

also will apply to the definition of “off-balance sheet arrangements” in the amendments.

## 2. Retained or Contingent Interests

As an alternative to guarantee contracts, companies may structure and facilitate off-balance sheet arrangements by retaining an interest in assets transferred to an unconsolidated entity. For example, a subordinated retained interest in a pool of receivables transferred to an unconsolidated entity can provide credit support to the entity by cushioning the senior interests in the event that a portion of the receivables becomes uncollectible. In this event, the value of the retained interest can decline and can therefore have a material effect on a registrant's financial condition. Accordingly, the second element of the definition of “off-balance sheet arrangements” includes retained or contingent interests in assets transferred to an unconsolidated entity or similar arrangements that serve as credit, liquidity or market risk support to such entity for such assets.<sup>90</sup>

## 3. Certain Derivative Instruments

Similar to guarantees or retained interests, certain derivative instruments have been used in structuring off-balance sheet arrangements. For example, a registrant may issue or hold derivative instruments that are indexed to its stock and classified as stockholders' equity under GAAP.<sup>91</sup> The impact of those derivative instruments often is not transparent to investors because those derivative instruments are classified as equity and subsequent changes in fair value may not be periodically recognized in the financial statements. Therefore, the third element of the definition includes those derivative instruments to better apprise investors of their impact. The definition for registrants whose financial statements are prepared in accordance with U.S. GAAP includes derivative instruments that are excluded from

guarantees for which the guarantor's obligations would be reported as an equity item (rather than a liability); certain guarantees in connection with a lease restructuring; guarantees issued between either parents and their subsidiaries or corporations under common control; a parent's guarantee of a subsidiary's debt to a third party; and a subsidiary's guarantee of the debt owed to a third party by either its parent or another subsidiary of that parent.

<sup>90</sup> See, e.g., Item 303(a)(4)(ii)(B) of Regulation S-K [17 CFR 229.303(a)(4)(ii)(B)].

<sup>91</sup> See FASB Emerging Issues Task Force Issue (“EITF”) No. 00-19 *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock* (Jan. 2001). The FASB has been reevaluating the accounting treatment for such financial instruments and is expected to issue SFAS No. 149 *Accounting for Financial Instruments with Characteristics of Liabilities or Equity* in February 2003.

SFAS No. 133 pursuant to paragraph 11a of that Statement.<sup>92</sup> Similarly, the definition for registrants whose financial statements are prepared in accordance with a non-U.S. GAAP includes any obligation under a derivative instrument that is both indexed to the registrant's own stock and classified in stockholders' equity, or not reflected, in the registrant's statement of financial position.<sup>93</sup>

## 4. Variable Interests

The fourth element of the definition includes any obligation, including a contingent obligation, arising out of a material variable interest held by the registrant in an unconsolidated entity, where such entity provides financing, liquidity, market risk or credit risk support to, or engages in leasing, hedging or research and development services with, the registrant.<sup>94</sup> We intend for this element of the definition to be consistent with the concept of a “variable interest” that is included in the recently issued FASB Interpretation No. 46 (“FIN 46”). The term “variable interest” is defined in FIN 46 as “contractual, ownership, or other pecuniary interests in an entity that change with changes in the entity's net asset value.”<sup>95</sup> In other words, variable interests are investments or other interests that will absorb a portion of an entity's expected losses if they occur or receive portions of the entity's expected residual returns if they occur.<sup>96</sup> To apply this element of the definition, a registrant must assess the variable interests it holds in the specified unconsolidated entities regardless of whether the entity is deemed to be a “variable interest entity” pursuant to paragraph 5 of FIN 46. To focus the disclosure on the most crucial off-balance sheet arrangements, however, the definition only applies to variable interests, that are material to the registrant, in entities that provide financing, liquidity, market risk or credit risk support to the registrant, or engage in leasing, hedging or research

<sup>92</sup> See SFAS No. 133, paragraph 11a. In particular, paragraph 11a excludes contracts issued or held by a registrant that are both: (1) indexed to its own stock and (2) classified in stockholder's equity in its statement of financial position.

<sup>93</sup> See, e.g., Item 5.E.2(c) of Form 20-F [17 CFR 249.220f].

<sup>94</sup> See, e.g., Item 303(a)(4)(ii)(D) of Regulation S-K [17 CFR 229.303(a)(4)(ii)(D)].

<sup>95</sup> See FIN 46 at paragraph 2c.

<sup>96</sup> See FIN 46 at paragraph 6. The definition of “off-balance sheet arrangement” only addresses obligations arising out of a variable interest held by a registrant, and not residual returns.

and development services with the registrant.<sup>97</sup>

## B. Disclosure Threshold

The amendments require disclosure of off-balance sheet arrangements that either have, or are reasonably likely to have, a current or future effect on the registrant's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors.<sup>98</sup> That disclosure threshold is consistent with the existing disclosure threshold under which information that could have a material effect on financial condition, changes in financial condition or results of operations must be included in MD&A.<sup>99</sup>

To apply the disclosure threshold, management first must identify and critically analyze the registrant's off-balance sheet arrangements, including its guarantee contracts, retained or contingent interests, derivative instruments and variable interests. Second, management must 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; an obligation under a variable interest or equity-linked or indexed derivative instrument; or recognition of an impairment). If management concludes that the known trend, demand, commitment, event or uncertainty is not reasonably likely to occur, then no disclosure is required in MD&A.<sup>100</sup> If management cannot make that determination, it must evaluate objectively the consequences of the known trend, demand, commitment, event or uncertainty on the assumption that it will come to fruition. Disclosure is then required unless management determines that a material effect on the registrant's financial condition, changes in financial condition, revenues or expenses, results of operations,

<sup>97</sup> We identified the need for improved disclosures about entities that conduct these activities in the January 2002 Commission Statement. See Commission Statement, Release No. 33-8056, FR-61 (Jan. 22, 2002) [67 FR 3746] at Section II.A.2.

<sup>98</sup> See, e.g., Item 303(a)(4)(i) of Regulation S-K [17 CFR 229.303(a)(4)(i)].

<sup>99</sup> See Release No. 33-6835 (May 18, 1989) [54 FR 22427] (the “1989 Interpretive Release”). The January 2002 Commission Statement indicated that “reasonably likely” is a lower disclosure threshold than “more likely than not.” See Release No. 33-8056, FR-61 (Jan. 22, 2002) [67 FR 3746].

<sup>100</sup> Even if management determines that the likelihood of a material effect is not reasonably likely, disclosure may still be required in the footnotes to the financial statements. See, e.g., FIN 45, paragraph 13.