CHAPTER 1

U.S. SOX Section 401: Off-Balance Sheet Arrangements

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INTRODUCTION[1]

Christopher Cox replaced William Donaldson as SEC Chairman in 2005. Since assuming his chairmanship, Cox has advocated a rethinking of regulations, arguing that they are overly complex and this complexity is partly to blame for the accounting scandals of the 1990s. Maybe the best evidence of this is the convoluted and confusing regulations and guidance around off-balance sheet (OBS) arrangements. This chapter will detail the current state of the U.S. regulations. It appears that the current regulations invite abuse and misunderstanding, and do not assure investors that Enron-type abuses are a thing of the past.

Section 401 of the Sarbanes-Oxley Act of 2002 requires the listing of off-balance sheet (OBS) arrangements, transactions, and obligations (including contingent obligations) that may have a material effect, current or future, on financial conditions, changes in financial results in operations, liquidity capital expenditures, capital resources, or significant components or revenues or expenses. The SEC final ruling requires the disclosure of "the nature and business purpose of the OBS arrangements, why and how they are needed in running a business." For those wondering why this is an area of concern, a one-word explanation should suffice—Enron. It was Enron's horrible abuse, and Arthur Andersen's blessing such OBS arrangements, that led to the most infamous and globally recognized scandal in a generation.

The problems stem from the complexity and resulting confusion in how to account for OBS arrangements. Unfortunately, the SEC has not simplified the process to the extent to preclude significant abuse.

Even a process as seemingly straightforward as procurement is given alternative interpretations. With U.S. GAAP's taking a rules-based approach (as opposed to principles-based as favored by the International Financial Reporting Standards (IFRS)), it is curious how rules and guidance can be issued which are not clear and straightforward. One cynical interpretation is that the complexity is by design serving those who make their living interpreting the regulations and those using the complexity of the regulations to minimize their tax exposure. A less cynical interpretation is that U.S. tax law continues to evolve to the point that even the brightest financial experts struggle in understanding it.

After reading this section, ask yourself if these regulations are straightforward enough to assure their consistent application by companies of all sizes and complexities and to avoid Enron-type abuses of the past.

The following are some simple examples of OBS obligations that may need to be accounted for:

- **Long-Term Purchase Agreements**: Common practice is to use long-term purchase agreements to assure a reliable source of supply for goods and services at the lowest price. Many companies are moving their direct material programs to Vendor/Supplier Managed Inventory (VMI) programs, which are controlled by long-term purchase agreements. Section 401 clearly requires a time-phased listing of obligations (Year 1, Years 2–3, etc.) in a tabular format specified by the SEC.
- **Cancellation and Restocking Charges**: Though the SEC is clear in defining the requirement to list time-phased obligations, restocking and cancellation charges are not mentioned specifically in Section 401 but are listed as new triggering events requiring an 8-K filing "any material early termination penalties" under Section 409. Most long-term agreements include such provisions. Though the SEC's intent is unclear, a company suffering a major downturn and paying restocking and/or cancellation charges will have trouble defending not listing these as OBS obligations.
- **Lease Agreements**: In addition to the aforementioned items, Capital and Operating Lease obligations should be listed as OBS obligations. Fees incurred due to early termination of agreements will need to be accounted for as well.

Even more complex is the requirement to account for contingent OBS obligations. The SEC provides an instruction "that a company must provide the disclosure required regarding off-balance sheet arrangements, whether or not the company is also a party to the transaction or agreement creating the contingent obligation arising under the off-balance sheet arrangement. In the event that neither the company nor any affiliate of the company is a party to the transaction or agreement creating the contingent obligation arising under the off-balance arrangement in question, the four-business-day period for reporting the event under this item would begin on the earlier of

- The fourth business day after the contingent obligation is created or arises, and
- The day on which an executive officer of the company becomes aware of the contingent obligation."

This has major ramifications for those enterprises that sell through channel partners with indirect channel sales agreements. OBS obligations may exist for consignment inventory, returns, rebate programs with volume incentives, warranty, special pricing agreements, and so on. Contingent OBS obligations may come into play for those who have outsourced manufacturing, distribution/logistics, and design.

Obviously stung by the terrible abuses of Enron, the SEC has laid out a comprehensive process for companies to explain OBS transactions and obligations.

The SEC's definition of OBS arrangements addresses certain guarantees that may be a source of potential risk to a company's future liquidity, capital resources, and results of operations, regardless of whether or not they are recorded as liabilities. The SEC has ruled that this may include "contracts that contingently require the guarantor to make payments to the guaranteed party based on another entity's failure to perform under an obligating agreement (e.g., a performance guarantee)."

Accounting for OBS arrangements is not enough. The SEC has ruled that companies will have to explain the nature and business purpose of such arrangements. "The disclosure should explain to investors why a company engages in off-balance sheet arrangements and should provide the information that investors need to understand the business activities advanced through a company's off-balance sheet

arrangements. For example, a company may indicate that the arrangements enable the company to lease certain facilities rather than acquire them, where the latter would require the company to recognize a liability for the financing. Other possible disclosures under this requirement may indicate the off-balance sheet arrangement enables the company to obtain cash through sales of groups of loans to a trust; to finance inventory, transportation, or research and development costs without recognizing a liability; or to lower borrowing costs of unconsolidated affiliates by extending guarantees to their creditors."

The SEC requires companies to explain the impact on their "liquidity, capital resources, market risk support, credit risk support or other benefits. This disclosure should provide investors with an understanding of the importance of off-balance sheet arrangements to the company as a financial matter . . . . Together with the other disclosure requirements, companies should provide information sufficient for investors to assess the extent of the risks that have been transferred and retained as a result of the arrangements."

The SEC goes further. "In addition, the disclosure should provide investors with insight into the overall magnitude of a company's off-balance sheet activities, the specific material impact of the arrangements on a company, and the circumstances that could cause material contingent obligations or liabilities to come to fruition. Disclosure is required to the extent material and necessary to investors' understanding of

- The amounts of revenues, expenses, and cash flows of the company arising from the arrangements,
- The nature and total amount of any interests retained, securities issued and other indebtedness incurred by the company in connection with such arrangements, and
- The nature and amount of any other obligations or liabilities (including contingent obligations or liabilities) of the company arising from the arrangements that is, or is reasonably likely to become, material and the triggering events or circumstances that could cause them to arise."

DEFINITION OF OBS ARRANGEMENTS[2]

The SEC has defined the term OBS arrangement as "any transaction, agreement or other contractual arrangement to which an entity that

is not consolidated with the company is a party, under which the company, whether or not a party to the arrangement, has, or in the future may have:

- Any obligation under a direct or indirect guarantee or similar arrangement,
- A retained or contingent interest in assets transferred to an unconsolidated entity or similar arrangement,
- Derivatives, to the extent that the fair value thereof is not fully reflected as a liability or asset in the financial statements, and
- Any obligation or liability, including a contingent obligation or liability, to the extent that it is not fully reflected in the financial statements (excluding the footnotes thereto)."

In particular, the proposals require a disclosure where the likelihood of the occurrence of a future event implicating an OBS arrangement or its material effect was higher than remote. As mentioned above, the SEC noted, "the disclosure threshold departed from the existing MD&A threshold, under which a company must disclose information that is 'reasonably likely' to have a material effect on financial condition, changes in financial condition or results of operations." While this is an improvement, there is still an ambiguity as to the dividing line between "reasonably likely" and "remote."

The SEC requires disclosure of enumerated items only "to the extent necessary to an understanding of the company's off-balance sheet arrangements and their effect on financial condition, changes in financial condition and results of operations." Specifically, the SEC requires a company to disclose

- "The nature and business purpose of the company's off-balance sheet arrangements;
- The significant terms and conditions of the arrangements;
- The nature and amount of the total assets and of the total obligations and liabilities of an unconsolidated entity that conducts off-balance sheet activities;
- The amounts of revenues, expenses and cash flows, the nature and amount of any retained interests, securities issued or other indebtedness incurred, or any other obligations or liabilities (including contingent obligations or liabilities) of the company

arising from the arrangements that are, or may become, material and the circumstances under which they could arise;

- Management's analysis of the material effects of the above items, including an analysis of the degree to which the company relies on off-balance sheet arrangements for its liquidity and capital resources or market risk or credit risk support or other benefits; and
- A reasonably likely termination or material reduction in the benefits of an off-balance sheet arrangement and any material effects."

The SEC specifies the need to account for "amounts of a company's known contractual obligations, aggregated by type of obligation and by time period in which payments are due." The SEC rejects requests to exclude "purchase orders and contracts for goods and services in the ordinary course of business." It requires "disclosure of the amounts of a company's purchase obligations without regard to whether notes, drafts, acceptances, bills of exchange, or other commercial instruments will be used to satisfy such obligations because those instruments could have a significant effect on the company's liquidity."

The SEC specifies that the categories of contractual obligations partly include

- Long-term debt obligations,
- Capital lease obligations,
- Operating lease obligations,
- Purchase obligations, and
- Other long-term liabilities reflected on the company's balance sheet under its Generally Accepted Accounting Principles (GAAP).

OBS ENTITIES[3]

In 2005, the SEC issued its "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," which added much needed clarification and expanded examples for purchase orders, leases, derivatives, and contingent OBS obligations. The SEC's introduction underscores the complexity around OBS: "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."

The 2005 SEC Report and Recommendations provide much needed additional background on OBS entities and obligations. The SEC's initial ruling was weak in providing examples and scenarios. "Companies have used off-balance-sheet entities responsibly and irresponsibly for some time. These separate legal entities were permissible under Generally Accepted Accounting Principles (GAAP) and tax laws so that companies could finance business ventures by transferring the risk of these ventures from the parent to the off-balance-sheet subsidiary. This was also helpful to investors who did not want to invest in these other ventures."

In a major understatement, the SEC noted in its 2005 Report that Enron and similar scandals have given OBS a bad reputation as 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."

The SEC defends OBS by noting that "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 are addressed in its 2005 Report. According to the SEC, the common characteristic of OBS is their creation of a condition "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."

The SEC describes how OBS can refer to many things: including separate legal entities, i.e., separate companies of which the parent holds less than 100% ownership, or contingent liabilities such as letters of credit or loans to separate legal entities that are guaranteed by the parent. Under U.S. GAAP, these items can be excluded from the parent's financial statements, but usually they must be described in footnotes. Ironically, Enron did list their OBS arrangements, but their implications were missed by Arthur Andersen and the SEC.

While U.S. GAAP and U.S. tax laws do allow off-balance-sheet entities for valid reasons, they can be abused by those wishing to hide obligations and thus overstate earnings. In the case of Enron, OBS vehicles were used to grossly inflate financial results by fraudulently creating earnings to cover bad trades.

The SEC defines a balance sheet as portraying the financial position of an organization at a point in time. It is made up of three basic components:

1. Assets, which are 'probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events';
2. 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'; and
3. Equity, which is 'the residual interests in the assets of an entity that remains after deducting its liabilities.'"

Liabilities or Equity

Though the SEC's definition appears straightforward, many questions and issues exist in determining which items should be captured on the balance sheet. "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."

Examples of off-balance obligations include purchase orders, leases, derivatives, and contingent OBS, which we will describe in greater detail.

PURCHASE ORDERS[4]

In its 2005 Report the SEC explains that a purchase obligation could be as simple as a standard one-time purchase order, or as complex as long-term contracts for goods and services for deliveries over an extended period. The major accounting and regulator issue is around the rights and obligations inherent in a contract, and when they take effect—upon signing, or later when performance against the contract occurs.

"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."

This seems straightforward until the SEC explains the contrary view: "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." With this approach assets and liabilities would not 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." The problem with the SEC's explanation is that nothing is mentioned about the obligations in canceling the contract or purchase agreement.

The SEC explains exceptions to this approach. "Two of the major exceptions are addressed in separate sections of this 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, and when a long-term construction contract is expected to result in a loss."

In January 2002, the SEC 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 OBS arrangements, including certain contractual obligations. Specifically, these new rules require tabular disclosure in Management Discussion and Analysis (MD&A) of contractual obligations, including open purchase orders, which will result in future cash payments.

This disclosure is intended to provide financial statement users with information about unrecognized and recognized obligations. Though 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.

OBS Issues in Accounting for Contractual Obligations

The SEC provides for ways to account for unperformed contractual obligations. "For example, all contractual rights and obligations could be recognized as assets and liabilities. 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."

Unfortunately, the SEC's guidance may provide too many options and add to the confusion in how to account for OBS arrangements: "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 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. 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."

The SEC Report and Recommendations does discuss the potential confusion: "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."

LEASES[5]

In its 2005 "Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act," the SEC defines leases as follows: "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 . . . ." SFAS No. 13, Accounting for Leases (issued in 1976), provides the basic guidance for leases. "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. 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."

Capital and Operating Leases

The SEC explains the difference between rental leases and capital leases: "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'. 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 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;
- 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.

The SEC does discuss the potential confusion and potential for errors in accounting for leases: "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. 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."

OBS Issues in Accounting for Leases

Compliance Week reported in its May 2005 issue that lease-related problems accounted for about one quarter of April's material weaknesses, up from 10% in March. Many of these stemmed from a letter by the SEC's chief accountant, Donald T. Nicolaisen, to a professional accounting group. The letter was written after a wave of restatements to correct lease-related accounting errors, reiterated the rules. According to *Compliance Week*: "The letter focused on three issues related to lease accounting: depreciation of the costs to improve leased property, how to recognize periods of free or reduced rent, and how to account for landlord incentives to make improvements."

The SEC explains that OBS issues arise from the contractual obligations that leases impose and "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 . . . . 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 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."

The SEC does acknowledge the complexity and potential for errors: "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."

DERIVATIVES[6]

In its 2005 "Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act," the SEC references Robert L. McDonald, (Derivatives Markets, 2003) to explain derivatives as "simply a financial instrument (or even more simply, an agreement between two people) which has a value determined by the price of something else. For example, a stock option contract derives its value, at least in part, from the price of the underlying stock; similarly, a gold futures contract derives its value from the price of the underlying gold; an interest rate swap derives its value from the underlying interest rates . . . 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. 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."

The current accounting guidance for derivatives has been in effect since 2001. It was a much needed update to an outdated accounting standard that the SEC maintains did not keep pace with changes in global financial markets and related financial innovations. According to the SEC, the current financial reporting for derivatives centers around three main issues:

1. Should derivative contracts be recognized on issuer balance sheets?
2. Should the changes in the value of derivative contracts be recognized in the income statement?
3. How should the overall sensitivity of the issuer to changes in important variables be conveyed?

Accounting for Derivatives

The SEC explains the accounting for derivatives as follows: "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. 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)."

Hedge Accounting

The SEC explains hedge accounting of derivates as follows: "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." The SEC notes that the core principle under SFAS No. 133 is to recognize changes in the value of derivatives in the income statement, but it also provides for an exception 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."

CONTINGENT OBS OBLIGATIONS[7]

In its 2005 Report on Section 401, the SEC describes contingent OBS obligations as "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 an organization which is:

- A party in a lawsuit and any payment is contingent upon the outcome of a settlement or an administrative or court proceeding;
- Providing a warranty for goods and services sold in which payment is contingent on the number of items that actually become defective and qualify for benefits under the warranty
- Acting as a guarantor on a loan for another organization and payment is contingent on whether the other organization defaults.

All these are examples of contingent OBS that present the potential for confusion, errors, and fraud. The issue is what, if any, liability should be recognized before such contingencies are resolved. The SEC notes that SFAS No. 5, Accounting for Contingencies, provides guidance for contingent OBS treating them in one of three ways. To begin with, a decision is made as to whether the loss itself is deemed "probable" to occur and whether the loss amount is estimable. Recognition of a liability is required if the loss is deemed probable and estimable.

No contingent OBS liability is recognized on a balance sheet, but financial reporting must note the existence of the potential loss if it is probable but the amount is not easily estimated, or if the loss is reasonably possible, but not probable. Of course the thresholds for "reasonable" and "probable" are not easily quantified and very much open to interpretation, which will be discussed in the next section.

The SEC acknowledges the lack of a consensus in how to handle OBS issues: "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."

OBS Issues in Accounting for Contingent Obligations and Guarantees

The key issue in contingent liabilities is how to account for uncertainty. The SEC notes, "If uncertainty is taken into account in the recognition of liabilities . . . 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."

But the SEC acknowledges that this treatment creates several issues: "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."

It is ironic that the SEC is so open in admitting to potential for abuse and errors in its treatment of contingent OBS. The SEC acknowledges the problems in relying on what may be a subjective management analysis of whether a loss is probable. This makes the audit process very difficult as well.

The SEC's Section 401 Report discusses their long-term advocacy of improvements in OBS reporting. Some of this is the obvious embarrassment over the Enron scandal in which OBS and SPEs were used to hide a majority of the firm's debt. The outrageous abuse of OBS arrangements and obligations and its certification by Arthur Andersen stand as one of the most embarrassing failures in regulations in U.S. corporate history. Ironically, the SEC does not reference any comments it made advocating improvements in OBS accounting prior to Enron.[8]

Sadly, after all the reports and recommendations by the SEC, there is little to prevent the continued abuse of OBS and SPEs. The rules are so complex that unethical companies have a great deal of weasel room to hide problems and inflate earnings. For ethical organizations, the rules are open to conflicting interpretations for even processes as straightforward as purchasing.

ENDNOTES

1. This section extensively quotes and references the SEC's "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."

2. This section extensively quotes and references the SEC's "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."
3. This section extensively quotes and references the SEC's "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."
4. This section extensively quotes and references the SEC's "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."
5. This section extensively quotes and references the SEC's "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."
6. This section extensively quotes and references the SEC's "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."
7. This section extensively quotes and references the SEC's "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."
8. SEC "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."