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Client Alert

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The SEC Adopts Rules Requiring Annual and Quarterly Disclosure of Off-Balance Sheet Arrangements and Contractual Obligations

On January 28, 2003, the Securities and Exchange Commission issued final rules to implement Sec. 401(a) of the Sarbanes-Oxley Act ("SOX"). *See* Rel. No. 33-8182 (the "MD&A Release").

As mandated by Sec. 401(a) and the MD&A Release, SEC filings by domestic and foreign registrants that include fiscal year-end financial statements must also include:

- disclosure of off-balance sheet arrangements — if the filing includes financial statements for a fiscal year ending on or after June 15, 2003; and
- disclosure of contractual and other obligations — if the filing includes financial statements for a fiscal year ending on or after December 15, 2003.

This client alert only summarizes the new rules. Reference to the rules and the explanatory text of the MD&A Release will be necessary to obtain a fuller understanding of these rules.

Sarbanes-Oxley Sec. 401(a)

Sec. 401(a) of SOX amends section 13 of the Securities Exchange Act of 1934 (the "Exchange Act") to add a new subsection (j) Off-Balance Sheet Transactions.[1] That section requires the SEC to adopt rules that provide that each quarterly and annual report required to be filed with the SEC 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 material current or future effect on the financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources or significant components of revenues or expenses.

The SEC's Rules

The MD&A Release amends each of the SEC's disclosure regulations that pertain to the Management's Discussion and Analysis ("MD&A")[2] section of periodic reports[3] and registration statements to require a discussion of off-balance arrangements and short- and long-term contractual obligations.

The MD&A Release reiterates that current SEC rules already require disclosure regarding off-balance sheet arrangements and other contingencies in the MD&A. However, the MD&A Release states that these proposals are necessary not only to implement Section 401(a) of SOX, but also to provide a better understanding of a registrant's current and future financial position and sources of liquidity, which may be affected by off-balance sheet arrangements and contractual obligations and contingent liabilities. Generally, under the proposals in the MD&A Release, a registrant is required to:

- discuss, in a separately labeled section of the MD&A, its "off-balance sheet arrangements" that either have or are reasonably likely to have a current or future material effect on the registrant's financial condition, changes in financial condi-

[1] Sec. 401(a) also added a new subsection (i) to section 13, which requires that each financial report that contains financial statements and that is required to be prepared in accordance with (or reconciled to) generally accepted accounting principles and is filed with the SEC reflects all material correcting adjustments that have been identified by a registered public accounting firm in accordance with GAAP and the rules of the SEC. This section became effective when SOX was adopted.

[2] Although Item 5 of Form 20-F refers to "Operating and Financial Review and Prospects," the requirements are the same and all references in this memo to MD&A are intended to cover the Item 5 disclosure as well.

[3] Item 303 of Regulation S-K, Regulation S-B (for small business issuers), Item 5 of Form 20-F (for foreign private issuers) and General Instruction B(7) of Form 40-F (for certain Canadian issuers).

tion, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources; and

- provide a table of its known contractual obligations (aggregated by categories) as of the latest balance sheet date for various periods ranging from less than one year to more than five years.

Definition of "off balance sheet arrangements. The definition of off-balance sheet arrangements set forth in the MD&A Release is highly technical and requires reference to U.S. GAAP principles and interpretations by the Financial Accounting Standards Board.[4] Generally, "off-balance sheet arrangements" are any transactions, agreements or other contractual arrangements to which an entity whose financial statements are not consolidated with those of the registrant is a party, and under which the registrant, whether or not a party to the arrangement, has, or in the future may have:

- any obligation under a direct or indirect guarantee;[5]
- a retained or contingent interest in assets transferred to an unconsolidated entity or similar arrangement that serves as support to that entity for such assets;
- certain "derivatives" depending on the type of GAAP used by the registrant;[6] and
- obligations arising out of material "variable interests" in an unconsolidated entity that provides financing, liquidity, market or credit risk support to the registrant or engages in leasing, hedging or R&D services with the registrant.

An off-balance sheet arrangement need not be disclosed unless an unconditional binding definitive agreement (subject to customary closing conditions) exists or if no such agreement exists, when the transaction occurs.

Threshold for disclosure. Generally, the SEC has taken the position that prospective information in a registrant's MD&A must be disclosed if a trend, demand, event, commitment or uncertainty is both presently known to management and is *reasonably likely* to have material current or future effects on the registrant's financial condition or results of operations.[7]

Scope of disclosure. The scope of the disclosure about a registrant's "off-balance sheet arrangements" is very broad. The goal is to provide investors with "a clear understanding of the registrant's business activities, financial arrangements and financial statements." Generally, all aspects of the off-balance sheet arrangement must be disclosed if they are reasonably likely to have a material effect on the registrant's financial position. The following information must be disclosed to the extent necessary for an understanding of off-balance sheet arrangements and their material effects:

- the arrangement's nature and business purpose;
- the arrangement's importance to the registrant for liquidity, capital resources, market risk or credit risk support or other benefits;
- the arrangement's financial impact on the registrant, including on its revenues, expenses, cash flows or securities issued and the exposure to risk, including retained interests or contingent interests;
- known events, demands, commitments, trends or uncertainties that affect the availability or benefit to the registrant of its material off-balance sheet arrangements; and
- such other information that the registrant believes is necessary for an understanding of its off-balance sheet arrangements and their material effects on its financial condition, changes in financial position, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

If several off-balance sheet arrangements would individually not materially affect a registrant's financial condition but if similar triggering events would cause such off-balance sheet arrangements to be accelerated, causing a material effect on the registrant, then these arrangements should be discussed collectively.

The disclosure should generally cover the most recent fiscal year, but it also should address changes from the prior year if required for a full understanding of the disclosure.

Contractual obligations. The MD&A Release amends each of the SEC's disclosure regulations that pertain to the MD&A section of periodic reports[8] to require registrants to include annual tabular disclosure about contractual obligations, excluding contingent liabilities and commitments. The tabular format is set out below.

All the categories of contractual obligations listed, other than "purchase obligations," are to be determined by all registrants that use U.S. GAAP for their primary financial state-

[4] Foreign companies will have to refer to these U.S. GAAP concepts in order to make the required MD&A disclosure, but will not be required to use them in their primary financial statements.

[5] Including similar arrangements identified in paragraph 3 of FASB Interpretation No. 45 (unless excepted under paragraph 6 or 7 of that Interpretation).

[6] For registrants using U.S. GAAP, derivatives are defined in SFAS No. 133 and for all other registrants the definition includes derivative instruments that are both indexed to the registrant's own stock and classified in stockholders' equity, or not reflected, in the registrant's statement of financial position.

[7] *See* Rel. No. 33-6835 (May 18, 1989).

[8] See footnote 3.

ments by reference to U.S. accounting literature. Foreign private issuers should use their home country GAAP to determine the appropriate classifications to be included in the table. The "purchase obligation" category captures a registrant's capital expenditures for the purchase of goods or services, regardless of whether commercial instruments will be used to satisfy these obligations.[9] The required disclosure would cover both on- and off-balance sheet contractual arrangements for periods beginning less than one year and ending more than five years from the date of the latest balance sheet. This disclosure need not be made in quarterly reports, although material changes to the annual disclosure should be made quarterly, as necessary.

The SEC has suggested a proposed tabular format in the following form (although disaggregation into subcategories is permissible):

Contractual Obligations	Payment 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 Obligations (GAAP)					
Total Contractual Obligations					

The table may be placed anywhere in the MD&A that the registrant chooses.

The coverage of this requirement is extremely broad and may pick up executory contracts, including, for example, ordinary supply and sales contracts, earn-out provisions, milestone payments, employment agreements, purchase agreements, operating leases, professional service contracts, licenses and franchises. Moreover, registrants will be required to estimate the future payments due under these contracts.

Safe Harbor. The SEC acknowledges in the MD&A Release that the information required to be provided would require disclosure of forward-looking information. In order to encourage full compliance with the proposals, the MD&A Release also expands the statutory safe harbor protection of Sections 27A of the Securities Act of 1933 and 21E of the Exchange Act to the forward-looking information that will be required to be supplied.

Application of foreign private issuers.

These requirements apply to foreign private issuers, including Canadian companies filing on Form 40-F. (This latter requirement modifies the SEC's Multi-jurisdictional Disclosure System for Canadian issuers, which heretofore has relied principally on Canadian disclosure requirements.) Foreign private issuers are not required to file quarterly reports, but, if they are required to provide interim financial statements in Securities Act registration statements, the SEC staff takes the position that they must provide interim MD&A information and these new requirements would apply in such instances. However, quarterly information provided on Form 6-K need not comply with the requirements unless it is incorporated by reference into a registration statement filed under the Securities Act.

Application to "small business issuers."

The requirements for disclosure about off-balance sheet arrangements apply to small business issuers. The requirements for disclosure about contractual commitments do not apply to small business issuers.

Suggested Procedures

SOX and the rules that the SEC has adopted under SOX and its general rulemaking authority under the Federal securities laws, particularly requirements for disclosure controls and procedures and internal controls and procedures for financial reporting and for CEO and CFO certifications, have caused companies to focus on their procedures for gathering, analyzing and disclosing information. These controls and procedures have been the subject of separate client alerts.

[9] A "purchase obligation" is defined as an agreement to purchase goods or services that is enforceable and legally binding on the registrant and that specifies all significant terms, including: fixed or minimum quantities to be purchased; fixed, minimum or variable price provisions; and the approximate timing of the transaction.

The rules for disclosure about off-balance sheet arrangements and contractual obligations require new focus on procedures. Companies subject to these requirements should consider, among other things:

- a review of their business to identify the types of transactions that could be subject to disclosure under these requirements;
- methods and assumptions to be used to estimate future payment obligations, including methods and assumptions used in budgeting; and
- how these matters integrate with the registrant's other disclosure controls and procedures and internal controls and procedures for financial reporting.

Conclusion

In addition to the SEC's continued focus on the MD&A, Sec. No. 408 of SOX requires enhanced review of periodic reports filed with the SEC by companies with securities listed on securities exchanges or traded on NASDAQ. The SEC must review the filings of these companies no less than once every three years. This places an added premium on developing appropriate disclosure controls and procedures and internal controls and procedures for financial reporting to support the required certifications by a registrant's CEO and CFO.

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