Disclosure in MD&A about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations under Section 401(a) of the Sarbanes-Oxley Act of 2002

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Introduction

On January 15, 2003, the Securities and Exchange Commission adopted final rules pursuant to Section 401(a) of the Sarbanes-Oxley Act of 2002 providing that companies disclose all material off-balance sheet transactions and similar arrangements in each quarterly and annual financial report filed with the SEC (see SEC Release No. 33-8182).

The SEC final rules require companies to disclose and provide an analysis of off-balance sheet transactions and arrangements in a separately captioned section of MD&A and provide tabular disclosure of contractual obligations in MD&A.

Time Frame for Compliance

The final rules with respect to disclosure of off-balance sheet arrangements are effective for all SEC filings that include financial statements for fiscal years ending on or after June 15, 2003. The final rules with respect to tabular disclosure of contractual obligations are effective for all SEC filings that include financial statements for fiscal years ending on or after December 15, 2003.

What are Off-Balance Sheet Arrangements?

The SEC has defined off-balance sheet arrangements to include any transaction, agreement or other contractual arrangement to which an entity that is not consolidated with the company is a party under which the company has:

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

The definition of off-balance sheet arrangements incorporates concepts from GAAP and is intended to encompass off-balance sheet transactions or other arrangements for which the company may have contingent liabilities or obligations that are not fully transparent to investors.

The SEC has modified the definition of an off-balance sheet activity slightly from that set forth in Section 401(a) of Sarbanes-Oxley Act and has also provided that the obligations must be contractual. Therefore, a company would not have a disclosure obligation unless the off-balance sheet arrangement is an unconditionally binding definitive agreement, subject only to customary closing conditions or, if there is no such agreement, when settlement occurs.

Which Off-Balance Sheet Arrangements and Other Obligations Must Be Reported?

Under the final rules, the SEC adopted the same threshold as that for existing MD&A disclosure requirements: a company would have to disclose off-balance sheet arrangements that have, or are reasonably likely to have, a material current or future effect on the financial condition, changes in financial condition, revenues or expenses, results
of operations, liquidity, capital expenditures or capital resources.

Thus, for every off-balance sheet arrangement, the company will have to:

- identify and critically analyze the arrangement; and
- assess the likelihood of the occurrence of any known trend, demand, commitment, event or uncertainty that could affect the arrangement.

If management concludes that the known trend, demand, commitment, event or uncertainty is not reasonably likely to occur, then no disclosure in MD&A is required. If management cannot make that determination, the company must assume that the known trend, demand, commitment, event or uncertainty will occur and determine objectively whether it could have a material effect on the company. Disclosure is required if such a materiality determination is made.

**What Disclosures About Off-Balance Sheet Arrangements Are Required**

Off-balance sheet activities must be disclosed in a separately captioned section of MD&A. The final rules amend Item 303 of Regulation S-K to provide that the company disclose, to the extent material and necessary for an understanding of the company’s off-balance sheet arrangements:

- the nature and business purpose of the off-balance sheet arrangements;
- the importance of the off-balance sheet arrangements to the company’s liquidity, capital resources, market risk support, credit risk support or other benefits;
- the financial impact of the off-balance sheet arrangements on the company and the company’s exposure to risk as a result of the arrangements; and
- known events, demands, commitments, trends or uncertainties that affect the availability or benefits to the company of the off-balance sheet arrangements.

In addition, the final rules require a company to provide any other information that it believes is necessary for an understanding of its off-balance sheet arrangements and the material effects of such arrangements on its financial condition and results of operations. A company’s discussion in MD&A should provide investors with management’s insight into the impact and proximity of the potential material risks that are reasonably likely to arise from material off-balance sheet arrangements.

**What Disclosures About Contractual Obligations Are Required**

The final rules also require that information about the amount of future payments due under the following categories of contractual obligations be listed in a tabular format in MD&A:

- long term debt obligations;
- capital leases and obligations;
- operating lease obligations;
- purchase obligations; and
- other long-term liabilities reflected in the company’s balance sheet under GAAP.

Each of the foregoing categories, except “purchase obligations,” is defined in the final rules by reference to the relevant GAAP accounting pronouncements. A “purchase obligation” is defined as an agreement to purchase goods or services that is enforceable and legally binding on the company 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 tabular disclosure of contractual obligations would require the company to disclose as of the date of the company’s latest fiscal year end balance sheet by type of obligation:

- the total amount of the obligations;
- payments due in less than one year;
- payments due between one year and three years;
- payments due between three and five years; and
- payments due in more than five years.

Is There Liability for Forward-Looking Information?

The final rules provide that forward-looking statements made in the course of disclosures about off-balance sheet activities and other obligations are subject to a safe harbor. The requirements for the safe harbor are those set forth in the Private Securities Litigation Reform Act of 1995.

This memorandum is intended only as general information about the matters discussed, and should not be construed as legal advice. For more information about these matters, please contact your Wilson Sonsini Goodrich & Rosati partner.