

the latest fiscal year end balance sheet date. The disclosure will be included in the MD&A section of a public company's annual reports, quarterly reports, registration statements and proxy and information statements.

A. Need for the Amendments

On July 30, 2002, the Sarbanes-Oxley Act of 2002 was enacted.¹⁸¹ Section 401 of the Sarbanes-Oxley Act, entitled "Disclosures in Periodic Reports," requires the Commission to adopt final rules by January 26, 2003 (180 days after the date of enactment) that require a company, in each annual and quarterly financial report that it files 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."¹⁸² The Commission is adopting the amendments to fulfill that legislative mandate. The amendments address the lack of transparency of off-balance sheet arrangements in a public company's financial disclosure. The amendments address this problem by requiring a discussion of off-balance sheet arrangements in a public company's MD&A. The potential consequences of not taking this action to require disclosure regarding the off-balance sheet arrangements are: (a) Less transparency in the presentation of companies' financial statements and, correspondingly, a lesser understanding of companies' financial condition, changes in financial condition and results of operations when making investment decisions; and (b) a potential decrease in investor confidence in the full and fair disclosure system that is the hallmark of the U.S. capital markets.

The amendments seek to improve transparency of a company's off-balance sheet arrangements and aggregate contractual obligations. We believe that improvements in the quality of information in these areas will promote investor understanding of a company's current and future financial position. Our objectives are:

- To implement the legislative mandate in section 401(a) of the Sarbanes-Oxley Act;

- To provide investors with the information and analysis necessary to gain a more comprehensive understanding of the implications of a company's obligations and contingencies from off-balance sheet arrangements that are neither readily apparent, nor easily understood, from a reading of the financial statements alone; and

- To better inform investors of the aggregate impact of short- and long-term contractual obligations, from both on- and off-balance sheet activities, by presenting a complete picture in a single location.

With a greater understanding of a company's off-balance sheet arrangements and contractual obligations, investors will be better able to understand how a company conducts significant aspects of its business and to assess the quality of a company's earnings and the risks that are not apparent on the face of the financial statements.

B. Significant Issues Raised by Public Comment

The Initial Regulatory Flexibility Analysis ("IRFA") appeared in the Proposing Release. We requested comment on any aspect of the IRFA, including the number of small entities that would be affected by the proposals, the nature of the impact, how to quantify the number of small entities that would be affected and how to quantify the impact of the proposals. We received no comment letters responding to that request.

C. Small Entities Subject to the Amendments

The amendments would affect companies that are small entities. Securities Act Rule 157¹⁸³ and Exchange Act Rule 0-10(a)¹⁸⁴ define a company, other than an investment company, to be a "small business" or "small organization" if it had total assets of \$5 million or less on the last day of its most recent fiscal year. We estimate that there are approximately 2,500 companies, other than investment companies, that may be considered small entities. The amendments would apply to any small entity that fulfills its disclosure obligations by complying with our standard disclosure requirements¹⁸⁵ or with our optional disclosure system available only to small businesses.¹⁸⁶

We believe that off-balance sheet arrangements involving small entities are most likely to be operating leases, but we did not receive any comments substantiating that belief. In our Paperwork Reduction Act analysis, we estimated that the cost of in-house staff time would translate into an approximate cost of \$4,000 per company.¹⁸⁷ This figure may be lower for a small entity if its average hourly cost for its personnel were lower than \$125, but we did not receive any specific data regarding these estimates. We also estimated that companies would spend approximately \$5,000 per company on outside professionals to comply with the disclosure.¹⁸⁸ This figure may be lower for a small entity if its average hourly cost of outside professionals were lower than \$300, but we did not receive any substantiating data.

D. Projected Reporting, Recordkeeping and Other Compliance Requirements

The amendments will impose reporting and recordkeeping requirements on the class of small entities subject to our reporting requirements, either due to Securities Act registration or by the Exchange Act reporting requirements. The amendments will subject this class of small entities to reporting and recordkeeping requirements in connection with drafting, reviewing, filing, printing and disseminating disclosure in annual reports, registration statements, proxy or information statements and quarterly reports. The data underlying the disclosure about off-balance sheet transactions should be readily available from a company's books and records. Since management should be fully apprised of material off-balance sheet arrangements to fulfill its existing disclosure requirements and to maintain proper internal controls, the amendments may not impose significant incremental costs related to the collection and calculation of data. Small entities will either utilize existing personnel or hire an outside professional to provide the required disclosure.

¹⁸⁷ We estimate the average hourly cost of in-house personnel to be \$125. This cost estimate is based on data obtained from *The SIA Report on Management and Professional Earnings in the Securities Industry* (Oct. 2001).

¹⁸⁸ To derive our estimates for the Paperwork Reduction Act, we multiplied the number of filers for each form by the incremental hours per form. The portion of the product carried by the company is reflected in hours and the portion carried by outside professionals is reflected as a cost.

¹⁸¹ Pub. L. 107-204, 116 Stat. 745 (2002).

¹⁸² Pub. L. 107-204 Sec. 401 [15 U.S.C. 78m(j)].

¹⁸³ 17 CFR 230.157.

¹⁸⁴ 17 CFR 270.0-10(a).

¹⁸⁵ Regulation S-K, 17 CFR 229.10-229.1016.

¹⁸⁶ Regulation S-B, 17 CFR 228.10-228.701.