabilities recognized on issuer balance sheets and the exposures reported in the notes to the financial statements.

Table III(E)(3) presents reported amounts of contingent obligations recognized as liabilities on issuer balance sheets, to the extent they are reported as such in the notes to the financial statements.<sup>172</sup> Issuers in the sample report that they had recognized liabilities on their balance sheets of approximately \$10 billion related to legal contingent liabilities, approximately \$9 billion related to environmental contingent liabilities, and almost \$86 billion related to liabilities related to guarantees. In each of these three categories, at least 98% of the total liability recognized was recognized by the large issuer sub-sample.<sup>173</sup> An extrapolation of the findings from the sample to the approximate population of active U.S. issuers suggests that legal contingent liabilities reported by the total population are approximately \$12 billion, environmental contingent liabilities are approximately \$19 billion, and guarantees are approximately \$124 billion.

**TABLE III(E)(3): Amounts Reported as Liabilities on Issuer Balance Sheet Related to Certain Contingent Obligations<sup>a</sup>**

| Categorized by Type of Contingent Obligation | Full Sample<br>(n=200)<br>( <i>millions</i> ) | Sub-Samples                                     |  | Estimate for Population<br>(N=10,100)<br>( <i>millions</i> ) |
|--|---|---|--|--|
|  |   | Large Issuers<br>(n=100)<br>( <i>millions</i> ) | Random Issuers<br>(n=100)<br>( <i>millions</i> ) |  |
| Legal contingent liabilities                 | \$10,725                                      | \$10,714  | \$11   | \$11,814   |
| Environmental contingent liabilities         | \$9,219                                       | \$9,123   | \$96   | \$18,723   |
| Guarantee liabilities                        | \$85,834                                      | \$85,449  | \$385  | \$123,949  |

<sup>a</sup> These data were collected from the notes to the financial statements in the filings of issuers selected for the Study.

As discussed earlier, SFAS No. 5 and Interpretation No. 45 require disclosures about exposure to “possible loss or range of loss” in the notes to financial statements.<sup>174</sup> Table III(E)(4) presents amounts related to these exposures reported by issuers. Issuers in the sample report almost \$32 billion in possible exposures related to legal contingencies, only approximately \$5 billion related to environmental contingencies, and approximately \$4 trillion related to guarantees. An extrapolation of the findings from the sample to the approximate population of active U.S. issuers suggests that potential losses reported by the population are approximately \$52 billion potential losses for legal contingent obligations, approximately \$23 billion for environmental contingent obligations, and more than \$46 trillion for guarantees.

<sup>172</sup> Many such contingencies may not be reported as a separate line item on the balance sheet. Thus, users of financial statements must usually rely on disclosures to indicate the magnitude of the contingent obligations recognized.

<sup>173</sup> This represents a disproportionate difference between the large issuer sub-sample and the random issuer sub-sample in that the ratio of total liabilities of the random issuer sub-sample to the large issuer sub-sample is approximately 1:100; the difference in contingent liabilities recognized by the two groups is 1:1000.

<sup>174</sup> See SFAS No. 5, paragraph 10.

| Categorized by Type of Contingent Obligation | Full Sample<br>(n=200)<br>( <i>millions</i> ) | Sub-Samples                                     |  | Estimate for Population<br>(N=10,100)<br>( <i>millions</i> ) |
|--|---|---|--|--|
|  |   | Large Issuers<br>(n=100)<br>( <i>millions</i> ) | Random Issuers<br>(n=100)<br>( <i>millions</i> ) |  |
| Legal contingent obligations                 | \$31,762                                      | \$31,554  | \$208  | \$52,354   |
| Environmental contingent obligations         | \$4,604                                       | \$4,414   | \$190  | \$23,414   |
| Guarantees                                   | \$4,053,499                                   | \$3,624,389                                     | \$429,110  | \$46,535,389   |

<sup>a</sup> These data were collected from the notes to the financial statements in the filings of issuers selected for the Study.

The Staff notes that the amounts of possible losses disclosed by the sample of issuers are largely unrelated to the liabilities recognized by issuers as reported in Table III(E)(3). For the most part, issuers seem to have concluded that they need not disclose quantitative information concerning additional potential losses related to those contingent losses recognized as liabilities on the balance sheet.<sup>175</sup> The Staff further notes that in many cases, issuers disclose the existence of the contingent legal obligation, but recognize no liability and disclose no maximum loss or range of loss.

## **F. Derivatives**

### **1. Nature of Arrangements and Financial Reporting Requirements**

A derivative is “simply a financial instrument (or even more simply, an agreement between two people) which has a value determined by the price of something else.”<sup>176</sup> For example, a stock option contract derives its value, at least in part, from the price of the underlying stock;<sup>177</sup> similarly, a gold futures contract derives its value from the price

<sup>175</sup>For example, of the \$10.328 billion in legal contingent liabilities recognized (see Table III(E)(3)), only approximately \$717 million are disclosed in conjunction with quantitative information about additional potential losses. Indeed, approximately 97% of the \$23,761 billion of potential legal contingent losses disclosed for the entire sample relate to instances where no liability was reported as being recognized on the balance sheet. In some cases, where liabilities are recognized, issuers may not deem additional losses to meet the “reasonably possible” criteria in SFAS No. 5.

<sup>176</sup>McDonald, Robert L., Derivatives Markets (2003), at 1.

<sup>177</sup>A stock option may be defined as a “right to purchase or sell a stock at a specified price within a stated period.” Barron’s Dictionary of Finance and Investment Terms, 5<sup>th</sup> ed. (1998).

of the underlying gold;<sup>178</sup> an interest rate swap derives its value from the underlying interest rates.<sup>179</sup>

Derivatives permit issuers to mitigate and take on risk, and also to select which risks they want to retain and manage, and which they want to shift to others willing to bear them. For example, a manufacturer that requires oil as an input to production is exposed to the risk of an oil price increase. If oil prices do increase, cost of production increases and the manufacturer's profitability may suffer. Such an issuer may choose to contract with another party to effectively fix the price it will pay for oil at some future date through a "forward" contract.<sup>180</sup> In this case, the issuer has "hedged" its exposure, and is protected from the negative economic effects of an adverse change in oil prices. Of course, locking in a price through such a forward contract also precludes any cost savings the issuer might have experienced from a beneficial change in oil prices. If, instead, the issuer wished to limit its exposure to price increases while still retaining the benefits of price decreases, it could enter into an option contract to purchase oil at a fixed price; if the price goes above the exercise price of the option, the issuer would gain upon exercise of the option, while if the price fell, the issuer would allow the option to expire while making its purchases through the spot market. Of course, entering into an option may be more costly than entering into a forward or futures contract.

#### **a. Accounting for Derivatives**

The current accounting guidance for derivatives has only been in effect since 2001.<sup>181</sup> Prior to that, many believed that accounting standards had not kept pace with changes in global financial markets and related financial innovations. As a result, the Commission, members of Congress, the General Accounting Office, and others urged the FASB to deal with reporting problems regarding derivatives.<sup>182</sup> During the almost 10 year period that this guidance was under development, there were several notable derivatives issues that captured the attention of the public, various regulators, and the

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<sup>178</sup>A futures contract may be defined as an "agreement to buy or sell a specific amount of a commodity or financial instrument at a particular price on a stipulated future date ... [where] [t]he price is established ... on the floor of a commodity exchange ..." Barron's Dictionary of Finance and Investment Terms, 5<sup>th</sup> ed. (1998).

<sup>179</sup>A swap may be defined as "[a] contract calling for the exchange of payments over time. Often one payment is fixed in advance and the other is floating, based upon the realization of a price or interest rate." McDonald, Robert L., Derivatives Markets (2003), at 851.

<sup>180</sup>Such a contract promises the delivery of a certain amount of oil at a certain date in the future, for a certain price.

<sup>181</sup>SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities (as amended), was originally effective for fiscal years beginning after June 15, 1999. The effective date was subsequently delayed by SFAS No. 137, Accounting for Derivative Instruments and Hedging Activities-Deferral of Effective Date of FASB Statement No. 133 to fiscal years beginning after June 15, 2000, or for the year ended December 31, 2001 for calendar year end issuers.

<sup>182</sup>SFAS No. 133, paragraph 212.

accounting standard setters.<sup>183</sup> These events influenced the deliberations that would ultimately address the actual accounting for derivatives.

Financial reporting for derivatives centers around three main issues. The first is whether derivative contracts should be recognized on issuer balance sheets. The second is whether changes in the value of derivative contracts should be recognized in the income statement. The third is how to convey the overall sensitivity of the issuer to changes in important variables—for example, say, oil prices for an issuer that uses large quantities of oil—in light of the derivative positions the issuer may have taken.

In general SFAS No. 133 requires that derivatives be recorded as assets or liabilities on the balance sheet at fair value, and re-measured each period with changes in fair value reflected in earnings. In part, the rationale for this approach was FASB's view that recognizing derivatives on the balance sheet based on measurements other than fair value was generally less relevant and understandable.<sup>184</sup> For example, if historical cost were used to measure derivatives, many would be reported at a value of zero because no payment is made at the inception of the contract (e.g., most forward contracts). In addition, under a historical cost measurement principle, changes that may have a significant effect on the issuer's value would not be reflected in its financial statements. While this is true for all assets and liabilities measured at historical cost, derivatives have a potential for substantial variability in value typically exceeding that of more traditional assets such as plant and equipment. Other methods proposed, such as intrinsic value and lower of cost or market, were also considered inappropriate because they ignored significant items that factor into the fair value of the derivative. In the end, the FASB concluded that fair value was the only relevant measurement for derivatives.<sup>185</sup>

Although the core principle in SFAS No. 133 of recording all derivatives on the balance sheet at fair value is simply stated, many complexities become apparent with further analysis. First is the issue of defining “derivative” for purposes of applying the principle. As discussed below, the FASB started with a definition that looks to certain characteristics of a contract to identify derivatives. However, various exceptions were made to this definition in order to ease implementation of the standard or to acknowledge that certain instruments that meet the characteristics-based definition were previously addressed as insurance contracts or in some other manner in the existing accounting guidance. In addition, the guidance includes a requirement that certain derivatives embedded in other non-derivative financial instruments or other contracts be separated out or “bifurcated” from those instruments and separately recognized in issuer financial statements. This provision prevents an issuer from avoiding the recognition and

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<sup>183</sup>In particular, during 1994 there were some well-publicized incidents related to derivatives. The largest was the bankruptcy of Orange County, California, which was partially attributed to what was considered the imprudent use of derivatives. In addition, there were several significant corporate losses from derivative transactions, including losses at The Proctor and Gamble Company, MG Corp. (a unit of Germany's Metallgesellschaft AG) and Gibson Greetings Inc.

<sup>184</sup>SFAS No. 133, paragraphs 221 and 223.

<sup>185</sup>Paragraph 3(b) of SFAS 133 states: “Fair value is the most relevant measure for financial instruments and the only relevant measure for derivative instruments.”

measurement requirements of SFAS No. 133 merely by embedding a derivative instrument in a non-derivative financial instrument or other contract.<sup>186</sup>

### **b. Hedge Accounting**

Many issuers utilize derivative instruments to hedge their exposure to certain economic risks. When a derivative is used to hedge an exposure, the value of the derivative should have an inverse relation to the value of the exposure it is hedging. While the core principle under SFAS No. 133 is to recognize changes in the value of derivatives in the income statement, SFAS No. 133 provides for an exception to this principle known as “hedge accounting,” to address potential timing differences in recognizing offsetting gains and losses. These timing differences occur in part because GAAP utilizes a “mixed-attribute” approach where some items are recognized at historical cost, others at the lower of cost or market, and still others at fair value. As a consequence, changes in the value of a derivative may not be reflected in earnings at the same time as changes in the value of the hedged exposure unless hedge accounting is used.

For example, consider an issuer that has a mortgage obligation with a term of 30 years at a fixed interest rate of 9% per year. The issuer enters into a contract designed to have the same effect as if the fixed rate of interest in the mortgage were changed to a variable rate of interest. The terms of the contract require the issuer to pay a variable rate based on the current rate on U.S. Treasury securities in exchange for payments based on the 9% rate in the mortgage. Economically, the issuer is in approximately the same position as if its 9% fixed-rate mortgage obligation were instead a variable rate mortgage obligation. Such a derivative contract is called an interest rate swap. If interest rates drop below 9%, the swap contract will have a positive value to the issuer; that is, it is an asset. If interest rates rise above 9%, the swap will have a negative value to the issuer and is a liability.

If changes in interest rates were recognized in the measurement of the mortgage, then the accounting for this would be relatively straightforward. For example, suppose interest rates dropped below 9%. Other things being equal, the recorded value of the mortgage liability would increase, but by approximately the same amount that the derivative asset (*i.e.*, the swap) increases in value. Thus, the changes in fair value would approximately offset each other, mirroring the economics of such contracts. However, changes in the fair value of the mortgage liability associated with changes in interest rates are not recognized in current earnings. Instead, debt, such as the mortgage liability, is recognized at its historical cost.

The FASB addressed the inconsistency resulting from recognizing the derivative at fair value and the instrument the derivative is designed to work with at historical cost by creating an exception to the general historical cost measurement for some assets/liabilities that are hedged with derivative contracts. If an asset (liability) is typically measured using historical cost and its fair value is hedged with a derivative, then the asset (liability) can be reflected on the balance sheet at its fair value for the

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<sup>186</sup>Paragraph 293 of SFAS No. 133.

portion of the risk that is being hedged. This accounting treatment—known as a “fair value hedge”—results in recognizing in the income statement both the change in fair value of the mortgage liability (due to changes in interest rates), and the offsetting change in fair value of the swap. Thus, this treatment reflects both sides of the economic story in the financial statements.

While fair value hedge accounting resolves certain issues caused by the mixed-attribute approach, another type of hedge accounting addresses situations where the issuer has hedged its exposure to variability in expected future cash flows. For example, consider an issuer that expects to purchase oil in the future and is thus exposed to market variability in oil prices. The issuer enters into a forward contract to purchase oil in the future at the current “spot” price of \$25 per barrel in order to hedge this exposure. A subsequent increase in the price of oil to \$27 would have no net economic effect on the issuer, because the forward contract would offset the effects of the price increase. That is, while the value of the oil being purchased has increased \$2 per barrel, the value of the forward contract would offset such a price increase by approximately the same amount.<sup>187</sup> Once the price of oil has risen above \$25, the forward contract clearly constitutes an asset, as it entitles the issuer to buy oil at less than the current market price. However, the issuer’s balance sheet does not recognize an obligation (or liability) related to the expected future purchase of oil—the item being hedged.

Such an accounting treatment introduces volatility into earnings that some believe does not represent the underlying economics of such transactions. Thus, the FASB developed an approach—known as a “cash flow hedge”—that allows the issuer to hold changes in value of derivatives (to the extent these offset changes in value of the hedged item) that hedge expected variability in future cash flows in a section of equity called “accumulated other comprehensive income” until the transaction being hedged occurs.<sup>188</sup> When the future transaction that was designated as being hedged actually occurs and is recognized in income, the amount initially recorded in equity is then also recognized in income to reflect the offsetting effect of the hedge.

It is important to note that SFAS No 133 strictly limits the kinds of situations that qualify for hedge accounting.<sup>189</sup> In addition, in order to qualify for hedge accounting, the issuer has to meet specific documentation requirements. This is to avoid an opportunity for an issuer, using hindsight, to freely pick the approach that presents the best results. It is also important to note that the risks that are eligible for hedging are market-related risks (changes in fair value and variability in cash flows), and not accounting risks, such as variability in reported net income. Finally, except in very rare situations,<sup>190</sup> the effectiveness of the derivative at offsetting the changes in value of the hedged item must

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<sup>187</sup>This is an oversimplification for expository purposes. It assumes that cash wasn’t paid upon the signing of the contract. Also, it does not take into consideration the time value of money.

<sup>188</sup>See SFAS No. 133, paragraph 30 for a discussion of the amounts to be deferred into accumulated other comprehensive income in the case of cash flow hedges.

<sup>189</sup>In addition to fair value and cash flow hedges, SFAS No. 133 provides for hedging the foreign currency risk related to an issuer’s net investment in foreign operations.

<sup>190</sup>See SFAS No. 133, paragraphs 65 and 68.



be periodically measured, and any ineffectiveness must be recognized in the income statement, even when the relationship does qualify for hedge accounting.<sup>191</sup>

### c. Disclosures

SFAS No. 133 also provides disclosure guidance, intended to help investors and creditors understand what an entity is attempting to accomplish through the use of derivatives. These disclosures are required to facilitate the understanding of the nature of an entity's derivative activities and evaluation of the success of those activities, their importance to the entity, and their effect on the entity's financial statements. As a result, SFAS No. 133 requires numerous qualitative disclosures about an entity's use of derivatives including, but not limited to:<sup>192</sup>

- Its objectives for holding or issuing derivative instruments, the context needed to understand those objectives, and its strategies for achieving those objectives;
- A description distinguishing between derivative instruments designated as fair value, cash flow, and foreign currency hedging instruments, and all other derivatives. The description shall also indicate the entity's risk management policy for each of those types of hedges, including a description of the items or transactions for which risks are hedged. For derivative instruments not designated as hedging instruments, the description shall indicate the purpose of the derivative activity; and
- Certain quantitative information related to cash flow and foreign currency hedges.

In addition to the SFAS No. 133 required disclosures about derivatives and hedging activities, Item 305 of Commission Regulation S-K requires certain additional disclosures about market risks and how those risks are managed, including the use of derivatives. In particular, Item 305 requires both quantitative and qualitative disclosures about each type of market risk including interest rate, foreign currency, commodity price and other relevant risks, such as equity price risk. In preparing the quantitative disclosures, the issuer can choose from three alternatives:

- Tabular presentation of fair value information and contract terms relevant to determining future cash flows – categorized by expected maturity dates;
- Sensitivity analysis assessing the potential loss in future earnings, fair values or cash flows of market sensitive instruments resulting from hypothetical changes in various market indices; or

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<sup>191</sup>Ibid, paragraphs 20, 22, 26, 28 and 30.

<sup>192</sup>See SFAS No. 133, paragraphs 44 to 47 for a complete list of the disclosure requirements for derivatives and hedging activities.

- Value at risk analysis estimating the potential loss in future earnings, fair values or cash flows from market movements with a specified likelihood of occurrence.<sup>193</sup>

## 2. Off-Balance Sheet Issues in Accounting for Derivatives

As can be seen from the above discussion, derivatives are, in fact, on the balance sheet. We include them in this Report, however, because derivatives are often an integral part of arrangements that are considered off-balance sheet, such as the Enron prepay transactions discussed in Section I.C. While many have criticized SFAS No. 133 (and its related interpretive guidance) for its complexity, and its “rules-based” guidance, it must be recognized that prior to the issuance of SFAS No. 133, many derivatives were indeed “off-balance sheet,” and issuers’ exposures to related risks and changes in financial condition was therefore entirely unreported. Furthermore, much of the complexity in SFAS No. 133 relates to hedge accounting, which is optional. In fact, hedge accounting is a modification or exception to the core principles of the standard. For the reasons already discussed, the FASB felt that hedge accounting was an appropriate part of SFAS No. 133. Nonetheless, it should be noted that, as is often the case with exceptions to basic principles, the hedge accounting guidance is complex and relies on a substantial number of rules.

There are over 850 pages of authoritative guidance on accounting for derivatives, generated primarily by four related accounting standards<sup>194</sup> and over 180 implementation and interpretive issues. What started out with a simple principle—“Record all derivatives at fair value”—became very rules-based through a proliferation of scope exceptions and extensive implementation and interpretive guidance, as preparers and auditors requested more detailed guidance. Many issues contribute to the complexity and challenges of the current approach to derivative accounting, but there appear to be four primary issues:

- i.) The scope of the guidance, including the definition of and identification of a derivative;
- ii.) The application of hedge accounting;
- iii.) The “bifurcation” requirements for embedded derivatives; and
- iv.) The valuation methodologies used.

In defining the scope of SFAS No. 133, the FASB avoided simply listing the instruments and contracts to which the standard would apply (for example, options, forward contracts, interest rate swaps, etc). If the scope of an accounting standard were defined in such a way, the definition would need to be revised regularly to deal with new

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<sup>193</sup>See Release Nos. 33-7386 and 34-38223 for full text of the rule.

<sup>194</sup>SFAS No. 133, as well as SFAS No. 137, Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133, SFAS No. 138, Accounting for Certain Derivatives and Certain Hedging Activities, and SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities.

instruments. Instead, SFAS No. 133 employed a characteristics-based definition<sup>195</sup> so that any instrument or contract reflecting those characteristics would be covered by the derivatives guidance. Further, to prevent issuers from avoiding the recognition and measurement guidance in SFAS No. 133, the standard requires that derivatives embedded in non-derivative financial instruments or other contracts be “bifurcated” from the host instrument and separately valued.<sup>196</sup>

Although FASB attempted to take an inclusive approach in developing SFAS No. 133, the Board also included a number of exceptions to the standard’s definition of a derivative. These exceptions served to exclude certain contracts that otherwise would be accounted for as derivatives. In some cases, the exceptions were included because other accounting pronouncements already covered certain instruments. For example, from an economic perspective, many insurance contracts are derivatives, but other guidance<sup>197</sup> already addressed such contracts. In addition, some contracts that would meet the definition of a derivative, but are deemed to be “normal purchase and sale” contracts, were excluded simply to be consistent with the current accounting for similar contracts that would not qualify as derivatives under SFAS No. 133.<sup>198</sup> Finally, derivatives on an issuer’s own equity are excluded because of questions surrounding whether such instruments represent assets or liabilities, as opposed to equity.<sup>199</sup>

While the scope issues present challenges, many more interpretive issues concern hedge accounting. The underpinnings for allowing hedge accounting, as described previously, are not all that difficult to understand. The principal idea is to avoid recognizing volatility in earnings that does not represent true economic volatility. However, because hedge accounting is optional, and results in changes in the way assets,

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<sup>195</sup>Those characteristics are discussed in paragraphs 6-9, and 57 of SFAS No. 133 (as amended), and in over 20 interpretative issues addressed by the DIG (“Derivatives Implementation Group”). Those characteristics generally are that a derivative has:

One or more underlyings and one or more notional amounts or payment provisions or both. Those terms determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required;

No initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and

Terms that require or permit net settlement, it can readily be settled net by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

<sup>196</sup>This guidance is found in paragraphs 12-16, 60-61, and 176-200 of SFAS No. 133 (as amended) and in 36 interpretative issues addressed by the DIG.

<sup>197</sup>See, for example, SFAS No. 60. Also note that the FASB has taken up a project to provide additional guidance on determining when an insurance contract that limits the amount of risk taken on by the insurer should be accounted for as insurance, and when it should instead be accounted for as an investment by the insured and a loan by the insurer.

<sup>198</sup>See SFAS No. 133, paragraphs 271 and 272.

<sup>199</sup>See SFAS No. 133, paragraph 11(a), EITF Issue No. 00-19, and SFAS No. 150.

liabilities, gains, and losses are reflected in the financial statements, the FASB felt it necessary to limit its use to situations in which the effectiveness of the derivatives at offsetting the risks being hedged were demonstrable. As such, to qualify for hedge accounting, an issuer must meet a number of requirements relating to identification of the hedging relationship and measurement of the effectiveness of that relationship – that is, measurement of the extent to which the changes in the fair value of the derivative can be expected to and in fact do offset changes in the value of the hedged item.<sup>200</sup>

Although the accounting for derivatives attempts to appropriately reflect the economics of hedged transactions, it is nonetheless true that an issuer engaged in derivative transactions is economically different from an issuer that is not, all other things being equal. Thus, it is important for disclosures to communicate the economic risks involved. The disclosures required by the accounting guidance and by the Item 305 of Regulation S-K are meant to provide the user with information that goes beyond the current value of the derivatives. Although fair value may reflect an important aspect of the “economics” of the derivative at a point in time, it nonetheless does not provide the user of the financial statements with the information necessary to understand what may happen to the derivative in the future should conditions change. For example, a gold mining company that has entered into fixed price forward contracts to sell its gold has a very different risk profile than one that has not entered into such contracts, other things being equal. It is important for investors to understand what risk profile the issuer has selected—specifically, whether or not the issuer will benefit from an increase in the price of gold.

Despite the disclosures required by the accounting standards and the Commission’s rules, there is still often a perceived lack of transparency as to an issuer’s market risk exposures, use of derivatives and the potential impact of those derivatives. The Staff believes that many issuers could do a better job in the notes to the financial statements, MD&A, and item 305 disclosures of providing disclosures on market risk exposures, hedge strategies, and the results of those strategies.

### **3. Empirical Findings from Study of Filings by Issuers**

In this section the Staff presents empirical findings from the Study of filings by issuers related to derivatives. The Staff also extrapolates from these findings to estimate amounts related to the approximate population of active U.S. issuers.

As noted previously, instruments that meet the definition of a derivative pursuant to SFAS No. 133 are reported on the balance sheet at fair value. However, also as noted above, the scope exceptions in SFAS No. 133 allow certain arrangements having the economic characteristics of derivatives to remain off-balance sheet. As there are no required disclosures for these latter arrangements, the Staff cannot reach any conclusions regarding the extent of these arrangements based on public filings.

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<sup>200</sup>There have been many interpretive issues that address whether hedge accounting can be applied to certain situations. Indeed, over 180 issues have been addressed to date by the DIG, many of which interpret the hedge accounting guidance in SFAS No. 133. The requirements further manifest themselves in the level of documentation necessary to maintain hedge accounting.

Since derivatives subject to SFAS No. 133 are reported on the balance sheet at fair value, the Staff did not make it a priority to report their extent in the Study of filings by issuers. However, as a result of conducting the Study of filings by issuers, the Staff notes that it is often difficult to determine the total dollar amounts that are on the balance sheet related to derivatives. This difficulty stems from the fact that derivatives may be presented as separate line items on the balance sheet, or alternatively, included as a component of some broader category (e.g., other assets).<sup>201</sup> This latter treatment occurs predominantly for derivatives whose current values are not considered material to the balance sheet presentation. Moreover, derivatives disclosures may be presented in different places in an issuer's 10-K filing.

Table III(F)(1) describes the percentage of issuers reporting derivatives for trading and non-trading purposes. Although only approximately 10% of the sample issuers report derivative transactions for trading purposes, approximately 63% of the sample issuers report using derivatives for non-trading purposes. Note fully 95% of the large issuer sub-sample report derivatives for non-trading (i.e., hedging) purposes. An extrapolation of the findings from the sample to the approximate population of active U.S. issuers suggests that approximately 3% of the population of issuers report that they use derivatives for trading purposes, while more than 30% report the use of derivatives for non-trading purposes.

| Categorized by Purpose <sup>b</sup> | Full Sample<br>(n=200)<br>(%) | Sub-Samples                        |                                     | Estimate for<br>Population<br>(N=10,100)<br>(%) |
|-------------------------------------|-------------------------------|------------------------------------|-------------------------------------|---|
|                                     |                               | Large<br>Issuers<br>(n=100)<br>(%) | Random<br>Issuers<br>(n=100)<br>(%) |   |
| For trading purposes                | 10.5                          | 18                                 | 3                                   | 3.1   |
| For non-trading purposes            | 62.5                          | 95                                 | 30                                  | 30.6  |

<sup>a</sup> These data were collected from the notes to the financial statements and the market risk disclosures in the filings of issuers selected for the Study.  
<sup>b</sup> These categories are not mutually exclusive.

Table III(F)(2) describes the percentage of issuers reporting the use of different types of derivative instruments. The largest percentages of issuers report the use of forwards and swaps, while few report using credit derivatives and combinations of derivatives. Again, these results are largely driven by the large issuer sub-sample.

<sup>201</sup>SFAS No. 133 does not require separate disclosure of the fair value of derivatives in the notes to the financial statements. Accordingly, many issuers do not provide this information, and the Staff noted that the disclosures by those who do may appear in many different places in the notes.

| Categorized by Type of Derivative Instrument <sup>b</sup> | Full Sample<br>(n=200)<br>(%) | Sub-Samples                     |                                  | Estimate for Population<br>(N=10,100)<br>(%) |
|---|-------------------------------|---------------------------------|----------------------------------|--|
|   |                               | Large Issuers<br>(n=100)<br>(%) | Random Issuers<br>(n=100)<br>(%) |  |
| Options   | 25.5                          | 47                              | 4                                | 4.4  |
| Futures   | 15                            | 25                              | 5                                | 5.2  |
| Forwards  | 39                            | 66                              | 12                               | 12.5   |
| Swaps   | 48                            | 78                              | 18                               | 18.6   |
| Credit derivatives  | 5.5                           | 10                              | 1                                | 1.1  |
| Combinations  | 4.5                           | 8                               | 1                                | 1.1  |

<sup>a</sup> These data were collected from the notes to the financial statements and the market risk disclosures in the filings of issuers selected for the Study.

<sup>b</sup> These categories are not mutually exclusive.

It is important to note, however, that even though the fair value of certain derivatives is on the balance sheet, the risks inherent in these instruments are not, and can not be, adequately presented on the balance sheet. Although it is true that the balance sheet is also unable to capture the risks associated with owning, say, equipment, or inventory, for the most part, investors understand the risks and rewards of such “ownership” arrangements. The difference between these more familiar arrangements and derivatives is the latter’s potential volatility, the low level of investment that may be required, and the flexibility available in structuring the agreements. As a consequence, supplemental disclosures are even more important for derivatives in understanding risk. Thus, the Staff believed it was important in evaluating balance sheet transparency to examine the disclosures related to derivatives in the Study of filings by issuers.

As described in Section III(F)(1)(c), disclosures about derivatives are presented in the notes to the financial statements and in a section of the filing that reports on the issuer’s exposure to market risks. The information in the notes to the financial statements includes both qualitative and quantitative information about the issuer’s involvement with derivatives. The issuer is required to report qualitative information about, among other things, “its objectives for holding or issuing those instruments, the context needed to understand those objectives, and its strategies for achieving those objectives.”<sup>202</sup> The issuer is also required to report quantitative information, but most of this information relates to hedge accounting, such as the amount of gain or loss temporarily deferred in accumulated other comprehensive income (a component of shareholders’ equity), and the amount of any ineffectiveness recognized in the income statement, resulting from the hedging arrangements.

Table III(F)(3) describes the percentage of issuers reporting the use of certain forms of hedge accounting. Approximately 46% of the sample issuers report using cash flow hedges and 42% report using fair value hedges. However, as these results are

<sup>202</sup>SFAS No. 133, paragraph 44.

largely driven by the large issuer sub-sample. An extrapolation of the findings from the sample to the approximate population of active U.S. issuers suggests that only approximately 17% of the population reports the use of cash flow hedges and approximately 8% report the use of fair value hedges.

| <b>TABLE III(F)(3): Issuers Reporting Use of Hedge Accounting <sup>a</sup></b> |                                      |  |   |   |
|--|--------------------------------------|--|---|---|
| Categorized by Type of Accounting Hedge <sup>b</sup>                           | Full Sample<br>(n=200)<br><u>(%)</u> | Sub-Samples                            |   | Estimate for Population<br>(N=10,100)<br><u>(%)</u> |
|  |                                      | Large Issuers<br>(n=100)<br><u>(%)</u> | Random Issuers<br>(n=100)<br><u>(%)</u> |   |
| Issuers reporting cash flow hedges   | 45.5                                 | 75                                     | 16                                      | 16.6  |
| Issuers reporting fair value hedges  | 42                                   | 77                                     | 7                                       | 7.7   |

<sup>a</sup> These data were collected from the notes to the financial statements and the market risk disclosures in the filings of issuers selected for the Study.  
<sup>b</sup> These categories are not mutually exclusive.

As noted above, issuers are required to disclose information about market risks in their filings; these issuers may or may not use derivatives to hedge such market risks. These disclosures are both qualitative and quantitative in nature. The qualitative information includes disclosures regarding the issuer’s primary market risk exposures, how those risks are managed, and actual or expected material changes in the issuer’s exposures. The quantitative information is intended to provide investors with information to assess the potential impact of market risks on the issuer.

Table III(F)(4) describes the percentage of issuers reporting different types of market risks. A total of 60% of the sample issuers report some type of exposure to market risk. Note that the largest number of issuers report interest rate risk and currency price risk—almost 50% and 43%, respectively—while fewer issuers report commodity price risk or equity price risk. In the large issuer sub-sample, 82% of the issuers report exposure to interest rate risk and 76% report currency price risk; but in the random issuer sub-sample only 17% of issuers report interest rate risk and only 9% report currency price risk.

| Categorized by Type of Market Risk <sup>b</sup> | Full Sample<br>(n=200)<br>(%) | Sub-Samples                     |                                  | Estimate for Population<br>(N=10,100)<br>(%) |
|---|-------------------------------|---------------------------------|----------------------------------|--|
|   |                               | Large Issuers<br>(n=100)<br>(%) | Random Issuers<br>(n=100)<br>(%) |  |
| Any market risk                                 | 60                            | 91                              | 29                               | 29.6   |
| Commodity price risk                            | 15                            | 24                              | 6                                | 6.2  |
| Interest rate risk                              | 49.5                          | 82                              | 17                               | 17.6   |
| Currency price risk                             | 42.5                          | 76                              | 9                                | 9.7  |
| Equity price risk                               | 15.5                          | 31                              | 0                                | 0 <sup>c</sup>                               |

<sup>a</sup> These data were collected from the notes to the financial statements and the market risk disclosures in the filings of issuers selected for the Study.  
<sup>b</sup> These categories are not mutually exclusive.  
<sup>c</sup> Less than 1%

The Staff notes that one barrier to achieving transparency is that the disclosures related to market risk are usually organized by type of market risk (e.g., commodity price risk, interest rate risk, etc.), but the SFAS No. 133 disclosures in the notes to the financial statements are usually organized by type of accounting hedge (e.g., cash flow hedges, fair value hedges, etc.). Thus, it may be difficult for issuers and investors to effectively integrate the disclosures.

Further, there is no one generally accepted method for characterizing and communicating information about risk. As a result, Commission rules allow issuers to choose among three types of quantitative disclosures. Issuers may simply disclose the terms of any outstanding derivative contracts in a tabular format, including information about fair values and contract terms relevant to determining future cash flows, categorized by expected maturity dates. Alternatively, issuers may disclose sensitivity analysis assessing the potential for loss (e.g., in terms of net income) resulting from hypothetical changes in various market factors (e.g., oil prices). Issuers may also present the results of a value-at-risk (“VaR”) analysis, which quantifies the potential loss in fair values, earnings or cash flows, from market movements with a selected likelihood of occurrence.

Table III(F)(5) describes the percentage of issuers using different types of disclosures in reporting market risks. As noted above, 60% of sample issuers report some type of exposure to market risk (see Table III(F)(4)). More than half of this group (i.e., more than half of those disclosing information about market risks) present sensitivity analysis in their disclosures; 12% present value-at-risk disclosures and another 9% present tabular disclosures.<sup>203</sup> As a result, comparing the risk disclosures across issuers can be difficult, due to lack of comparability. As is the case with regard to the earlier results, these percentages are driven by the predominance of derivative use in the large issuer sub-sample.

<sup>203</sup> Issuers may use different methods to disclose information about different market risks.



| Categorized by Type of Risk Disclosure <sup>b</sup> | Full Sample<br>(n=200)<br><i>(%)</i> | Sub-Samples                            |   | Estimate for Population<br>(N=10,100)<br><i>(%)</i> |
|---|--------------------------------------|--|---|---|
|   |                                      | Large Issuers<br>(n=100)<br><i>(%)</i> | Random Issuers<br>(n=100)<br><i>(%)</i> |   |
| Tabular   | 9                                    | 14                                     | 4                                       | 4.1   |
| Sensitivity analysis                                | 32                                   | 52                                     | 12                                      | 12.4  |
| Value-at-risk                                       | 12                                   | 21                                     | 3                                       | 3.2   |

<sup>a</sup>These data were collected from the market risk disclosures in the filings of issuers selected for the Study.  
<sup>b</sup>These categories are not mutually exclusive.

However, even if two issuers use the same type of disclosure about derivatives, direct comparisons between issuers still may not be possible. Consider two issuers that both use sensitivity analysis to communicate information about their risk exposure to interest rate risk. These disclosures require that an issuer estimate the change in some component of issuer value (the numerator) as a result of a change in some component of market risk (the denominator). One issuer may report the change in net income (this particular issuer's choice of numerator) as a result of a 1% increase in LIBOR rates (this issuer's choice of denominator). Another issuer may report the change in a different numerator as a result of a change in a different denominator. Both of these disclosures may meet the requirements set up by the Commission, but investors may not be able to effectively compare these two issuers based upon public filings.

As an example, Table III(F)(6) reports the numerators and denominators for the sensitivity analyses related to interest rate risk for a set of pharmaceutical issuers (*i.e.*, SIC=2834). The disclosures identified in this table are for illustrative purposes only and are not highlighted as being in any way insufficient or inconsistent with the disclosure requirements under Item 305 of Regulation S-K, but were simply selected to show the range of potential disclosures under Item 305 and the resulting difficulty of comparing the disclosures of different companies.

**TABLE III(F)(6) Empirical Findings Regarding Comparability of Sensitivity Analysis Disclosures Related to Interest Rate Risk for Pharmaceutical Industry (SIC=2834) <sup>a,b</sup>**

|                        | Numerator  | Denominator                              |
|------------------------|--|--|
| Company A <sup>b</sup> | Cash flows, income, or market values                                   | 100 basis point change in interest rates |
| Company B <sup>b</sup> | Financial position, results of operations, or cash flows               | 10% change in interest rate structure    |
| Company C              | Fair value of derivative and other interest rate sensitive instruments | 10 basis point change in interest rates  |
| Company D              | Fair value of debt and investments                                     | 1 basis point change in interest rates   |
| Company E              | Net income related to financial instruments                            | 10% adverse change in interest rates     |
| Company F              | Fair value of outstanding long term debt outstanding                   | 10% decrease in interest rates           |
| Company G              | Fair value of outstanding debt   | 1% point increase in interest rates      |

<sup>a</sup> These data were collected from the market risk disclosures in the filings of issuers selected for the Study.  
<sup>c</sup> The sensitivity is reported to be immaterial for these issuers.

Overall, based on information available in public filings, not only is it difficult to ascertain the magnitude of the fair values of derivatives that are reported on the balance sheet, it is also difficult to ascertain the extent of the underlying market risk exposures, as well as the effects of derivative transactions intended to hedge these risks. Although the tradeoff between comparability and representational faithfulness presents significant challenges, the Staff believes improvements can and should be made to enhance the transparency of reporting issuer activities related to derivatives and risk management. The Staff notes the FASB’s recently announced project to consider enhancing the existing disclosure requirements of SFAS No. 133. The FASB has stated that it will also consider whether to expand the scope of any disclosure enhancements to include financial instruments outside the scope of SFAS No. 133.

## **G. Other Contractual Obligations**

### **1. Nature of Arrangements and Financial Reporting Requirements**

Issuers are involved in any number of contractual obligations, including debt obligations, retirement obligations, compensation agreements, leases, guarantees, derivatives, and obligations to purchase goods and services. In many cases, liabilities are recognized on the balance sheet at the inception of the contract, because one party has performed. For example, if an issuer borrows money, it recognizes a liability upon receipt of the funds. In other cases, liabilities are recognized as time passes, as in the case of interest related to the borrowed funds. In still other cases, contractual obligations remain off the balance sheet. Examples of these obligations may include operating

leases, portions of obligations related to retirement plans, certain guarantees, and certain derivatives, all of which have been discussed above. Although the discussion generally applies to other types of contractual obligations, this section will primarily focus on one major class of contractual obligations that remain off issuer balance sheets—purchase obligations.<sup>204</sup>

A purchase obligation could be as simple as a standard one-time purchase order. Alternatively, the purchase obligation may be attributable to the purchase of goods or services to be delivered over an extended period of time. Generally, the accounting question is whether or not a party to a contract should reflect the rights and obligations inherent in the contract upon signing the contract, and, if so, in what way.

Consider a contract to purchase one million units of inventory per year for the next three years.<sup>205</sup> Upon signing the contract, the purchaser could record an asset (e.g., “Inventory Receivable”) and a liability (e.g., “Purchase Obligation”). The seller could also record an asset for the cash to be received and a liability reflecting its obligation to deliver the inventory. However, at this point in time, nothing has been delivered and no payment has been made. Nonetheless, one could argue that, even though no performance has occurred, the issuers have many of the same risks and rewards as if the exchange had already been completed, and thus should recognize the related assets and liabilities. Under this view, it could be argued that binding contracts give rise to assets and liabilities in advance of any performance under the contract.

The contrary view is that assets and liabilities should only be recognized to the extent performance has occurred—that is, to the extent that one or both parties have carried out the actions (duties) agreed to in the contract, such as delivering or paying for the goods. Under this view, until some amount of performance has occurred on a contract, the buyer does not have an asset for the goods or services to be received nor a liability (i.e., a present obligation) to pay for them, and the seller does not have a recognizable asset for the right to collect the contractual payments. Thus, no asset or liability would be recorded until some performance has occurred. For example, if the purchaser of the inventory paid for it in advance, the purchaser’s obligation to pay would be considered performed, and the purchaser would at that time record an asset to recognize its right to receive inventory.

The latter view underlies the more common financial reporting treatment. Thus, signing a contract for the sale/purchase of goods generally does not result in the recognition of an asset or liability by either party. However, there are exceptions to this general treatment. Two of the major exceptions are addressed in separate sections of this

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<sup>204</sup>The Staff does not address loan commitments, lines of credit, and other similar arrangements in the Study, due to their specialized industry-specific nature and the fact that these obligations to provide funding under certain terms and conditions themselves constitute a financial service, which is arguably more similar to an obligation to sell than an obligation to purchase.

<sup>205</sup>The motivation to enter into such contractual commitments is straightforward. An issuer that uses certain raw materials in its production may wish to secure its supply of those materials—and possibly the price, as well—by entering into long-term purchase contracts. The provider of raw materials may also benefit from knowing how much to produce.

report: leases and derivatives. In yet other cases, while the assets and liabilities related to an unperformed contract are not separately recognized, losses embedded in those contracts are recognized. This so called “loss contract” accounting is required when an issuer has committed to purchase inventory at prices that ensure a loss on resale of that inventory,<sup>206</sup> and when a long-term construction contract is expected to result in a loss.<sup>207</sup>

In January 2002, the Commission released FR-61, “Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations,” which described the views of the Commission regarding certain disclosures that should be considered by issuers, including disclosures about contractual obligations and commercial commitments. This guidance was updated in the 2003 revision by the Commission of Item 303(A)(4) of Regulation S-K. Item 303(A)(4) requires disclosures about certain off-balance sheet arrangements, including certain contractual obligations. Specifically, these new rules require tabular disclosure in MD&A of contractual obligations, including open purchase orders, that will result in future cash payments. This disclosure is intended to provide financial statement users with information about unrecognized (as well as recognized) obligations. While the disclosures do not provide information about the related assets to be received as a result of those cash payments, the disclosures are an attempt to portray contractual obligations broadly.

## **2. Off-Balance Sheet Issues in Accounting for Contractual Obligations**

Conceptually, the accounting for unperformed contractual obligations could be done in a variety of ways. For example, all contractual rights and obligations could be recognized as assets and liabilities.<sup>208</sup> This would recognize the fact that once an entity enters into a firm contract to buy or sell something, the entity is generally subject to many of the same risks and rewards as if the transaction had already been completed. For example, once an issuer has entered into a firm fixed-price contract to purchase inventory, future declines in the value of that inventory affect the issuer. Similarly, once an issuer has agreed to sell inventory for a particular price, future decreases in the value of that inventory do not affect the issuer.

However, to the extent neither party to a contract has performed, each party's rights and obligations are, at least implicitly, contingent upon the other party's. As such, some assert the rights and obligations in the contract do not qualify as assets and liabilities because they do not result from past transactions. Others believe that, because the rights and obligations are contingent upon one another, they should be accounted for only as a group—that is, the “unit of account” would be the contract as a whole, rather than the assets and liabilities individually. In this analysis, the assets and liabilities would be offset against one another. Assuming the contract represents an exchange of equal

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<sup>206</sup>See ARB 43, Chapter 4, Statement 10.

<sup>207</sup>See SOP 81-1, paragraphs 85-89.

<sup>208</sup>The CFA Institute (formerly AIMR) has called upon standard setters to treat all executory contracts with terms greater than one year as assets and liabilities. See Financial Reporting in the 1990s and Beyond, AIMR (1993), page 86.

values, the values of the assets and liabilities would likely net to zero, thus effectively resulting in no impact on the balance sheet.

Although standard-setters have almost invariably determined that such unperformed contracts should not result in the recording of assets and liabilities, the basis for these decisions is not always stated.<sup>209</sup> For example, as mentioned above, losses on certain contractual commitments, such as inventory purchases and construction contracts, are required to be recognized before performance occurs. Conceptually, the loss in these contracts might be viewed as akin to an asset impairment loss, even though the rights in these contracts have not previously been reported as assets.

Another potentially confusing aspect of accounting for loss contracts is that the accounting is applied far beyond the situations specifically addressed in the accounting guidance. Although this guidance specifically applies to very narrow classes of transactions, issuers and auditors have often applied it by analogy to other unperformed contractual obligations. These analogies have been applied sporadically, meaning that losses inherent in some unperformed contracts are recorded, while others are not. This diversity led the EITF to consider two issues related to losses on unperformed contracts. Neither, however, resulted in a consensus.<sup>210</sup>

### **3. Empirical Findings from Filings by Issuers**

In this section the Staff presents empirical findings from the Study of filings by issuers related to purchase obligations, a subset of contractual obligations. Other major categories of contractual obligations, such as leases, guarantees, and derivatives, have been addressed in other sections of this Report. The Staff also extrapolates from these findings to estimate amounts for the approximate population of active U.S. issuers.

Table III(G)(1) describes the percentage of issuers reporting purchase obligations. Approximately 54% of issuers in the sample report cash flows committed under purchase obligations. An extrapolation of the findings from the sample to the approximate population of active U.S. issuers suggests that approximately 30% of the total population of issuers report cash flows committed under purchase obligations.

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<sup>209</sup>Neither the FASB's actual, or proposed, Statements of Financial Accounting Concepts clarifies, one way or the other, whether recognition of contractual commitments fits within the current conceptual framework. By commissioning a research report on Recognition of Contractual Rights and Obligations, the FASB gave some recognition, in 1980, to the need to consider the conceptual framework in relation to executory contracts. That research report was written by Yuji Ijiri, Recognition of Contractual Rights and Obligations (Stamford, CT: FASB, December, 1980).

<sup>210</sup>See EITF 99-14 and EITF 00-26.

| <b>TABLE III(G)(1): Issuers Reporting Future Cash Flows Committed under Purchase Obligations <sup>a</sup></b>                               |                               |                                    |                                     |   |
|---|-------------------------------|------------------------------------|-------------------------------------|---|
|   | Full Sample<br>(n=200)<br>(%) | Sub-Samples                        |                                     | Estimate for<br>Population<br>(N=10,100)<br>(%) |
|   |                               | Large<br>Issuers<br>(n=100)<br>(%) | Random<br>Issuers<br>(n=100)<br>(%) |   |
| Issuers Reporting Purchase Obligations  | 54                            | 78                                 | 30                                  | 30.5  |
| <sup>a</sup> These data were collected from the contractual obligations table in the MD&A of the filings of issuers selected for the Study. |                               |                                    |                                     |   |

Table III(G)(2) presents the total future cash flows committed under purchase obligations for the 200 issuers in the sample, which are not recorded on the balance sheets of issuer. The undiscounted sum of the future committed cash flows related to purchase obligations for our sample of issuers is approximately \$434 billion. An extrapolation of the findings from the sample to the approximate population of active U.S. issuers suggests that the total (undiscounted) cash flows associated with purchase commitments reported by the population is approximately \$725 billion.

| <b>TABLE III(G)(2): Reported Future Cash Flows Committed under Purchase Commitments <sup>a</sup></b>   |                                      |   |  |  |
|--|--------------------------------------|---|--|--|
|  | Full Sample<br>(n=200)<br>(millions) | Sub-Samples                               |  | Estimate for<br>Population<br>(N=10,100)<br>(millions) |
|  |                                      | Large<br>Issuers<br>(n=100)<br>(millions) | Random<br>Issuers<br>(n=100)<br>(millions) |  |
| Total undiscounted cash flows  | \$433,661                            | \$430,713                                 | \$2,948                                    | \$725,513  |
| <sup>a</sup> These data were collected from the contractual obligations table in the off-balance sheet arrangements section of the MD&A (required by FR67) for the filings of issuers selected for the Staff Study. It is important to note that these amounts are not discounted. |                                      |   |  |  |

Issuers reported other types of contractual obligations in the Contractual Commitments table in MD&A. In many cases, it is obvious whether the commitment in question is, indeed, on the issuer's balance sheet (e.g., debt). However, in some cases, the Staff notes that whether the item is on or off the balance sheet remains unclear.

## **IV. EMPIRICAL FINDINGS ON CERTAIN POST-SARBANES-OXLEY IMPROVEMENTS IN FINANCIAL REPORTING ON OFF-BALANCE SHEET ARRANGEMENTS**

### **A. Consolidation of Variable Interest Entities**

#### **1. Discussion**

After the downfall of Enron, attention became focused on special purpose entities, a vehicle frequently used by Enron as a means to get assets and liabilities off the balance sheet. In response to the attention on previous SPE accounting,<sup>211</sup> the FASB developed a new accounting interpretation that targets what are now referred to as variable interest entities (“VIEs”). FASB Interpretation No. 46, Consolidation of Variable Interest Entities—an interpretation of ARB No. 51, was issued in January 2003, with a revision—Interpretation No. 46(R), Consolidation of Variable Interest Entities (revised December 2003)—an interpretation of ARB No. 51—issued in December 2003.<sup>212</sup>

Variable interest entities include SPEs and can be generally described as entities in which the equity investment at risk does not provide its holders with the characteristics of a controlling financial interest or is not sufficient for the entity to finance its activities without additional subordinated financial support.<sup>213</sup> These characteristics are meant to identify arrangements in which control of the entity would not be achieved through voting stock ownership, but through some other method.

FASB Interpretation No. 46(R) requires consolidation of a variable interest entity by a party that has a majority of the risks and rewards (*i.e.*, greater than 50%) associated with the entity. Interpretation No. 46(R) also establishes a methodology for determining which party associated with a VIE should consolidate the VIE. Essentially, the requirement is that the party exposed to a majority of the variations in the outcome of the performance of a VIE, both positive and negative, should consolidate the VIE, because such exposure is likely to be indicative of control. Interpretation No. 46(R) refers to such a party as the primary beneficiary of the VIE.

An issuer’s involvement with a VIE can manifest itself in debt instruments, guarantees, service contracts, written put options, total return swaps, etc. These arrangements with a VIE can put the issuer in a position akin to an equity holder in that the issuer bears the same risks and rewards of the VIE as an equity holder would. For example, consider an issuer that owns 50% of the voting stock of another entity and is the sole guarantor of debt of the entity. Before Interpretation No. 46(R), such an issuer may

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<sup>211</sup>See EITF Topic D-14, Transactions involving Special-Purpose Entities; EITF 96-21, Implementation Issues in Accounting for Leasing Transactions involving Special-Purpose Entities; EITF 90-15, Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions.

<sup>212</sup>As has been the convention in the rest of this document, the Staff will generally refer to the revised version of the interpretation (*i.e.*, Interpretation No. 46(R)). However, there are some cases in this section that require reference to the original version of the interpretation (*i.e.*, Interpretation No. 46).

<sup>213</sup>See Interpretation No. 46(R), paragraph D2.

not have been required to consolidate the other entity based upon voting control. However, subsequent to the promulgation of Interpretation No. 46(R), if this same entity is deemed to be a VIE, then the issuer would likely be required to consolidate, due to the issuer's additional risk of loss from the outstanding guarantee.

In anticipation of the implementation of Interpretation No. 46 and Interpretation No. 46(R), a number of entities restructured arrangements with potential VIEs such that they would not require consolidation. Disclosures of such restructurings were noted in the sample companies. The Staff also is aware anecdotally that many arrangements with potential VIEs were restructured such that the entity either would not be considered a VIE or such that no party would be required to consolidate the VIE. The effect of such changes is difficult to measure. However, in some cases, it appears that the changes made involved substantive changes to the economics of the variable interests or to the decision-making capabilities of the investors, while in other cases, the changes may have been less substantive.

Although Interpretation No. 46(R) constitutes an improvement over the previously existing consolidation guidance, a number of interpretive questions remain. Many users of Interpretation No. 46R find it theoretically and practically challenging to apply. Currently, the FASB is considering ways to resolve an issue originally discussed by the EITF in issue 04-07, Determining Whether an Interest Is a Variable Interest in a Potential Variable Interest Entity. A consensus on this EITF issue may change how some issuers apply Interpretation No. 46(R).

The Staff has noted that Interpretation No. 46(R) has resulted in a number of non-SPE type entities being consolidated such as joint ventures and jointly owned entities such as LLCs. However, it is unclear to the Staff whether Interpretation No. 46(R) has significantly increased the number of SPE entities that are consolidated. In part, this may be a result of practice being ahead of the standard setters, effectively restructuring arrangements in advance of the effective date of standards in order to achieve desired financial reporting results. Even so, if the changes made to SPEs in order to avoid consolidation do indeed represent substantive changes, such that the issuers in question no longer control the SPE, Interpretation No. 46(R) will have improved financial reporting even if there is not a significant increase in the frequency of consolidation of SPEs. The Staff believes more time is needed to fully evaluate the effects of Interpretation No. 46(R).

## **2. Empirical Findings from Study of Filings by Issuers**

This section summarizes the empirical findings from the Study of filings by issuers related to VIEs. The Staff also extrapolates from these findings to estimate amounts related to the approximate population of active U.S. issuers.

The Staff examined the disclosures related to Interpretation No. 46 and Interpretation No. 46(R) in the annual 10-K filings used for the remainder of the Study. However, as of that point in time, many of the sample issuers had not yet fully adopted Interpretation No. 46(R), so the available data was primarily limited to disclosures about



the expected impact of adopting Interpretation No. 46(R).<sup>214</sup> In light of these limitations, the Staff supplemented the data by collecting additional information regarding issuers' implementations of Interpretation No. 46(R) from selected quarterly 10-Q filings.

Table IV(A)(1) describes the percentage of issuers reporting different levels of actual or anticipated effects of implementing Interpretation No. 46 (and to some extent, of Interpretation No. 46(R)) as of the date of our sample issuers' annual 10-K or 10KSB filings.

| <b>Table IV(A)(1): Anticipated Effects of Adoption of Interpretation No. 46 Presented in Annual 10-K Filings<sup>a</sup></b>    |                                      |   |  |  |
|---|--------------------------------------|---|--|--|
|   | Full Sample<br>(n=200)<br><u>(%)</u> | Sub-Samples                               |  | Estimate for<br>Population<br>(N=10,100)<br><u>(%)</u> |
|   |                                      | Large<br>Issuers<br>(n=100)<br><u>(%)</u> | Random<br>Issuers<br>(n=100)<br><u>(%)</u> |  |
| Issuers with no Interpretation No. 46 disclosures   | 18.5                                 | 7   | 30   | 29.8   |
| Issuers reporting no VIEs <sup>b</sup>  | 13                                   | 6   | 20   | 19.9   |
| Issuers reporting no material VIEs <sup>b</sup>   | 8.5                                  | 11  | 6  | 6.0  |
| Issuers reporting that the effect of adopting Interpretation No. 46 was not material or not expected to be material             | 38                                   | 48 <sup>c</sup>                           | 28   | 28.2   |
| Issuers reporting no statement about materiality for any VIEs   | 12                                   | 14  | 10   | 10.0   |
| Issuers reporting they are still evaluating for some VIEs   | 6.5                                  | 7   | 6  | 6.0  |
| Issuers reporting that the impact of adopting Interpretation No. 46(R) was material or was expected to be material for any VIEs | 3.5                                  | 7   | 0  | 0.0 <sup>d</sup>                                       |

<sup>a</sup> These data were collected from the notes to the financial statements in the 10-K filings of issuers selected for the Study. In some cases, issuers had fully or partially implemented Interpretation No. 46(R) as well.

<sup>b</sup> Issuers included in this category are not counted in the categories below, even though some of these issuers also stated that the effects were not material.

<sup>c</sup> Approximately 16% of the issuers in this group reported the existence of VIEs other than those for which they considered impact of Interpretation No. 46(R) to be immaterial, but these issuers did not make any statement about materiality for these other VIEs.

<sup>d</sup> Less than 0.5%.

<sup>214</sup> As of the 10-K filing dates for the sample, most issuers had either not adopted or had only partially adopted Interpretation No. 46(R), because Interpretation No. 46(R) replaced Interpretation No. 46, but only after the effective date of Interpretation No. 46. The effective date for Interpretation No. 46(R) was after the balance sheet date for most 10-K filings in the sample. In addition, public small business issuers (*i.e.*, issuers that file a 10KSB) were not required to adopt Interpretation No. 46(R) until 9 months after other public issuers.

The information gathered for this table mainly relies on disclosures under Staff Accounting Bulletin No. 74, Disclosure of the impact that recently issued accounting standards will have on the financial statements of the registrant when adopted in a future period (“SAB 74”). As can be seen, less than 4% of the sample issuers reported that the impact of the interpretations either was material or was expected to be material, and all of these issuers were members of the large issuer sub-sample. An extrapolation of the findings from the sample to the approximate population of active U.S. issuers suggests that less than 1% of the issuers in the population would expect the effect of the interpretations to be material.

In addition, as mentioned above, the Staff believes that some arrangements with potential VIEs were restructured such that the entity would not be consolidated under Interpretation No. 46 or 46(R). In fact, seven issuers in the large issuer sub-sample made reference in their filings to restructurings that occurred in anticipation of or coincident with the implementation of Interpretation No. 46 and 46(R).

The Staff supplemented its analysis of the annual 10-K filings by collecting additional information about the application of Interpretation No. 46 and 46(R) from selected quarterly 10-Q filings, which is presented in Tables IV(A)(2) and IV(A)(3).<sup>215</sup>

Table IV(A)(2) describes the percentage of issuers reporting adoption of Interpretation No. 46(R) and the percentage of issuers that are affected. Approximately 77% of the sample issuers report that they have adopted Interpretation No. 46(R).<sup>216</sup> Approximately 12% of the sample issuers report in their quarterly 10-Qs that they have no VIEs, which is a similar proportion of those who reported no VIEs in their SAB 74 disclosures (*i.e.*, 13%). Issuers reporting the existence of VIEs in their quarterly 10-Qs amounted to approximately 32%. Finally, approximately 23% of the sample issuers report the existence of VIEs that are consolidated.

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<sup>215</sup>The Staff selected the quarterly 10-Q filing for each issuer in the sample for the period in which Interpretation No. 46(R) should have been fully adopted. Public small business issuers (*i.e.*, issuers that file a 10KSB) were not required to adopt Interpretation No. 46(R) until 9 months after other public issuers. As a result, the Staff cannot comment on the effects of Interpretation No. 46(R) for many of the issuers in this category.

<sup>216</sup>Some sample issuers may not have reported adoption if they had no arrangements that were in the scope of Interpretation No. 46(R) and thus concluded that no disclosure was necessary.

| <b>Table IV(A)(2): Effects of Adoption of Interpretation No. 46(R) Presented in Quarterly 10-Q Filings <sup>a</sup></b> |                               |                                    |                                     |   |
|---|-------------------------------|------------------------------------|-------------------------------------|---|
|   | Full Sample<br>(n=200)<br>(%) | Sub-Samples                        |                                     | Estimate for<br>Population<br>(N=10,100)<br>(%) |
|   |                               | Large<br>Issuers<br>(n=100)<br>(%) | Random<br>Issuers<br>(n=100)<br>(%) |   |
| Issuers Reporting Full Adoption of Interpretation No. 46(R) <sup>b</sup>  | 76.5                          | 88                                 | 65 <sup>c</sup>                     | 65  |
| Issuers Reporting No VIEs   | 11.5                          | 5                                  | 18                                  | 17.9  |
| Issuers Reporting Existence of VIEs <sup>a</sup>  | 32                            | 50                                 | 14                                  | 14.4  |
| Issuers Reporting VIEs that are Consolidated <sup>b</sup>   | 22.5                          | 39                                 | 6                                   | 6.3   |

<sup>a</sup> These data were collected from the notes to the financial statements in the 10-Q filings of issuers selected for the Study.

<sup>b</sup> In many cases, filings did not clearly indicate whether the consolidations occurred as a result of adopting Interpretation No. 46(R).

<sup>c</sup> Includes 8 of the 26 small business issuers in the sample.

The findings for the sub-samples present a different picture. Only 5% of the large issuer sub-sample report that they have no VIEs, compared to 18% of the random issuer sub-sample. Approximately 50% of the large issuer sub-sample reports the existence of VIEs, and 39% of this sub-sample reports consolidating at least some of these VIEs. In contrast, only 14% of the random issuer sub-sample report the existence of VIEs, and only 6% report any consolidation.

Table IV(A)(3) presents the reported amounts of assets and liabilities consolidated under Interpretation No. 46(R). The sample issuers consolidated approximately \$208 billion in assets and almost \$170 billion in liabilities, the vast majority of which reflects consolidations in the large issuer sub-sample. These assets and liabilities represent approximately 2% of the total assets and 2% of the total liabilities for the sample (as shown in Table II(A)(2)), and are proportionate for each of the sub-samples. An extrapolation of the findings from the sample to the approximate population of active U.S. issuers suggests that VIEs with approximately \$516 billion in assets and \$444 billion in liabilities are consolidated by the population.

| <b>TABLE IV(A)(3): Reported Amounts Related to Consolidated Assets and Liabilities of Variable Interest Entities <sup>a</sup></b> |   |  |   |   |
|---|---|--|---|---|
|   | Full Sample<br>(n=200)<br><i>(millions)</i> | Sub-Samples                                      |   | Estimate for<br>Population<br>(N=10,100)<br><i>(millions)</i> |
|   |   | Large<br>Issuers<br>(n=100)<br><i>(millions)</i> | Random<br>Issuers<br>(n=100)<br><i>(millions)</i> |   |
| <b>VIEs Consolidated by Issuers:</b>  |   |  |   |   |
| Assets  | \$208,312                                   | \$205,206  | \$3,106   | \$515,806   |
| Liabilities   | \$169,706                                   | \$166,938  | \$2,768   | \$443,738   |

<sup>a</sup> These data were collected from the notes to the financial statements in the 10-K and 10-Q filings of issuers selected for the Study. In most cases, filings did not clearly indicate whether the consolidations occurred as a result of adopting Interpretation No. 46(R).

## **B. Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations**

### **1. Discussion**

As directed by Section 401(a) of the Act, the Commission adopted amendments to its rules to require each annual and quarterly financial report required to be filed with the Commission to disclose “all material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the issuer with unconsolidated entities or other persons, that may have a material current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses.”<sup>217</sup> The rule requires an issuer to provide an explanation of its off-balance sheet arrangements in a separately captioned subsection of the Management's Discussion and Analysis section of the issuer’s disclosure documents. It also requires issuers (other than small business issuers) to provide an overview of certain known contractual obligations in a tabular format.

FR 67 requires disclosure for any contractual arrangement to which an unconsolidated entity is a party, and under which a registrant has:

- Any obligation under certain guarantee contracts;
- A retained or contingent interest in assets transferred to an unconsolidated entity;
- Any obligation under certain derivative instruments; or
- Any obligation under a variable interest held by the issuer in an unconsolidated entity.<sup>218</sup>

<sup>217</sup>Final Rule: Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, Release No. 34-47264, also codified in FR 67

<sup>218</sup>See FR 67 for a more detailed description of these categories.

Disclosure is required to the extent necessary to provide an understanding of the issuer's material off-balance sheet arrangements as well as the material effects of those arrangements on financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources. As the Commission noted in the release accompanying the final rule, management has the responsibility to identify and address the key variables and other qualitative and quantitative factors that are peculiar to, and necessary for, an understanding and evaluation of the issuer. More specifically, to the extent necessary for an understanding of the issuer's off-balance sheet arrangements, an issuer must provide the following four items:

- The nature and business purpose of the issuer's off-balance sheet arrangements;
- The importance of the off-balance sheet arrangements to the issuer for liquidity, capital resources, market risk or credit risk support or other benefits;
- The financial impact of the arrangements on the issuer (e.g., revenues, expenses, cash flows or securities issued) and the issuer's exposure to risk as a result of the arrangements (e.g., retained interests or contingent liabilities); and
- Known events, demands, commitments, trends or uncertainties that affect the availability or benefits to the issuer of material off-balance sheet arrangements.

## **2. Empirical Findings from Study of Filings by Issuers**

This section summarizes the empirical findings of the Staff Study of filings by issuers related to off-balance sheet arrangements reported in the section of MD&A, as required by FR 67. The Staff also extrapolates from these findings to estimate amounts related to the approximate population of active U.S. issuers.

Table IV(B)(1) describes the percentage of issuers reporting different types of arrangements in the off-balance sheet section of MD&A. Approximately 23% of issuers report information about guarantees in the off-balance sheet section of their MD&A. Only approximately 8% report information about variable interests held in unconsolidated VIEs. Approximately 13% also report information about retained interests in financial assets transferred to an unconsolidated entity. Even fewer issuers—approximately 1% of the sample—report the existence of the derivatives required to be disclosed under FR 67 (e.g., equity-linked derivatives).

| <b>TABLE IV(B)(1): Issuers Reporting Arrangements in MD&amp;A Off-Balance Sheet Section <sup>a</sup></b> |                                      |  |   |   |
|--|--------------------------------------|--|---|---|
| Categorized by Type of Arrangement <sup>b</sup>  | Full Sample<br>(n=200)<br><i>(%)</i> | Sub-Samples                            |   | Estimate for Population<br>(N=10,100)<br><i>(%)</i> |
|  |                                      | Large Issuers<br>(n=100)<br><i>(%)</i> | Random Issuers<br>(n=100)<br><i>(%)</i> |   |
| Variable Interest Entities   | 7.5                                  | 14                                     | 1                                       | 1.1   |
| Retained Interests   | 13                                   | 25                                     | 1                                       | 1.2   |
| Guarantees   | 22.5                                 | 39                                     | 6                                       | 6.3   |
| Equity-linked Derivatives  | 1                                    | 2                                      | 0                                       | 0 <sup>c</sup>                                      |

<sup>a</sup> These data were collected from the section on off-balance sheet arrangements in the MD&A of the filings of issuers selected for the Study.  
<sup>b</sup> These categories are not mutually exclusive.  
<sup>c</sup> Less than 0.5%.

In many cases, the Staff notes that a greater proportion of issuers report OBS arrangements in the notes to the financial statements, as compared to the off-balance sheet section of the MD&A. For example, more than twice as many issuers report information on guarantees in the notes to the financial statements as in the off-balance sheet section. One possible explanation for this is that FR 67 requires disclosures for only a subset of the guarantees encompassed by the disclosure requirements under Interpretation No. 45.<sup>219</sup> Specifically, FR 67 only requires disclosures for the types of guarantees that are required to be recognized as liabilities on the balance sheet under Interpretation No. 45, while Interpretation No. 45 also requires disclosures for certain arrangements, such as product warranties, that are not required to be recognized on the balance sheet.

Nevertheless, it appears that issuers may not have identified all of the off-balance sheet arrangements that are required to be discussed in the OBS section of MD&A. Further, the Staff believes—based in part on the difficulties faced in gathering the data necessary for the Study and Report—that the quality of the issuer disclosures provided in the off-balance sheet section of MD&A can and should be improved. To some extent, this is not surprising, given that this was the first year for such disclosures. The Staff expects to focus on these areas in its reviews of issuer filings.

## **V. Initiatives to Improve Financial Reporting Transparency**

This Report has presented analyses and discussion on various types of transactions and arrangements that may give rise to questions regarding the content of the balance sheet. The Staff does not, however, view these issues as totally separable from certain other issues that arise in financial reporting. In the course of the Staff’s day-to-day work, which includes working with issuers on accounting questions as well as overseeing the work of the FASB in the development of accounting standards, the Staff often develops views as to how financial reporting might be improved. While that

<sup>219</sup>Recall that Interpretation No. 45 governs disclosures in the footnotes.

cumulative knowledge informs this Report, the work to produce this Report has also reinforced some of the Staff's prior views on several broad goals that it believes are key to raising the level of quality of financial reporting. We present these items below.

Readers will note that the goals do not speak to particular improvements in accounting standards. While we do provide specific recommendations related to accounting standards in Section VI, it is the broad goals that we believe should guide the work of the standard-setters, and, more importantly, that should be in the minds of preparers, auditors, regulators, and others who affect financial reporting. The Staff believes that discussions on improvements in financial reporting too often focus inappropriately and singularly on standard-setting activities. The Staff believes that improvement will best be achieved when all parties in the financial reporting process are working towards the same goals. Indeed, the Staff believes that significant improvement in the transparency of the balance sheet and of financial reporting in general is possible without any changes in standards.

### **A. Eliminate (or at least Reduce) Accounting-Motivated Structured Transactions**

As noted in the introduction to this Report, we have not limited the scope of our consideration of off-balance sheet transactions to only those transactions that involve deliberate manipulation on the part of the issuer. Nonetheless, it is true that most of the scandals that provided a catalyst to the passage of the Act did indeed involve transactions that were structured so as to present information in a manner inconsistent with the underlying economics. In fact, deliberate attempts to work around the intent of the standards have contributed to many of the largest financial reporting failures. These attempts normally involve transactions that are structured in an attempt to achieve accounting results that do not mirror the economics of the transaction. With regard to certain of Enron's structured transactions, Neal Batson concluded that:

broad concepts have given way to rules-based, bright-line tests under which the financial accounting for a transaction often depends on the form of the transaction rather than its economic substance. In fact, in many cases the very purpose of designing a structured finance transaction to comply with the literal GAAP rules is to report the transaction in accordance with its form rather than its economic substance.<sup>220</sup>

In addition, transparency and the degree to which accounting and disclosure standards achieve their goals can be greatly diminished by the use of structuring, even when that structuring appears to comply with the standards. Examples of this abound in financial reporting, and touch on several of the topics that are addressed in this Report. Leasing is a prime example of this. The guidance that currently exists was developed with regard to the transactions that were commonplace at the time that guidance was issued. And, indeed, it might have produced results that would have reflected the

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<sup>220</sup>See Second Interim Batson Report, pages 51 and 52.

economics of those transactions, if not for the fact that lease transactions changed in response to the guidance. Interpretation No. 46(R), which addresses the consolidation of variable interest entities (including SPEs), could well suffer a similar fate. In some cases, securitizations and derivatives have been used in accounting-motivated transactions.

When we refer to accounting-motivated structured transactions, we are speaking of those transactions that are structured in an attempt to achieve reporting results that are not consistent with the economics of the transaction, and thereby impair the transparency of financial reports.<sup>221</sup> Further, we include not only those transactions that would not have been undertaken but for the perceived “benefits” of the resultant financial reporting, but also those that adopt a more complex form than would otherwise be the case, in order to achieve an accounting result. For example, an issuer might contemplate a secured borrowing transaction because it needs capital—a true business purpose. However, if that issuer transfers the assets to an SPE, which then borrows the funds and transfers them to the issuer in a transaction that keeps the debt off the balance sheet while exposing the issuer to virtually the identical risks and rewards as if the simple secured borrowing had been undertaken, the Staff considers the transaction to be accounting-motivated.

It is tempting to blame the use of accounting-motivated transactions on accounting standards that can be exploited. However, while the fact that accounting standards may be vulnerable to exploitation may be thought of as representing a failure of the standard-setter, it is the creation and use of a structured transaction undertaken with purpose and intent to obfuscate, conceal and/or deceive that reduces transparency, not the standards themselves. Issuers, auditors, and advisors who work to implement transactions that are structured in ways that attempt to portray the transactions differently from their substance do not operate in the interests of investors, and may be in violation of the securities laws.<sup>222</sup> Underscoring the seriousness of the problems caused by accounting-motivated transaction structures, the Commission has recently entered into settlements with several entities that engaged in the development or facilitation of transaction structures.<sup>223</sup>

The Staff believes that the significant use of accounting-motivated transactions has contributed to a reduction in the transparency and credibility of financial statements.

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<sup>221</sup>Thus, we do not mean to include situations where, for example, an issuer increases its sales efforts at the end of a period to generate revenue. In that situation, the reporting of revenue would generally mirror the economics if additional sales are generated. Such situations may, however, result in the need for explanatory disclosures, particularly in MD&A.

<sup>222</sup>See Release No. 34-49695, Policy Statement: Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities

<sup>223</sup>See Commission Press Releases SEC Charges Merrill Lynch, Four Merrill Lynch Executives with Aiding and Abetting Enron Accounting Fraud (where Merrill Lynch simultaneously settles charges for permanent anti-fraud injunction and payment of \$80 million in disgorgement, penalties and interest) (2003-32); SEC Settles Enforcement Proceedings against J.P. Morgan Chase and Citigroup (where J.P. Morgan Chase agrees to pay \$135 million to settle Commission allegations that it helped Enron commit fraud and Citigroup agrees to pay \$120 million to settle Commission allegations that it helped Enron and Dynegy commit fraud) (2003-87); see also American International Group, Inc. Agrees to Pay \$126 Million to Settle Fraud Charges Arising Out of Its Offer and Sale of An Earnings Management Product (2004-163).



In addition, transaction structuring has substantially contributed to the complexity of accounting and reporting standards in certain areas, a point we address immediately below.

## **B. Continue Implementation of Objectives-Oriented Approach to Standard Setting**

In many areas of accounting, including several of the areas discussed in Section III, the accounting and reporting standards are complex. While complexity is not in-and-of-itself a bad thing, and in some cases may be necessary, it nevertheless typically entails added cost. On July 25, 2003, the Commission released a Staff study on the adoption by the U.S. financial reporting system of a principles-based accounting system.<sup>224</sup> The Staff recommended therein that FASB more consistently develop accounting standards on a principles-based or “objectives-oriented” basis, as defined in the study. The FASB has indicated that it “agrees with the recommendations” of the study.<sup>225</sup> The results of the current Study of off-balance sheet arrangements have only served to reinforce the Staff’s previous conclusion of the importance of taking an objectives-oriented approach to standard setting.

As noted in Section I above, the Objectives-Oriented Accounting Standards Study recommended that accounting standards should be developed using an objectives-oriented approach and that such standards should have the following characteristics:

- Clearly state the accounting objective of the standard with the objective incorporated in the standard;
- Minimize the use of exceptions from the standard;
- Avoid use of percentage tests (“bright-lines”) that allow financial engineers to achieve technical compliance with the standard while evading the intent of the standard;
- Be based on an improved and consistently applied conceptual framework; and
- Provide sufficient detail and structure so that the standard can be operationalized and applied on a consistent basis.

Objectives-oriented standards would clearly establish the objectives for a class of transactions—and incorporate those objectives as an integral part of the standard itself. Under an objectives-oriented approach, preparers would be held responsible to present financial statements that are in accordance with the substantive accounting objectives built into the pertinent standards. Moreover, under an objectives-oriented approach, the cost to investors and analysts of comprehending the standards themselves should be lower. Indeed, ideally, an investor or analyst could obtain a reasoned conceptual understanding of the meaning of reported numbers by simply studying the stated

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<sup>224</sup>The study was conducted pursuant to the provisions of Section of the Sarbanes-Oxley Act. See Objectives-Oriented Accounting Standards Study.

<sup>225</sup>FASB Response to SEC Study on the Adoption of a Principles-Based Accounting System, July 2004.

objectives of the pertinent standards. That is, under an objectives-oriented regime, each standard’s stated objective assists the user in comprehending how the standard is constructed, how it is to be applied to a class of transactions or events, and how those transactions or events should be reflected in the financial statements. This intuitive coherence serves to enhance transparency.

As noted in the previous study, rules-based standards “further a need and demand for voluminously detailed implementation guidance on the application of the standard, creating complexity in and uncertainty about the application of the standard.” For example, the derivatives accounting guidance is often criticized as being excessively long and overly complex, but much of that guidance is devoted to determining whether an instrument qualifies for one of the exceptions from the definition of derivative, or one of the exceptions in the application of hedge accounting. Objectives-oriented standards that rely on a coherent and consistent conceptual framework with less bright lines and fewer exceptions may allow a significant reduction in complexity of the accounting guidance.

Moreover, rules-based standards can provide a roadmap to avoidance of the accounting objectives inherent in the standards. Internal inconsistencies, exceptions and bright-line tests reward those willing to engineer their way around the intent of standards. This can result in financial reporting that is inconsistent and not representationally faithful to the underlying economic substance of transactions and events.<sup>226</sup> For example, with respect to securitizations, current standards allow issuers to structure transactions to achieve desired accounting results—that is, either sale or borrowing treatment for the items being securitized—for what are economically similar transactions. Other examples of accounting-motivated structured finance transactions are discussed throughout this Report.

Again, it is tempting to look to the accounting standard-setter for progress towards objective oriented standards. However, while the FASB must be a driver of greater use of objectives-oriented standards and the accompanying reduction in complexity of the guidance, they cannot do it alone. Other parties must also be committed to these goals in order to make them a reality. As noted in the previous study, the complexity in current standards exist in large part due to requests for guidance from preparers and auditors, due to exceptions to basic principles that were requested by preparers or others in the financial reporting process, and due to concerns about litigation that might stem from standards that require a greater use of judgment on the part of management and auditors. It is important that all participants in the financial reporting process do their part to reduce complexity in financial reporting by being willing to apply (and accept) reasonable judgments.

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<sup>226</sup>For example, as indicated in Batson’s Second Interim Report, “Enron’s intimate knowledge and carefully calculated application and manipulation of the GAAP rules ... provided a leading example of how abuse of the rules-based approach to GAAP standard setting can result in reported financial results materially different from the underlying substance of the transactions reported.” Batson’s Second Interim Report, Appendix B (Accounting Standards), page 12.

### **C. Improve the Consistency and Relevance of Disclosures**

As discussed in Section II above, the basic financial statements themselves cannot convey all of the relevant information about an issuer's rights, obligations, and transactions. Disclosures outside of the basic financial statements are necessary to complement that information in order to enhance the decision-usefulness of financial reporting. In the process of conducting this Study, including the gathering of empirical data, the Staff observed that the quality of the information presented in some areas varies greatly from issuer to issuer, and among topical areas. Some of these issues are mentioned in the subsections of Section III dealing with empirical data, as the Staff noted that it was not able to comprehensively compile data in certain areas.

In addition, the Staff observed that disclosures sometimes appear haphazard, with the disclosures required by each rule or standard developed independent of other disclosures. While it was observed that disclosures made by issuers did in fact often provide information about the potential variability of estimates, alternate measurement attributes, assumptions used by management, and detail of summarized financial statement captions, it was not always clear why particular disclosures were included in various situations, or, in some cases, what the purpose of the disclosures was.

Indeed, both users and preparers in various industries have stated that they believe that disclosures in the area of financial instruments, among others, do not provide a complete or meaningful picture for investors. The Staff believes that it is important that issuers take the time and make the effort to prepare disclosures in a meaningful way and to provide sufficient disclosures to allow investors to understand the substance of the issuer's situation and activities.<sup>227</sup>

### **D. Improve Communication Focus in Financial Reporting**

An unfortunate effect of the large volume and complexity of financial reporting requirements is that many accountants, lawyers, and others seem to view the goal of financial reporting as achieving technical compliance with the rules without regard to communicating effectively to investors. As we have noted, the Staff believes the goal is to communicate effectively to investors while complying with the rules.

The Commission has previously noted the importance of clear communication in financial reports. Perhaps most notable were the efforts to achieve greater use of "plain English" in filings. The Commission issued rules in this area in 1998, noting in the release that:<sup>228</sup>

Full and fair disclosure is one of the cornerstones of investor protection under the federal securities laws. If a prospectus fails to communicate

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<sup>227</sup> Cf. Exchange Act Rule 12b-20 which states that "In addition to the information expressly required to be included in a statement or report, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made not misleading."

<sup>228</sup> See Release No. 33-7497, Plain English Disclosure (January 28, 1998)

information clearly, investors do not receive that basic protection...A major challenge facing the securities industry and its regulators is assuring that financial and business information reaches investors in a form they can read and understand.

The plain English rules require the use of short sentences, everyday language, and tabular presentation of complex information, amongst other things. Despite these and other efforts to encourage better communication, the Staff believes that a substantial number of issuers continue to focus the bulk of their efforts on technical compliance with the rules, rather than true communication.

While this mindset is certainly not limited to off-balance sheet issues or the types of transactions discussed in this Report, it does manifest itself in the volume of accounting motivated transaction structures and in disclosures that may provide certain required data, but remain insufficient to permit a true understanding of the issuer's activities or position. No matter how many improvements are made to accounting standards, financial reporting will continue to suffer if it remains an accepted premise by some practitioners that efforts to avoid the intent of standards while maintaining seeming technical, minimal compliance with the letter of those standards are acceptable.<sup>229</sup>

A stronger focus on communication with readers should also have the effect of making financial reports easier to understand and digest. Turning again to the example of financial instrument disclosures, the Staff noted during its work on the Study and Report that even where significant information was available in filings, it was often spread in several places, and there was little explanation of how the various disclosures related to each other or to the amounts reported in the financial statements.

If all participants in the process came at financial reporting with a view of complying with the objectives of the guidance and clearly and transparently communicating material information to investors, significant improvements would occur even if none of the other recommendations in this Report were to be adopted. Conversely, the focus on seeming technical compliance results in a tendency to only make improvements when new rules or standards require those improvements. This burdens the standard-setters with the responsibility for driving all improvements, and investors with the responsibility for deciphering reports that are not written clearly.

Changing this situation will not be a short-term proposition. However, opportunities to improve exist, and most of the opportunities depend on the actions and intentions of issuers. The Commission and the Staff will continue to attempt to assist. For example, recent Commission rules that require auditors to make audit committees aware of situations where management has chosen a less preferable method of accounting may help preparers and auditors identify opportunities to improve.<sup>230</sup> The recent

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<sup>229</sup>Notably, proof of compliance with GAAP does not imply that an issuer or auditor acted in good faith and that the "facts as certified were not materially false or misleading." See U.S. v. Simon 425 F.2d 796.

<sup>230</sup>Release No. 33-8183, Strengthening the Commission's Requirements Regarding Auditor Independence; Section 210.2-07 Communication with audit committees

interpretive release on MD&A information also provides various suggestions to improve the quality and transparency of these disclosures.<sup>231</sup>

The Staff is also exploring the ways that technology can help to provide information to investors that is easier to use and understand, and that increases the ability to make comparisons across companies. Among other things, the Commission is implementing a voluntary program to allow issuers to file certain information using XBRL, which may facilitate the analysis of financial information by users.<sup>232</sup> It is hoped that preparers and users will take advantage of this program to identify the most useful information to provide in this format, including information relating to the arrangements discussed in this Report. The Staff will continue to explore ways to encourage better and more useful disclosures. However, efforts in this area will have a much greater chance of success with the commitment of preparers to communicate with investors in the most effective ways possible.

## **VI. Recommendations Related to Accounting Standards**

The recommendations below represent suggestions for changes in accounting and reporting standards that we believe have the greatest potential to result in improved transparency. It is important to note that all of the standards that currently exist were actively debated and discussed when they were set, and were subject to an open and deliberative process. The Staff believes that this process has worked well, and is the appropriate process by which improvements to the existing standards should be considered and developed. Furthermore, by including these recommendations, the Staff does not mean to suggest the primary responsibility for improvements in reporting rests solely with the FASB. Rather, the recommendations are meant in part to make clear to readers of this Report the kinds of changes which would likely flow from attempts by the FASB to help achieve the goals discussed in Section V. In each case, the recommendations speak directly to issues of transparency the Staff identified during its work in preparing this Report.

### **A. Standards on Accounting for Leases**

Lease accounting has been identified repeatedly as an area that should be reexamined by the FASB.<sup>233</sup> The current “all or nothing” lease accounting guidance is not designed to reflect the wide continuum of lease arrangements that are used, and

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<sup>231</sup>Release Nos. 33-8350; 34-48960 Interpretation: Commission Guidance Regarding Management’s Discussion and Analysis of Financial Condition and Results of Operations FR 72.

<sup>232</sup>Release Nos. 33-8529, 34-51129, 25-27944, 39-2432, IC-26747 XBRL Voluntary Financial Reporting Program on the EDGAR System

<sup>233</sup>See, for example, AICPA’s Special Committee on Financial Reporting, Improving Business Reporting—A Customer Focus (Dec. 1994) (discussion of users’ concerns with accounting and disclosures on long term leases); Robert C. Lipe “Lease Accounting Research and the G4+1 Proposal” Accounting Horizons (Sept. 2001); Dennis W. Monson “The Conceptual Framework and Accounting for Leases” Accounting Horizons (Sept. 2001) (Notes that “there is virtually universal agreement that SFAS No. 13 fails to achieve its stated objectives and needs to be reconsidered.”)

therefore, it cannot transparently and consistently reflect the varying economics of the underlying arrangements. In addition, the Staff is aware that sophisticated users, such as credit-rating agencies, often adjust balance sheets in their work so they can analyze companies as if all leases were reflected on the balance sheet. A project on lease accounting would be consistent with several of the goals described above in Section V.

The lease accounting standards rely extensively on bright lines, greatly increasing the potential for similar arrangements to be portrayed very differently. Indeed, for a lessee, the accounting can flip between recording no assets and liabilities at lease inception to recording the entire leased asset and entire loan price with only a very small change in economics. As discussed previously, the bright line tests have served to facilitate significant structuring of leases to obtain particular financial reporting goals. The extensive structuring further erodes the effectiveness of the standards.

Some have suggested that lease accounting should focus on contractual cash inflows and outflows<sup>234</sup> in determining the amount of assets and liabilities to record on entities' balance sheets. Lease accounting methods based on cash flows would generally require both parties in lease agreements to report their economic interests in the leased assets as well as assets and/or liabilities related to payments mandated by the lease agreement. The FASB, as part of a group of standard setters known as the G4+1,<sup>235</sup> has considered, in some depth, such approaches in the past.<sup>236</sup> The Staff believes that these approaches, among others, remain worthy of further consideration.

In suggesting that the FASB should undertake a project to reconsider the standards for accounting for leases, the Staff does not mean to suggest that such a project would be simple. Leases can have many different terms, including contingent rents, optional extensions, penalty clauses, purchase options, and others that each will require consideration in any project. The challenges in developing an approach that considers each of these terms in a conceptually consistent way are not insignificant. Furthermore, it is likely that a project on lease accounting would generate significant controversy; many issuers see leasing as an attractive form of financing asset acquisition in part because leases can be structured so as to avoid recording debt. For these reasons, a project on lease accounting would also likely take a significant amount of time as well as necessitate a substantial commitment of FASB staff resources. Nonetheless, the Staff believes that the potential benefits in terms of increased transparency of financial reporting would be substantial enough to justify the time and effort required.

The project to reconsider the accounting for leases may be most effective if conducted as a joint project with the International Accounting Standards Board ("IASB").

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<sup>234</sup>See SFAC No. 1, paragraph 37.

<sup>235</sup>Members of the G4+1 included the Australian Accounting Standards Board, the Canadian Accounting Standards Board, the International Accounting Standards Committee, the New Zealand Accounting Standards Review Board, the New Zealand Financial Reporting Standards Board, the United Kingdom Accounting Standards Board and the United States Financial Accounting Standards Board.

<sup>236</sup>See Financial Accounting Series Special Report: Accounting for Leases: A New Approach, July 1996 and Financial Accounting Series Special Report: Leases: Implementation of a New Approach, February 2000.

The IASB's standards are widely used outside of the United States. In an area as pervasive as leasing, it would be beneficial to have similar accounting standards be used around the world to the greatest extent possible.

## **B. Standards on Accounting for Defined-Benefit Retirement Arrangements**

The accounting for defined-benefit retirement arrangements provides a good example of a situation in which different accounting is achieved solely due to the form of arrangement used. An issuer could meet its pension obligations by paying them out as they become due, and funding those payments from assets held by the issuer. If it did so, the assets would be accounted for like any other assets held by the issuer, and the obligation would be estimated and accrued like any other long-term compensation arrangements. As discussed above, most U.S. companies choose instead to fund their retirement arrangements by setting up separate entities for their pension plans and funding those plans. Although the company generally has almost the same risks and rewards and much of the same level of control over the assets and obligations whether they are in a separate plan or not, the accounting changes completely if a plan is used. The FASB itself questioned whether the accounting guidance that addresses defined-benefit pension plans is sufficiently transparent, as pointed out in SFAS No. 87:

The Board believes that it would be conceptually appropriate and preferable to recognize a net pension liability or asset measured as the difference between the projected benefit obligation and plan assets, either with no delay in recognition of gains and losses, or perhaps with gains and losses reported currently in comprehensive income but not in earnings.

The Staff believes that a project that would reconsider the accounting for defined-benefit pension plans is warranted.

The Staff believes that such an effort would further several of the initiatives discussed previously in Section V. First, the accounting for defined-benefit pension plans deviates from the accounting required for other business and compensation arrangements, even when the economics are similar. While issues such as how to most appropriately measure the pension obligation and report pension items in the income statement should be considered, the Staff believes that work on the accounting for defined-benefit plans should also focus on those areas that are inconsistent with the accounting for similar items in other areas, including:

- Consolidation—Given the fact that the plan sponsor generally controls and is subject to the vast majority of the risks and rewards of the pension plan, there is not an obvious conceptual reason why the plan should not be consolidated, especially since other trusts used to fund liabilities typically are consolidated. In addition, the consolidation exemption results in a very different financial statement presentation based on whether a separate entity is used to manage the retirement benefits. While separate plans are common in the U.S. because of employment and tax laws, laws in other jurisdictions vary, again raising the possibility of different accounting for similar transactions.

- Deferral of Actuarial Gains and Losses—It is not clear why changes in estimates related to retirement obligations should not be treated in the balance sheet the same way as changes in estimates related to other obligations. Changes in estimated amounts to be paid on obligations other than retirement obligations almost invariably are recognized immediately as an adjustment to the recorded liability, while such changes are permitted to be deferred and recognized over time when they relate to defined-benefit pension plans.
- Valuation of Assets—The guidance for valuing assets of retirement plans and recognizing related gains and losses is not consistent with the guidance that applies to other entities. As the sponsor of a defined-benefit plan is affected by the gains and losses on pension plan assets in almost the same way as it is affected by gains and losses on other investments, this distinction appears questionable.<sup>237</sup>

The Staff also believes that the complex series of smoothing mechanisms, and the disclosures to explain them, render financial statements more difficult to understand and reduce transparency. SFAS No. 87 does require certain disclosures that help explain the effect of SFAS No. 87's many netting and smoothing provisions. In this case, however, the disclosures seem designed to compensate for less than desirable accounting. A recent FASB project revised the disclosure requirements to provide even more information.<sup>238</sup> While the disclosures are quite detailed, the Staff notes that it has long been accepted that “good disclosure doesn't cure bad accounting.”<sup>239</sup> The combination of the accounting and disclosure provisions contribute to the length and complexity of financial statements, a common complaint among users and preparers alike. Revisions to the guidance that eliminate optional smoothing mechanisms would allow significant reduction in disclosures without a loss of important information.

Much like the recommendation to undertake a project on lease accounting, it is likely that a project on pension accounting would generate significant controversy. Indeed, it was such controversy that caused the FASB to deviate from its preferred accounting when it promulgated SFAS No. 87. Nevertheless, the Staff believes that a project on pension accounting should be undertaken when resources permit. Like lease

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<sup>237</sup>This does not necessarily suggest that all assets of retirement plans should be recorded at fair value, as this is not always the treatment that applies outside of retirement plans. See SFAS No. 115 and APB No. 18.

<sup>238</sup>See Statement of Financial Accounting Standard No. 132 (revised 2003): Employers' Disclosures about Pension and Other Postretirement Benefits—an amendment of FASB Statement No. 87, 88, and 106 (issued 12/2003). According to the FASB, the “Statement was developed in response to concerns expressed by users of financial statements about their need for more information about pension plan assets, obligations, benefit payments, contributions, and net benefit cost.” See FASB Summary of Statement No. 132 (revised 2003) at FASB.org web site.

<sup>239</sup>Remarks by Michael H. Sutton, Chief Accountant, U.S. Securities and Exchange Commission, to American Institute of Certified Public Accountants 1996 Twenty-Fourth Annual National Conference on Current SEC Developments, December 10, 1996.



accounting, the Staff believes that a pension accounting project may be most effective if conducted as a joint project with the IASB, for similar reasons.

### **C. Continue Work on Consolidation Policy**

Individual decisions relating to which entities should be reflected in the consolidated financial statements of an issuer—that is, decisions relating to determining the “reporting entity”—can create much more significant differences than individual decisions about how to report particular transactions. This is because the consolidation decision determines whether all of the assets and liabilities of another entity should be included in the financial statements instead of one asset representing the issuer’s investment in the other entity. As noted in Section III above, the consolidation decision is typically based on whether or not control exists, with the determination of control generally based on legal ability to control the entity. However, it is possible to effectively control an entity without having legal control. An issuer that owns 49% of the voting shares of an entity whose shares are otherwise widely distributed would almost certainly be able to set policy for that other entity, but currently would not be deemed to control that other entity for accounting purposes.

The FASB previously considered replacing legal control as the trigger for consolidation with standards that focus on what has been called “effective control.”<sup>240</sup> A consolidation standard based on effective control would seek to identify characteristics of control other than a majority voting interest, in order to ensure that all entities for which the issuer can direct policy and make decisions are included in the issuer’s consolidated financial statements.

While the FASB discontinued its broad project on effective control, Interpretation No. 46(R) is an attempt to deal with SPEs by creating a consolidation test for those entities that is meant to identify which entity has the majority of the exposure to variations in performance and in turn effective control. However, because that test is so different from the test used to determine consolidation of other entities, a new series of structures that straddle the lines between consolidation approaches has sprung up, and various structures have been designed to work around the guidance in Interpretation No. 46(R). The Staff believes that more time should be taken to evaluate the results of Interpretation No. 46(R) and to allow the development of interpretive guidance that may assist in its application. Several projects currently being undertaken by the EITF and the FASB staff may provide such guidance.

Clearly, the current consolidation guidance is complicated, despite the consistent objective of requiring consolidation when an investor controls another entity. The Staff believes additional standard setting efforts related to consolidation should be focused on whether there are ways to achieve the objectives with less complex guidance. In addition, once the questions regarding Interpretation No. 46(R) have been more fully addressed, the FASB may also wish to consider whether it should again explore the use of effective, rather than legal, control to guide all consolidation decisions. Finally,

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<sup>240</sup>See Exposure Draft, Proposed Statement of Standards: Consolidated Financial Statements: Policy and Procedures, (1996).

additional work holds the promise of promoting further convergence between of consolidation guidance in US GAAP and the consolidation guidance in the IASB's standards.

#### **D. Continue to Explore the Feasibility of Reporting All Financial Instruments at Fair Value**

Whether financial instruments are reported at fair value or not is obviously not a question of whether they are on or off the balance sheet. However, the Staff believes that the issue of whether particular financial instruments are reported at fair value is related to a number of the topics discussed in this Report, and is directly related to a number of the goals discussed in Section V.

Questions of whether to record assets and liabilities based on their historical costs or their current market values ("fair value") have long been high profile issues in the financial reporting world. Supporters of greater use of fair values in the balance sheet argue that the most useful information is that which reflects the current value of the issuer's assets and obligations, as this represents the "opportunity cost" of the resources being used by the issuer. As previously discussed, GAAP requires a mix of historical costs and fair values on the balance sheet—what is often termed a "mixed-attribute model." Derivative assets and liabilities are generally recorded at their fair values. Financial assets are often reflected at fair value, although there are significant exceptions. Non-financial assets are generally reflected at historical cost, but are also generally subject to an impairment test that is based in part on fair value. Both financial and non-financial liabilities are generally recorded based on their historical basis, with accretion over time to their final settlement values. For certain instruments, the accounting is dependent upon the issuer's intent or policy elections. In an extreme example, an issuer could conceivably own three of the exact same corporate debt instruments, and account for each in a different manner. This mixed-attribute model has developed in part because of concerns as to whether fair value information is reliable enough to be included in the balance sheet and income statement, and in part because of disagreements regarding the relevance of fair value information.

The mixed-attribute model has prompted a significant amount of accounting-motivated transaction structures. For example, as noted above, some sales of financial assets seem motivated primarily by a desire to recognize gains that could not otherwise be recognized, by selling (at least for accounting purposes) receivables, available-for-sale securities, cost method investments, or other financial assets that are not recognized at fair value with changes recorded in earnings. Others seem designed to change the assets' form into assets with a different measurement basis in order to minimize income statement volatility, match the measurement basis of assets with that of liabilities, or for other reasons. Similarly, investments in the stock of other entities are often designed to either achieve or avoid use of the equity method of accounting. In many of the accounting-motivated transactions noted above, the motivation for the transaction or the structuring could be essentially eliminated if all financial instruments were recorded at fair value.

In addition, fair value accounting for all financial instruments would reduce the complexity of financial reporting. Investors would not have to study the accounting

guidance or the choices made by management to determine what basis of accounting is used for particular instruments. Further, fair value hedge accounting would no longer be needed if all financial instruments were recorded at fair value, as the gains and losses would naturally offset each other to the extent the hedges were effective. This would eliminate the related documentation, record keeping, and other associated issues. In addition, fair value accounting for all financial instruments would eliminate the need to bifurcate and separately value derivatives embedded in financial instruments, as the accounting would be the same for both the host instruments and the derivative. Users of financial statements would be spared from having to comprehend a complicated set of rules regarding which financial instruments are at fair value and which are at historical cost.

As discussed above, fair value accounting for all financial instruments would appear to have benefits in terms of reduced complexity, more understandability, and less motivation to structure transactions to meet accounting goals. In addition, many believe that fair value is simply the most relevant measure for financial instruments.<sup>241</sup> There are, however, significant concerns with requiring fair value accounting for all financial instruments including:

- Relevance—Some supporters of historical cost measurements “believe that amortized cost provides relevant information because it focuses on the decision to acquire the asset, the earning effects of that decision that will be realized over time, and the ultimate recoverable value of the asset. Among other things, many argue that this is particularly valuable information in monitoring the performance of management. They argue that fair value ignores those concepts and focuses instead on the effects of transactions and events that do not involve the enterprise, reflecting opportunity gains and losses, whose recognition in the financial statements is, in their view, not appropriate until they are realized.”<sup>242</sup>
- Reliability—“Opponents of fair value reporting also challenge the subjectivity that may be necessary in estimating fair values and question the usefulness of reporting fair values for securities if they are not readily marketable.”<sup>243</sup>
- Manipulability—When applied to instruments without readily available markets, some are concerned that management may be able to use fair value estimates to manage earnings, inflate reported equity, or otherwise deceive users as to the value of the company.<sup>244</sup>

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<sup>241</sup>For example, paragraphs 39 – 50 of SFAS No. 107 discuss the relevance of fair value information. It states in part in paragraph 41, “Information about fair value better enables investors, creditors, and other users to assess the consequences of an entity’s investment and financing strategies, that is, to assess its performance.”

<sup>242</sup>SFAS 115, paragraph 42.

<sup>243</sup>SFAS 115, paragraph 43.

<sup>244</sup>As Paton and Littleton (1940, 65) write: “The process of measuring periodic income involves the division of the stream of costs incurred between the present and the future.” They also write: “In general,

The Staff appreciates these concerns, and acknowledges, in particular, the concern about the potential manipulation of fair value measurements, which has been a part of some of the recent financial reporting scandals. However, in light of the potential benefits, the Staff believes that exploration of ways to eliminate the obstacles to fair value accounting for financial instruments is warranted.

Of course, the broad issue of the reliability of fair value measurements will continue to be a concern. The Staff notes, however, that it is now possible to reliably value many instruments that could not be reliably valued in the past. The continued development of financial markets should further expand the types of instruments for which reliable information on fair value is available. In addition, the FASB plans soon to issue a document that includes better guidance on fair value measurement than previously existed.<sup>245</sup> This should help to encourage convergence of practices in this area.

One of the other significant obstacles to reporting financial instruments at their fair values in the balance sheet is their treatment in the income statement. Many believe that income statements become too difficult to understand if changes in the value of reported assets and liabilities attributable to market fluctuations are combined with changes in assets and liabilities related to business transactions. Some believe that holding gains and losses are simply of a different character than transactional gains and losses. Others believe that investing and financing activities should not be combined with operating activities. Still others believe that unrealized and realized gains and losses are different in character and should not be combined. There are also those who would prefer that gains and losses related to highly subjective estimates be reported separately from those related to measurements that are more certain.

Indeed, the ability to differentiate changes in equity that have these various characteristics in different combinations could be useful to users in understanding the results of operations and in evaluating the company's ability to generate cash flows in the future. The FASB and IASB currently have a joint project on Reporting Financial Performance that could address this issue.<sup>246</sup> The Staff has encouraged the two Boards to

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the only definite facts available to represent exchange transactions objectively and to express them homogeneously are the price-aggregates involved in the exchanges; hence such data constitute the basic subject matter of accounting." Paton, W. A. and A.C. Littleton, 1940, at 7, An Introduction to Corporate Accounting Standards, American Accounting Association, Sarasota, FL. Ijiri (1975) emphasizes that historical cost is consistent with accountability, because it is both hard (difficult to manipulate) and tracks managements' actual decisions rather than would-be decisions tracked by fair values. (On the other hand, one might argue that to choose to not enter into a transaction that would serve to convert an asset into its fair value also constitutes a decision. To wit, a decision to incur that opportunity cost. Such a decision, and its measurement by means of fair value, might be of interest to investors.)

<sup>245</sup>The FASB issued an Exposure Draft of a proposed statement, Fair Value Measurements, on June 23, 2004. The comment period ended on September 7, 2004 and on September 21, 2004, the FASB held a public roundtable meeting. The FASB is currently deliberating both the results of the comment letters received and the roundtable discussions. A final pronouncement is currently expected to be released during the second quarter of 2005.

<sup>246</sup>The first meeting of the joint international group on performance reporting took place on January 13-14, 2005. The FASB and IASB anticipate that an initial public discussion document in the form of a

focus on this project, consider the various views discussed, and devise ways to report changes in values of assets and liabilities that are consistent and transparent and best facilitate appropriate analysis of reported results.<sup>247</sup>

Another important, and related, issue is to determine whether changes in an issuer's own credit risk should be reflected in the reported value of that issuer's financial instruments. This possibility raises concern because the effect of an increase in the issuer's credit risk would be to reduce the value of liabilities reported, resulting in an increase in equity (and, potentially, income). This result seems counterintuitive to many. The FASB has recently decided to specifically consider this issue.<sup>248</sup>

The Staff hopes to promote further discussions regarding the use of fair value in the coming year.

### **E. Develop a Disclosure Framework**

The disclosures in the notes to the financial statements are a critically important complement to the financial statements and are necessary to achieve transparency in financial reporting. Based on this Study, as well as experience with issuer filings, the Staff believes that disclosures can be improved. First, as discussed above, the Staff believes that disclosures could be improved if issuers were to seek to achieve the goal of communicating with investors, rather than focusing principally on technical compliance with rules and regulations.

The Staff also believes that more useful and consistent disclosure requirements for the notes to the financial statements could be achieved if a disclosure framework were developed that set forth the objectives to be used in these disclosures. Currently, the FASB's conceptual framework does not contain a substantial amount of guidance related to the notes to the financial statements. As a consequence, disclosure guidance tends to vary from standard to standard. A project directed at developing a framework for use in determining the content of notes to the financial statements might consider, for example, whether (and if so, when) the following goals—each of which is evident in certain currently required disclosures—are appropriate.<sup>249</sup>

- Provide information about alternative measurement attributes;

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Preliminary Views will be issued in late 2005. For more information about the project status see the Project Updates section at [www.fasb.org](http://www.fasb.org)

<sup>247</sup>For example, the IASB has considered a matrix format income statement that includes rows organized into categories of: "business", "financing", "tax" and "discontinued operations". The columns include: "total," "before re-measurements," and "re-measurements." International Accounting Standards Board, 2003, IASB Project Summary: Reporting Comprehensive Income.

<sup>248</sup>The FASB is currently considering adding a project to its agenda that would amend SFAS No. 133 addressing whether an issuer's own credit risk should be considered when measuring derivative liabilities at fair value. While this proposed project is narrow in that it relates only to derivative liabilities, the same issue would also apply to other issuer liabilities that are measured at fair value. Accordingly, the Staff believes that the FASB will likely consider this issue in other projects where fair value is the measurement attribute for the liability

<sup>249</sup>The list is not intended to be all-inclusive.

- Explain the nature and extent of uncertainty in the reported figures;
- Allow users to recompute certain items using different assumptions than those used by management;
- Make it more difficult for management to engage in financial fraud;
- Allow comparisons between issuers that have chosen different accounting policies;
- Explain the sensitivity of the issuer's results to various risks;
- Provide detailed breakdowns of certain financial statement captions;
- Explain the issuer's future cash requirements;
- Highlight the impact of unusual or non-recurring events;
- Disaggregate the issuer's results;
- Explain how management's intentions affected the reported financial position and results of operations; and
- Confirm compliance with GAAP.

Disclosure relating to financial instruments, including derivatives, in particular, could be improved through consistent objectives and principles. Changing the disclosure requirements for financial instruments would not require changes in recognition and measurement. Indeed, assets and liabilities could be carried on the books under the same principles as before. Disclosures about fair values will be informative to users, even in cases where there is variation inherent in the valuation (so long as it is disclosed that there is variation in the valuation). The Staff notes that the IASB has recently proposed/promulgated guidance in this area that could be used as a starting point for work in this area in the U.S.<sup>250</sup>

In order to stimulate thought and discussion, we identify below some possibilities for financial instrument disclosures that arose from the Staff's work in preparing this Report, as well as its work reviewing filing and following the IASB's project on financial instrument disclosures that is referred to above:

- Carrying value as of balance sheet date;
- Explanation of changes in carrying value since last balance sheet date;
- Fair market value as of balance sheet date (include range as well as point estimate);
- Changes in fair market value since last balance sheet date;

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<sup>250</sup>See International Accounting Standards Board Exposure Draft ED 7 Financial Instruments: Disclosures July 2004.

- Description of valuation methods, including what proportions were valued based on the different types of inputs, as well as description of significant assumptions (and possibly access to example/actual valuation models);
- Related derivative positions as of balance sheet date;
- Fair value of related derivative positions as of balance sheet date;
- Description of income statement impact;
- Sensitivity of fair value and income to changes in significant underlying variable(s) without considering related derivative positions; and
- Sensitivity of fair value and income to changes in significant underlying variable(s) net of related derivative positions.

By highlighting potential objectives for disclosures in the notes to the financial statements and explaining what factors might influence the decision as to which objectives should drive disclosure requirements in a particular standard, the addition of disclosure guidance to the FASB's conceptual framework could drive more consistent disclosures across various accounting issues, while helping users to understand why certain disclosures are included in financial statements. The Staff has suggested to the FASB that adding disclosures to its conceptual framework would be helpful.

Of course, insights generated by the development of such a disclosure framework might also lead to recommendations from the Staff regarding the Commission's regulatory disclosure requirements. Indeed, some of the objectives noted above, each of which is evident in the disclosure requirements for notes to the financial statements in some areas, are also objectives of MD&A or other regulatory disclosure requirements. As such, the Staff would be willing to work closely with the FASB in its development of a disclosure framework, in order to consider whether complementary changes to the Commission's disclosure requirements would generate further improvement as well as to ensure that disclosure is provided in the most appropriate location, whether it be in notes to the financial statements, MD&A or in some other location.