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CLIENT ADVISORY

SEC Increases Disclosure Requirements for Off-Balance Sheet Arrangements and Contractual Obligations

In order to give investors a better understanding of off-balance sheet arrangements and aggregate contractual obligations, the Securities and Exchange Commission, pursuant to its mandate under the Sarbanes-Oxley Act of 2002, is requiring greater disclosure in public filings.

As required by the Sarbanes-Oxley Act, the SEC adopted revised rules affecting Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") that mandate disclosure of off-balance sheet arrangements that have, or are reasonably likely to have, a material effect on a company's financial condition, results of operations, liquidity, capital expenditures or capital resources.¹ Under these revised rules, a company must provide in any MD&A section part of a filing with the SEC a comprehensive explanation of its off-balance sheet arrangements, as well as a tabular overview of its aggregate contractual obligations.² Quarterly filings need only cover material changes. The new disclosure requirements regarding off-balance sheet arrangements take effect for SEC filings required to include financial statements for fiscal years ending on or after June 15, 2003, while the requirements for the table of contractual obligations take effect for such filings for fiscal years ending on or after December 15, 2003.

Definition of Off-Balance Sheet Arrangements. Off-balance sheet arrangements are generally used to provide financing, liquidity, market or credit risk support, or to engage in leasing, hedging or research and development services. The SEC has determined that the required disclosure for such arrangements should employ concepts in U.S. GAAP and existing accounting standards in order to define the categories of arrangements with more precision than the potentially broader concepts described in the Sarbanes-Oxley Act or earlier SEC proposals. The SEC's definition includes transactions, agreements or contractual arrangements with an unconsolidated entity in which the public company has:

- any obligation under certain guarantee contracts that may be a source of potential risk to a company's future liquidity, capital resources and results of operations, regardless of whether they are recorded as liabilities;
- 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 such assets;
- any obligation under certain derivative instruments classified as equity; or

¹ Accounting standard setters have recently issued revised guidance for consolidation of the entities involved in off-balance sheet arrangements and continue to review existing accounting rules. Some arrangements with previously unconsolidated entities that would have otherwise been subject to the revised rules will now be reflected in financial statements and may, therefore, not technically be subject to expanded disclosure. Companies should nonetheless consider whether disclosure about arrangements even with consolidated entities would be useful to investors' understanding of the financial condition, results of operations, liquidity, capital expenditures or capital resources of the company.

² The SEC's January 2002 "Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations" encouraged many of the practices now codified by these rules. The revised rules call for more detail than this previous informal guidance.

- 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.

There is no obligation, however, to make disclosure of an off-balance sheet arrangement unless it is an unconditionally binding definitive agreement, subject only to customary closing conditions, or, if no agreement exists, upon settlement. In addition, contingent liabilities arising out of litigation, arbitration or regulatory actions are not considered off-balance sheet arrangements.

Disclosure of Off-Balance Sheet Arrangements. With respect to off-balance sheet arrangements, a company must disclose all items which have, or are reasonably likely to have, a material current or future effect on the company's financial condition, changes in financial condition, revenues or expense, results of operations, liquidity, capital expenditures or capital resources. Such disclosure must be set apart in a separately-captioned section of MD&A. A company must disclose the nature and business purpose of the off-balance sheet arrangements. The company must also disclose the importance to the company for liquidity, capital resources, market risk or credit risk or other benefits. Moreover, specific disclosure is required of the financial impact and exposure to risk and known events, demands, commitments, trends or uncertainties that implicate the company's ability to benefit from its off-balance sheet arrangements.

A company must provide whatever additional information it believes is necessary for an understanding of its off-balance sheet arrangements and their effects, as well as insight into the overall magnitude of a company's off-balance sheet activities. Investors should be able to understand the amounts of revenues, expenses and cash flows arising from the arrangements, the nature and total amount of any interests retained, securities issued and other indebtedness incurred, and the nature and amount of any other obligations or liabilities (including contingent obligations or liabilities) of the company arising from the arrangements that are, or may become, material, and the triggering events or circumstances that could cause them to arise. Even though not specifically required in the MD&A revisions, companies should consider whether disclosure of additional factors such as the following would be useful to investors' understanding:

- significant terms and conditions of the company's off-balance sheet arrangements;
- the nature and amount of the total obligations or liabilities of an unconsolidated entity that conducts off-balance sheet activities on behalf of the company;
- identification of the class and amount of any debt or equity securities issued by the company, either to the off-balance sheet entity or to third parties;
- the amounts of any related guarantees, lines of credit, standby letters of credit, take-or-pay contracts or throughput contracts;
- the effects of a termination or material reduction in the benefits of off-balance sheet arrangements;
- any factors that would affect the company's ability to continue to use off-balance sheet arrangements and the circumstances that could cause material contingent obligations to come to fruition; and
- changes from previous fiscal periods.

Disclosure should be complete, but also concise and easy for an average investor to understand. To avoid unnecessary repetition, the revised rules allow companies to include clear cross references to information in the footnotes to their financial statements.

Disclosure of Contractual Obligations. Under the revised MD&A rules, the SEC mandates that each public company (excluding small business issuers) disclose aggregate information about contractual obligations in a single location so as to improve transparency of the company's short and long term liquidity and capital resource needs and demands.³ Companies must therefore include tabular disclosure about contractual obligations. Such disclosure may be in whatever section of MD&A a company deems appropriate. This information must include information about a company's known contractual obligations, encompassing both on-balance sheet and off-balance sheet arrangements as of the latest balance sheet date.

The SEC has provided a sample table for disclosure of the amounts of contractual obligations, aggregated by the type of contractual obligation. The table is divided into the headings "Contractual Obligations" and "Payments Due by Period." The Payments Due by Period section is divided into subheadings for: total, less than one year, one to three years, three to five years, and more than five years. The types of contractual obligations listed are: long-term debt obligations, capital lease obligations, operating leases, purchase obligations, other long-term liabilities reflected on the company's balance sheet under GAAP, and total contractual obligations.⁴ The SEC stated that while a company may use other categories in the table as may be suitable for its business, the table must include all of the obligations that fall within the categories specified by the SEC. The table should be accompanied by footnotes as necessary to describe important information.

As with other MD&A requirements, the companies must disclose material changes each quarter to the amounts of contractual obligations, though disclosure will not be required in quarterly reports when no changes have occurred.

Application to Foreign Private Issuers. The new MD&A disclosure requirements apply to foreign private issuers' reports and registration statements, just as to domestic issuers (though the new requirement for tabular disclosure of contractual obligations will not apply to small business issuers). However, although domestic issuers must update MD&A for material changes in quarterly reports on Form 10-Q, the revised rules do not apply to Form 6-K reports submitted by foreign private issuers.

Safe Harbor for Forward-Looking Information. The revised MD&A rules deem the disclosure regarding off-balance sheet arrangements and contractual obligations to be forward-looking statements. Previously, companies were permitted, but not required, to provide forward-looking information. For clarity, the revised rules explicitly apply previously existing statutory safe harbor protections that were generally available for forward-looking statements in MD&A and elsewhere to the forward-looking information that is required by the revised MD&A rules. In order to avail itself of the safe harbor for forward-looking statements, a company must identify such statements as forward-looking and they must be accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statements. A company's safe-harbor language should be carefully tailored to cover forward-looking statements now disclosed under the revised MD&A rules.

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Public companies need to carefully analyze their relationships, obligations and other interests to determine whether additional MD&A disclosure is now required in their periodic reports. All MD&A discussions should be presented in a format and with language that is clear, concise and understandable. Boilerplate disclosures that do not specifically address the company's particular circumstances and operations do not satisfy the MD&A requirements, and any important distinctions regarding the items disclosed should be discussed.

³ The rules as originally proposed would have required similar disclosure for contingent liabilities and commitments. While not mandated by the final rules, this disclosure is still encouraged under the SEC's January 2002 Commission Statement.

⁴ Purchase obligations are defined as agreements to purchase goods or services that are enforceable or legally binding on a company and that specify all significant terms. The other items required to be included in the table are defined by reference to existing accounting standards.

For a more comprehensive discussion of the topics covered in this client advisory, or for assistance with any of the matters discussed herein, please contact the lawyer at ZAG/S&W LLP with whom you regularly consult, or one of the lawyers below:

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