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In This Issue:

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SEC to Open the Curtains on "Window Dressing"

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Introduction

On September 17, 2010, the SEC unanimously approved a proposed rule, *Short-Term Borrowings Disclosure*, to address temporary declines in short-term borrowings — usually around a period-end — commonly referred to as "window dressing." In part, the measures in the proposed rule result from (1) liquidity issues caused by certain transactions involving repurchase agreements known as "Repo 105" transactions; (2) SEC inquiries earlier this year of registrants to understand the types, extent of use, and accounting for repurchase agreements and other similar transactions; and (3) the SEC's conclusion that there was insufficient disclosure related to these types of transactions and other similar arrangements.

The proposed rule would require registrants to disclose more information about their short-term borrowing arrangements and therefore help investors better understand a registrant's financings during a period as well as at period-end. The SEC also issued a companion release, *Commission Guidance on Presentation of Liquidity and Capital Resources Disclosures in Management's Discussion and Analysis*, which provides interpretive guidance intended to improve the overall discussion of liquidity and capital resources in MD&A.

Although short-term borrowings are often considered a good indicator of a registrant's liquidity, period-end amounts often do not give investors enough information about potential areas of concern. Because such borrowings are short term, a registrant's use of them may fluctuate greatly during a reporting period, especially during periods of illiquidity as were seen during the recent financial crisis. The enhanced disclosures aim to improve transparency and give investors the information they need to understand how registrants finance their operations. The objective of both the proposed rule and the interpretive guidance is to address divergent practices in liquidity and capital resources disclosures and improve the discussion of liquidity and funding risks to which the registrant is exposed.

Key Provisions of the Proposed Rule

The proposed rule:

- Creates a new subsection within the liquidity and capital resources disclosures in MD&A consisting of (1) tabular information about short-term borrowings and (2) an analysis of such information.
- Expands the applicability of disclosure requirements related to short-term borrowings from bank holding companies[1] to all registrants.

[1] As defined in Section 2 of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(p)).

- Requires intraperiod disclosures of maximum and average short-term borrowings.
- Requires quarterly reporting of short-term borrowings in addition to annual disclosures.

Proposed Disclosures Related to Short-Term Borrowings

Currently, Item 303 of Regulation S-K requires registrants to consider short-term borrowings as part of their discussion of known material changes, trends, or uncertainties that result in or are reasonably likely to result in material changes to their liquidity. Bank holding companies are subject to additional short-term borrowings disclosures under the SEC's "Industry Guide 3, Statistical Disclosure by Bank Holding Companies" ("Guide 3"). The proposed rule would significantly increase the disclosures required for short-term borrowings for all registrants under Item 303 of Regulation S-K.

The proposal defines "short-term borrowings" as follows:

> [A]mounts payable for short-term obligations that are:
>
> - federal funds purchased and securities sold under agreements to repurchase;
> - commercial paper;
> - borrowings from banks;
> - borrowings from factors or other financial institutions; and
> - any other short-term borrowings reflected on the registrant's balance sheet. [Footnote omitted]

The proposed requirements "do not include a quantitative threshold for purposes of disaggregating amounts into categories of short-term borrowing."

The proposed requirements "do **not** include a quantitative threshold for purposes of disaggregating amounts into categories of short-term borrowing" (emphasis added). This represents a departure from Guide 3, which permits bank holding companies to aggregate categories that do not exceed certain thresholds. In aggregating, a registrant would also need to consider interest rate and currency differences, and it would need to disaggregate when necessary to promote an investor's understanding or prevent the information from being misleading.

Quantitative Disclosures

The proposed rule requires registrants to provide the following quantitative disclosures in a tabular format in the new subsection within the liquidity and capital resources discussion in MD&A:

- The balance for each short-term borrowing category at period-end and the weighted average interest rate for those borrowings.
- The average balance for each short-term borrowing category for the reporting period (including the weighted average interest rate).
- The maximum balance for each short-term borrowing category for the period (daily maximum for financial companies, month-end maximum for all other registrants).

Qualitative Disclosures

In addition to the quantitative disclosures, registrants are required under the proposed rule to disclose qualitative information within MD&A, including:

- A general description and the business purpose for the arrangements within each short-term borrowing category.
- The importance of short-term borrowing arrangements and how these arrangements affect funding of a registrant's operations and its risk-management activities (e.g., "liquidity, capital resources, market-risk support, credit support or other benefits").
- The rationale or context for the maximum level reported for the period as well as significant fluctuations between average short-term borrowings for the period and the balance at period-end.

Financial Companies

The proposal defines a financial company as an entity "engaged to a significant extent in the business of lending, deposit-taking, insurance underwriting or providing investment advice, or is a broker or dealer as defined in Section 3 of the Exchange Act." Because financial companies are more likely to invest the borrowed funds to generate earnings, the SEC determined that the addition of daily information would be meaningful.

Editor's Note: The proposed rule does not provide a specific threshold or define "to a significant extent." If the rule is finalized as proposed, a registrant will need to exercise judgment in this area and should discuss its conclusions with its legal adviser.

Registrants With "Mixed" Operations

In some cases, the nature of a registrant's operations may be both financial and nonfinancial, such as a manufacturing company with a subsidiary that provides financing to its customers to purchase its products. The proposed rule acknowledges that for such registrants, the costs of providing disclosures about short-term borrowings for the entire company could outweigh the benefit to investors. Accordingly, the proposal allows such registrants to provide separate disclosures for its financial operations and nonfinancial operations.

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Applicability and Reporting Periods

The proposed rule's requirements would apply to quarterly and annual reports and registration statements as follows:

- *Annual reporting* — For annual reports, three years of annual disclosures and fourth-quarter disclosures would be required. For registration statements, all registrants are expected to include disclosure of short-term borrowings for the most recent three fiscal years and the corresponding interim information in a manner consistent with general MD&A requirements and instructions to the relevant registration statement. For registrants not subject to Guide 3, the proposal also includes transition provisions to phase in comparative information over a three-year period until three years are reported.
- *Interim reporting* — For interim reporting under the proposed rule, the same level of disclosure would be required as that for annual reporting. In addition, registrants would be required to identify material changes. For quarterly reports, the proposal requires short-term borrowings disclosure information only for the relevant quarter; it does not require comparative data.

The proposed rule includes certain exceptions for smaller reporting companies, such as the ability to (1) exclude the fourth-quarter disclosure in the annual report and (2) limit interim reporting requirements to disclosure of material changes when they have occurred or are likely to result in material change. Further, the proposed rule would apply to foreign private issuers other than filers of Form 40-F under the U.S. Canadian Multijurisdictional Disclosure System.

Leverage Ratio

Currently, bank holding companies are required to disclose certain capital and leverage ratios in accordance with ASC 942-505[2]-50. The SEC staff has also noted that some bank holding companies include these ratios in their MD&A and discuss material changes in these ratios. The proposed rule requests feedback on whether investors of nonbank holding companies would benefit from similar disclosures and the types of metrics or ratios that should be disclosed.

[2] FASB Accounting Standards Codification Subtopic 942-505, *Financial Services — Depository and Lending: Equity.*

Interpretive Release on Liquidity and Capital Resources Disclosures

As the complexity and types of financing activities used by registrants increase, it becomes increasingly important that the disclosures in MD&A give investors meaningful information about a registrant's liquidity and funding risks. The interpretive release clarifies the SEC's guidance on liquidity, leverage ratios, and the table of contractual obligations.

Liquidity Disclosures

The release reiterates the need for registrants to focus on transparent disclosures that allow an investor to understand a registrant's business from management's perspective. It highlights three specific items for registrants to consider in preparing MD&A:

- When borrowings during a reporting period are materially different from the amount reflected in the financial statements at a period-end, whether disclosure of these variations is necessary for an investor to understand the liquidity position.
- For repurchase transactions or other transfers of financial assets accounted for as sales, any obligation and potential exposure, including whether the transaction did, or is reasonably likely to, result in the registrant's liquidity materially increasing or decreasing.
- Cash management and risk management policies that would help provide context about and facilitate an understanding of the registrant's financial condition.

The release reiterates the need for registrants to focus on transparent disclosures that allow an investor to understand a registrant's business from management's perspective.

Leverage Ratio Disclosures

The release also reminds registrants that when they use a capital or leverage ratio in their filings, they should include a clear explanation of the calculation method they used and explain why the ratio helps investors understand their financial condition.

Contractual Obligations Table Disclosures

The interpretive release does not provide guidance on determining whether items should be included in the table of contractual obligations or on how such obligations should be allocated over the periods shown in the table. It notes that the requirements of Item 303(a)(5) of Regulation S-K were intentionally written to give registrants a great deal of flexibility in presenting meaningful information. It also notes that the intent of these disclosures is "to provide aggregated information about contractual obligations and contingent liabilities and commitments in a single location so as to improve transparency of a registrant's short-term and long-term liquidity and capital resources needs and to provide context for investors to assess the relative role of off-balance sheet arrangements." Registrants are therefore encouraged to develop a presentation method that is transparent, easily understandable, and appropriate to their situation.

Next Steps

Comments on the proposed rule are due to the SEC within 60 days after the proposal's publication in the *Federal Register*. The guidance in the interpretive release will be effective immediately upon its publication in the *Federal Register*.

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