

Off-Balance Sheet Update

31 July 2002

On Tuesday, 30 July 2002 President Bush signed the Public Company Accounting Reform and Investor Protection Act of 2002.¹ Certain provisions of the new law arguably pose a threat to the use of off-balance sheet accounting treatment for many types of financial transactions including swaps, other derivatives, synthetic leases, and securitizations. In this brief report, our focus is on securitizations.

Section 401(a) of the new law will require companies to disclose all material off-balance sheet transactions in quarterly and annual reports. The S.E.C. has until late January 2003 to promulgate rules implementing the new requirement. The relevant language reads as follows:

SEC. 401. DISCLOSURES IN PERIODIC REPORTS.

(a) DISCLOSURES REQUIRED- Section 13 of the Securities Exchange Act of 1934 (15 U.S.C. 78m) is amended by adding at the end the following:

* * *

'(j) OFF-BALANCE SHEET TRANSACTIONS- Not later than 180 days after the date of enactment of the Public Company Accounting Reform and Investor Protection Act of 2002, the Commission shall issue final rules providing that each annual and quarterly financial report required to be filed with the Commission shall 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.'

In addition, section 401(c) of the new law requires the S.E.C. to study the question of whether generally accepted accounting standards fairly address off-balance sheet transactions. The S.E.C. has one year to complete the study after it promulgates new rules covering off-balance sheet transactions and an additional six months to prepare a report of the study's findings. That means that the outer limit for delivery of the report will be around mid-2004. The relevant language reads as follows:

(c) STUDY AND REPORT ON SPECIAL PURPOSE ENTITIES-

(1) STUDY REQUIRED- The Commission shall, not later than 1 year after the effective date of adoption of off-balance sheet disclosure rules required by section 13(j) of the Securities Exchange Act of 1934, as added by this section, 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

(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.

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¹ Pub. L. No. 107-2___, H.R. 3763, 107th Cong., 2d Sess. (2002).

(2) REPORT AND RECOMMENDATIONS- Not later than 6 months after the date of completion of the study required by paragraph (1), the Commission shall 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.

Section 401(c) reveals that Congress is generally dissatisfied with the present treatment of off-balance sheet transactions under GAAP. However, it is not clear whether that dissatisfaction extends to the treatment of securitization transactions, particularly asset-backed commercial paper programs and collateralized debt obligations.²

An important potential effect of the new law is that it may influence the view of the Financial Accounting Standards Board (FASB) as it grapples with off-balance sheet accounting issues on its own. In light of the new law, it is somewhat more likely than before that FASB will adopt a tough stance on the issue of consolidating special purpose entities under FAS 94.³

Although the S.E.C.'s ultimate findings potentially could lie anywhere along a wide spectrum of possible outcomes, it seems reasonable to expect the S.E.C. to avoid extreme positions. Accordingly, we expect the S.E.C. ultimately to take a position that preserves off-balance sheet accounting treatment for common types of securitizations backed by static, liquidating pools of mortgage loans and auto loans. For other types of deals, we feel the future accounting treatment is much less certain.⁴

² U.S. Fixed Income Research Mid-Year Review: *Tale of Two Cities*, Nomura Fixed Income Research at 15-17 (July 2002).

³ *Id.*

⁴ See generally *Accounting vs. Reality: Can We Handle the Truth?*, Nomura Fixed Income Research (16 April 2002); *Thirty Years Later Securitization Is Still Good for America*, Nomura Fixed Income Research (15 March 2002).

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