

Off-Balance Sheet Arrangements and Contractual Obligations

As part of its implementation of the Sarbanes-Oxley Act of 2002, the Securities and Exchange Commission has recently adopted final rules increasing the transparency of a registrant's off-balance sheet arrangements and contractual obligations. Release No. 33-8182 (Jan. 27, 2003) <http://www.sec.gov/rules/final/33-8182.htm>. The final rules expand the management's discussion and analysis section (MD&A) of a public company's disclosure to include new information regarding off-balance sheet arrangements and require a tabular summary of contractual obligations.

Background

In recent years, corporate scandals at Enron and elsewhere have focused national attention on the use of off-balance sheet arrangements to avoid disclosure and thus potentially distort public perception of a company's financial health. Section 401(a) of the Sarbanes-Oxley Act called on the SEC to develop additional disclosure requirements in this area.

The SEC proposed new requirements for disclosures of off-balance sheet arrangements and contractual obligations in November 2002. Release No. 34-8144 (Nov. 4, 2002) <http://www.sec.gov/rules/proposed/33-8144.htm>. Although several provisions were narrowed in response to the 48 public comments submitted, the central features of the proposals remain intact.

The final rules take effect on April 7, 2003.¹ The new disclosure requirements concerning off-balance sheet arrangements apply to registration statements, annual reports and proxy or information statements that must include financial statements for fiscal years ending on or after June 15, 2003. The new requirement for a table of contractual obligations applies to registration statements, annual reports and proxy or information statements that must include financial statements for the fiscal years ending on or after December 15, 2003. Earlier compliance is permitted.²

Off-Balance Sheet Arrangements

How Are "Off-Balance Sheet Arrangements" Defined?

The final rules in this area define off-balance sheet arrangements by focusing on the types of obligations or interests which companies usually use to structure off-balance sheet transactions or to take on other risks which may not be apparent on the face of a

¹ These final rules amend Item 303 of Regulation S-K (and Regulation S-B), Item 5 of Form 20-F, and General Instruction B of Form 40-F under the Securities Exchange Act of 1934.

² The SEC issued a statement in January 2002 with guidance on additional factors that management should weigh with respect to certain MD&A disclosure requirements. These final rules will supercede the guidance in that statement regarding disclosure of off-balance sheet arrangements and contractual obligations, on their respective compliance dates.

company's balance sheet. The definition includes any contractual arrangement³ with an unconsolidated entity under which the registrant has any of the following:

- an obligation under specified types of guarantee contracts;
- an arrangement (e.g., a retained or contingent interest in assets) that provides credit, liquidity or market risk support to the unconsolidated entity;
- an obligation under specified types of derivative instruments; and
- an obligation that is material to the registrant and arises from a variable interest where the entity assists the registrant with financing, liquidity, market risk or credit risk support, or where such an entity cooperates in leasing, hedging, or research and development services.

When Must Disclosures Be Made?

The final rules require companies to disclose those off-balance sheet arrangements “that have or are reasonably likely to have a current or future effect on the registrant’s financial condition, changes in financial condition, revenues or expenses, results of operation, liquidity, capital expenditures or capital resources that is material to investors.” This requirement applies to both U.S. companies and foreign private issuers that file their annual reports on Form 20-F or Form 40-F. Prior to this final rule, disclosure of off-balance sheet arrangements has been covered only by general MD&A requirements to disclose arrangements that are “reasonably likely” to have a material effect on the company’s financial condition, changes in financial condition or results of operations.⁴

Management must apply the threshold in three steps. First, it must identify and analyze its off-balance sheet arrangements, including the four types described above. Second, it must assess the probability that any known trend, demand, commitment, event or uncertainty that could affect an off-balance sheet arrangement will actually occur. If management finds that such an event is not reasonably likely to occur, then nothing need be disclosed in MD&A. Third, if management cannot reach that conclusion, it must assume that the known trend, demand, commitment, event or uncertainty will occur and evaluate the consequences. Management must then disclose, unless it determines that a material effect is not reasonably likely.

What Must the Disclosure Contain?

A registrant must disclose information to the extent needed to understand its material off-balance sheet arrangements and their material effects. Such disclosure must include the following:

- the nature and business purpose of the off-balance sheet arrangements;
- their importance to the registrant for liquidity, capital resources, market or credit risk support or other benefits;

³ Because the definition covers only contractual arrangements, the new disclosure obligation arises only if there is an unconditionally binding definitive agreement (except for the usual closing conditions) or if the transaction has occurred.

⁴ The proposed rule had a disclosure threshold based on whether the likelihood that an off-balance sheet arrangement “may” have a material effect that was more than “remote.” Discussion about that threshold figured prominently in the open meeting at which this rule was proposed and later in comment letters. The concession to a “reasonably likely” standard was among the most significant in the final rule.

- their financial impact on the registrant and the risks to which they expose the registrant;⁵ and
- known events, demands, commitment, trends or uncertainties that affect their availability or benefit to the registrant.

How Must the Disclosure Be Presented?

Disclosures about off-balance sheet arrangements must be presented in a separate section of the MD&A, set apart by its own caption. The SEC's adopting release says these arrangements should be aggregated in a way that minimizes repetition and immaterial information. The language and format should be succinct and comprehensible to readers other than just accountants, financial analysts and industry experts. To avoid redundancy with generally accepted accounting principles (GAAP) disclosure requirements, the final rules allow a registrant to insert into the MD&A discussion a cross-reference to information in the footnotes of the financial statements. The cross-reference must be to particular footnote information and integrate its essence into the MD&A discussion in a way that conveys its significance.

Table of Contractual Obligations

Under existing rules, disclosure of certain contractual obligations may be scattered throughout a company's filings. The final rules require registrants to consolidate information about specified categories of contractual obligation into a single tabular presentation in the MD&A section. This disclosure requirement applies to all registrants, including foreign private issuers, except for small business issuers.

What Types of Contractual Obligations Are Covered?

The proposed rules merely suggested categories of contractual obligations to be included in the table, but the final rules specify the following five mandatory categories:

- long-term debt obligations;
- capital lease obligations;
- operating lease obligations;
- purchase obligations; and
- other long-term liabilities reflected on the registrant's balance sheet under GAAP.⁶

⁵ This includes disclosure regarding the following:

- revenues, expenses and cash flows of the registrant that arise from off-balance sheet arrangements;
- the nature and amounts of interest retained, securities issued and other indebtedness incurred by the registrant in connection with off-balance sheet arrangements; and
- the nature and amounts of other obligations or liabilities (including contingent ones) of the registrant that arise from off-balance sheet arrangements (that are material or reasonably likely to become so) and the circumstances that could trigger those contingencies.

⁶ The final rules define the first four categories, incorporating by reference financial accounting standards promulgated by the Financial Accounting Standards Board.

The SEC rejected suggestions to narrow the scope of covered obligations (1) by excluding commercial instruments or ordinary course items, (2) by limiting items to those reflected in financial statements or notes under GAAP, or (3) by inserting a materiality threshold. The SEC had proposed a requirement that *contingent* liabilities and commitments be disclosed as well but decided not to include it in the final rules pending further consideration.

How Must Covered Contractual Obligations Be Presented?

The required table may be located wherever the registrant deems appropriate within the MD&A section. It need not appear under a separate caption. The information must be presented in a single table, aggregated by type of contract and by payment period, and must be current as of the latest fiscal year-end balance sheet date. The final rule requires that the format substantially resemble the following:

	Payments due, by period				
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Contractual Obligations					
Long-Term Debt					
Capital Lease Obligations					
Operating Leases					
Purchase Obligations					
Other Long-Term Liabilities Reflected on the Registrant's Balance Sheet under GAAP					
Total					

The specified categories may be split or supplemented to suit a company's business, as long as all the obligations that fit these five categories are included somewhere.

Safe Harbor for Forward-Looking Information

Some of the disclosure required by these final rules will entail forward-looking information. The final rules create a safe harbor for such information by expressly applying the statutory safe harbors contained in § 27A of the Securities Act of 1933 and in § 21E of the Exchange Act. These statutory safe harbors protect registrants against private suits relating to alleged misstatements or omissions. To be safely within the statutory safe harbors, (1) a registrant must include meaningful cautionary statements along with the forward-looking information, (2) the forward-looking information must not be material, or (3) the plaintiff must be unable to prove that a forward-looking statement was made or approved by an executive officer with actual knowledge that it was false or misleading.

Conclusion

The final rules for disclosure of off-balance sheet arrangements and contractual obligations represent only an incremental increase in required disclosures. The changes are in line, however, with the general direction of the SEC's approach to MD&A disclosure in recent years. Even before the Sarbanes-Oxley Act of 2002, the SEC has demonstrated its growing impatience with the analytical quality of MD&A disclosure. The new requirements, though hardly momentous, offer additional tools for registrants to continue to enhance MD&A disclosure.

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