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ALERT

New MD&A Disclosures for Off-Balance-Sheet Arrangements and Contractual Obligations

A new SEC rule requires companies to disclose off-balance-sheet arrangements that currently have or are *reasonably likely* to have a material future impact on the registrant, but the rule's influence will be tempered by its debt to interpretive guidance on the same subject in place since last year.¹ Most of the interpretive guidance is incorporated in the new rule, which applies to all registrants, including foreign private issuers, except for registered investment companies.

Mandated by the Sarbanes-Oxley Act, the rule requires a new section of Management's Discussion and Analysis (MD&A) for off-balance-sheet arrangements and a tabular disclosure of contractual obligations. The final rule did not carry forward a proposed requirement to disclose aggregate contingent liabilities or commitments. Calendar-year companies will have to apply the new rule in reports or filings that include the December 31, 2003 financial statements. Prior to the effective date of the new rule, companies would apply the interpretative guidance related to off-balance-sheet arrangements issued last year, unless they elect to adopt the new rule earlier.

⁽¹⁾ SEC Release No. 34-47264, *Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations*, January 27, 2003; *Financial Reporting Release No. 61, Management's Discussion and Analysis of Financial Condition and Results of Operations*, January 22, 2002.

OFF-BALANCE-SHEET ARRANGEMENTS

The final rule has a broad definition of an off-balance-sheet arrangement. It includes (1) any obligation of the registrant that meets the definition of a guarantee under GAAP² (warranty and similar arrangements are not captured by the definition of guarantee); (2) a retained or contingent interest in assets transferred to an unconsolidated entity or similar arrangement that serves as credit, liquidity, or market risk support; (3) specified derivative arrangements accounted for and classified within stockholders' equity; or (4) any obligation, including a contingent obligation, arising out of a material variable interest in an unconsolidated entity that provides financing, liquidity, market or credit risk support to the registrant, or engages in leasing, hedging, or research and development services with the registrant.³ The definition brings in concepts from the FASB's recently issued Interpretations on guarantees and variable interest entities as well as its earlier Statement on derivatives.

Contingent liabilities arising from litigation, arbitration, or regulatory actions are not considered off-balance-sheet arrangements. Routine transactions, such as executory contracts, employment agreements, consulting agreements, and minimum purchase commitments, are not included in the definition.

Foreign Private Issuers.

Consistent with existing MD&A requirements for foreign private issuers, the disclosure about off-balance-sheet arrangements and the table of contractual obligations pertain to the primary financial statements presented in the filing regardless of whether

those primary financial statements are prepared in accordance with US GAAP. Foreign private issuers must apply the same definition of off-balance-sheet arrangements that U.S. registrants apply. For example, a foreign private issuer determining whether a contractual arrangement meets the definition of a variable interest would look to the definition in FASB Interpretation No. 46 on variable interest entities. The consolidation rules applied in the primary financial statements would, however, determine whether that arrangement was on- or off-balance-sheet. If the contractual arrangement was with an entity that was not consolidated in preparing the primary financial statements, the disclosures required by the SEC rule would be made in MD&A in the separate caption on off-balance-sheet arrangements.

Threshold for Disclosure. Registrants must discuss in a separately-captioned section of MD&A off-balance-sheet arrangements that currently have or are *reasonably likely* to have a material future effect on the registrant's financial condition, changes in financial condition, revenues or expenses, results of

operations, liquidity, capital expenditures, or capital resources. The Commission adopted this probability threshold in response to concerns that its original proposal to disclose arrangements that *may have* a material current or future effect would have established a lower disclosure threshold for off-balance-sheet arrangements than for other MD&A items with the attendant risk that investors might be confused or misled by the different probabilities attaching to different disclosures. In addition, some raised concerns that the lower threshold would yield voluminous disclosures and would be more difficult to apply.

Disclosure Requirements for Off-balance-sheet Arrangements

- The nature and business purpose of the arrangements;
- The importance of the arrangements to the registrant's liquidity, capital resources, market risk support, credit risk support or other benefits;
- The amounts of the registrant's revenues, expenses, and cash flows that arise from the arrangements; the nature and amounts of any interests retained, securities issued, and other indebtedness incurred by the registrant in connection with the off-balance-sheet arrangements; and the nature and amounts of other obligations or liabilities (including some contingent obligations or liabilities) of the registrant arising from such arrangements that are or are reasonably likely to become material and the triggering events or circumstances that could cause them to arise; 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 registrant, of off-balance-sheet arrangements that provide material benefits, and the course of action that the registrant has taken or proposes to take in response to those circumstances.

(2) FASB Interpretation No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, November 2002.

(3) FASB Interpretation No. 46, Consolidation of Variable Interest Entities, January 2003.

Disclosures. The final rule is based on the principle that annual and interim MD&A disclosures must include information necessary to understand the off-balance-sheet arrangements and their material effects. As in the case of other MD&A disclosure requirements, management must present the key variables and other qualitative and quantitative factors that are necessary for an understanding of the registrant. For example, a registrant should disclose the nature and frequency of its asset securitization program if it materially relies on securitizations to meet its liquidity and capital resource needs. Other candidates for disclosure are material contractual provisions calling for termination or for material reduction in the off-balance-sheet arrangement or the effect on a registrant’s off-balance-sheet arrangements of a change in the registrant’s credit rating.

The off-balance-sheet arrangements may be aggregated into groups or categories that provide information in an efficient and understandable manner. Aggregation intended to diminish materiality is not permitted.

Disclosures generally are required for only the most recent fiscal year. However, the registrant should address changes from the previous year if the changes are necessary to an understanding of the current-year disclosure. Consistent with other MD&A disclosure requirements, new or material changes in off-balance-sheet arrangements are to be disclosed in interim period filings. Finally, the MD&A disclosures need not repeat information in the notes to the financial statements, if the specific information in the relevant notes is clearly cross-referenced in the MD&A. Cross-references should identify the significance of the information if it is not otherwise apparent.

CONTRACTUAL OBLIGATIONS

The final rule requires that the MD&A in annual reports include a tabular disclosure of contractual obligations for all registrants other than small-business issuers. While the information in the table is not required to be disclosed in interim reports, interim reports should disclose material interim period changes.

For the most part, the captions in the table represent items for which disclosure is required by GAAP in the financial statement notes or on the balance sheet. The exception is purchase obligations, which is a defined term under the new rule. A purchase obligation is a legally binding and enforceable agreement to purchase goods and services that specifies all significant terms (quantity, price, and timing of the transaction). Because of the broad definition, registrants may be required to develop new procedures to quantify these obligations.

One objective of the new rule was to require aggregated disclosure of contractual obligations in a single location. For that reason, the rule does not permit omitting the tabular data by cross-referencing it to the financial statements. The tabular disclosure of contractual obligations must follow the specified format shown in the table below, although the categories can be disaggregated using detailed headings to more closely reflect the registrant’s business.

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



EFFECTIVE DATE

The off-balance-sheet arrangement disclosure provisions of the final rule do not take effect until a registrant files an annual report, registration statement, proxy, or information statement that includes financial statements for an annual period ending on or after **June 15, 2003**. For a calendar-year company, the new rule will take effect for reports or filings that include the December 31, 2003 financial statements.

Registrants (other than small-business issuers) must include the table of contractual obligations in registration statements, annual reports, and proxy or information statements for fiscal years ending after **December 15, 2003**.

Until superseded by the new rule, the existing interpretive guidance on off-balance-sheet disclosures for MD&A that was included in FRR 61 is still applicable. However, the SEC permits early adoption of its new rule.

The descriptive and summarizing statements above are not intended to substitute for the official texts of the requirements. All relevant facts and circumstances should be brought to bear when complying with the SEC releases and the Sarbanes-Oxley Act of 2002. Companies should consult with their accounting and legal advisors.

Additional information on the SEC's initiatives is available from your local KPMG representative or office.

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