

Client Alert

SEC Adopts Final Rules on MD&A Disclosure of Off-Balance Sheet Arrangements and Contractual Obligations

A. Introduction

On January 22, 2003, the SEC adopted final rules that will require companies to disclose in a separately captioned subsection of the “Management’s Discussion and Analysis” (MD&A) section of their SEC filings an explanation of their off-balance sheet arrangements. The rules also will require companies to include in their MD&A a table disclosing amounts due under specified categories of contractual obligations.¹ The rules implement Section 401(a) of the Sarbanes-Oxley Act of 2002 (SOA) and will become effective on April 7, 2003. Companies will be required to include the new disclosures regarding off-balance sheet arrangements in SEC filings that include financial statements for fiscal years ending on or after June 15, 2003 and to include the table of contractual obligations in SEC filings that include financial statements for fiscal years ending on or after December 15, 2003. Earlier voluntary compliance is permitted.

B. Off-Balance Sheet Arrangements

Definition of “Off-Balance Sheet Arrangements.” The new SEC rules define “off-balance sheet arrangements” to include any transaction, agreement or other contractual arrangement with an unconsolidated entity, under which the company has:

- any obligation under certain guarantee contracts;
- a retained or contingent interest in assets transferred to an unconsolidated entity or similar arrangement that serves as credit, liquidity or market risk support to that entity for those assets;
- any obligation under certain derivative instruments; or

¹ Securities and Exchange Commission Release Nos. 33-8182; 34-47264; File No. S7-42-02. A copy of the final rule is available on the SEC website at <http://www.sec.gov/rules/final/33-8182.htm>.

- any obligation under a material variable interest held by the company in an unconsolidated entity that provides financing, liquidity, market risk or credit risk support to the company, or engages in leasing, hedging or research and development services with the company.

U.S. GAAP concepts determine which guarantee contracts, derivative instruments or variable interests² are “off-balance sheet arrangements” under the rules.³

Under the rules, an “off-balance sheet arrangement” must be disclosed only when there is a definitive agreement that is unconditionally binding or subject only to customary closing conditions or, if there is no such agreement, when settlement of the transaction occurs.

Threshold for Disclosure of Off-Balance Sheet Arrangements. The final rules require disclosure in a separately captioned subsection of MD&A of “off-balance sheet arrangements” that either have, or are reasonably likely to have, a current or future effect on the company’s financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors. The SEC noted that this disclosure threshold is consistent with the existing threshold for other MD&A disclosure in SEC filings.

The SEC outlined steps management must take to determine whether to disclose an off-balance sheet arrangement under the rules:

- first, identify and critically analyze the company’s off-balance sheet arrangements; and
- second, assess the likelihood of the occurrence of any known trend, demand, commitment, event or uncertainty that could affect an off-balance sheet arrangement (*e.g.*, performance under a guarantee).

No disclosure would be required if management concludes that the known trend, demand, commitment, event or uncertainty is not reasonably likely to occur. If management cannot make that determination, it must evaluate objectively the consequences of the known trend, demand, commitment, event or uncertainty on the

² FASB Interpretation No. 46, entitled “Consolidation of Variable Interest Entities,” was issued by FASB in January 2003 and imposes new financial reporting rules on companies involved with variable interest entities. These new FASB rules, which are independent of the new SEC rules outlined in this Client Alert, include disclosure requirements that apply immediately to financial statements issued after January 31, 2003.

³ U.S. GAAP concepts apply to all issuers, including foreign private issuers, for purposes of off-balance sheet disclosure requirements. The SEC notes, however, that it is not imposing U.S. GAAP on foreign private issuers with respect to preparation of their primary financial statements.

assumption that it will occur. Disclosure would then be required unless management determines that a material effect on the company's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources is not reasonably likely to occur. The assessment must be objectively reasonable, viewed as of the time the determination is made.

Disclosure about Off-Balance Sheet Arrangements. Disclosure of the following items is required to the extent necessary to an understanding of a company's off-balance sheet arrangements:

- the nature and business purpose to the company of the off-balance sheet arrangements;
- the importance to the company of the off-balance sheet arrangements in respect of its liquidity, capital resources, market risk support, credit risk support or other benefits;
- the amounts of revenues, expenses and cash flows of the company arising from the arrangements;
- the nature and amounts of any interests retained, securities issued and other indebtedness incurred by the company in connection with the arrangements;
- the nature and amounts of any other obligations or liabilities (including contingent obligations or liabilities) of the company arising from the arrangements that are or are reasonably likely to become material and the events or circumstances that could trigger those obligations or liabilities; and
- any known event, demand, commitment, trend or uncertainty that will result in or is reasonably likely to result in the termination, or material reduction in availability to the company, of its off-balance sheet arrangements that provide material benefits to it, and the course of action that the company has taken or proposes to take in response to any such circumstances.

In addition to the categories of disclosure listed above, there is a principles-based rule requiring a company to provide any other information that it believes is necessary to understand its off-balance sheet arrangements and the material effects of these arrangements.

The SEC has advised that off-balance sheet arrangements should be aggregated in groups or categories that provide information in an efficient and understandable manner and avoid repetition and disclosure of immaterial information. Common or similar effects of a number of different off-balance sheet arrangements must be analyzed in the aggregate if that increases understanding. However, distinctions among aggregated off-balance sheet arrangements should be discussed if the distinctions are material.

The time period covered by the disclosure of off-balance sheet arrangements would generally be the most recent fiscal year, but changes from the previous year should be addressed where necessary to an understanding of the disclosure.

C. Tabular Disclosure of Contractual Obligations

Under the SEC's new rules, companies must disclose in MD&A in tabular format the amounts of payments due within specified time periods under long-term debt, capital leases, operating leases, purchase obligations and other long-term liabilities reflected on the company's balance sheet under GAAP. The information must be provided as of the latest fiscal year-end balance sheet date, and the table should be in substantially the following format:

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

A company may disaggregate these categories and use sub-categories more suitable to its business, but the table must include all of the obligations that fall within the first four specified categories. The table should be accompanied by footnotes necessary to describe material contractual provisions or other material information to the extent necessary for an understanding of the timing and amount of the contractual obligations disclosed in the table.

The obligations to be included in the long-term debt, capital lease and operating lease categories are defined by reference to U.S. GAAP. A company that prepares financial statements in accordance with non-U.S. GAAP should include contractual obligations in the table that are consistent with the classifications used in the GAAP under which its primary financial statements are prepared.

The rules define a “purchase obligation” as an agreement to purchase goods or services that is enforceable and legally binding on the company and that specifies all significant terms, including (i) fixed or minimum quantities to be purchased; (ii) fixed, minimum or variable price provisions; and (iii) the approximate timing of the transaction. If the purchase obligations are subject to variable price provisions, additional disclosures may be required.

Unlike the off-balance sheet arrangement disclosures, which must be in a separately captioned subsection of MD&A, a company may place the contractual obligation table anywhere within MD&A it deems appropriate. The table is not required in the MD&A section of interim reports. However, companies should disclose material changes outside the ordinary course of business in the specified contractual obligations during interim periods.

D. Safe Harbor for Forward-Looking Information

The new MD&A disclosures are protected by the existing statutory safe harbor for “forward-looking statements” in SEC filings. Under the final SEC rules, all information (other than historical facts) required to be disclosed would be deemed to be “forward-looking statements” for purposes of the existing statutory safe harbor.

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February 17, 2003

For Additional Information

This client alert can be found, together with other recent Chadbourne & Parke LLP client alerts, at http://www.chadbourne.com/publications/sub_Publications.html. If you have any questions regarding the new SEC rules, please contact any of the following:

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