



**FENWICK & WEST LLP**

*CORPORATE & SECURITIES LAW UPDATE*

## **SEC Issues Final Rule Regarding Disclosure of Off-Balance Sheet Arrangements and Contractual Obligations**

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## SEC Issues Final Rule Regarding Disclosure of Off-Balance Sheet Arrangements and Contractual Obligations

On January 22, 2003, the SEC issued a final rule to implement Section 401(a) of the Sarbanes-Oxley Act of 2002 and to codify earlier SEC statements regarding the transparency and quality of financial disclosure. The complete text of this rule can be found at [www.sec.gov/rules/final/33-8182.htm](http://www.sec.gov/rules/final/33-8182.htm).

The rule affects public companies in two separate areas:

- disclosure of off-balance sheet arrangements; and
- disclosure of contractual obligations.

### I. Disclosure of Off-Balance Sheet Arrangements

Section 401(a) of the Sarbanes-Oxley Act directed the SEC to issue rules requiring public companies to disclose in their annual and quarterly financial reports all material off-balance sheet transactions, arrangements, obligations (including contingent obligations) and other relationships with unconsolidated entities or other persons that may have a material current or future effect on one or more of the companies' financial measures.

***What does the final rule require companies to disclose?*** The rule requires public companies to discuss their "off-balance sheet arrangements" that have or are *reasonably likely* to have a current or future effect on their financial condition, changes in financial condition, revenues, expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors. This disclosure will first be required for filings containing financial statements for fiscal years ending on or after June 15, 2003.

***How does the SEC define "off-balance sheet arrangement"?*** At the suggestion of commentators and to narrow the scope of the matters about which more transparent disclosure is required, the SEC substantially revised the definition of "off-balance sheet arrangements" contained in its proposed rule, to incorporate concepts from U.S. GAAP. This final definition likely will result in a company's accountants being actively involved in each judgment of whether disclosure must be made.

The final rule defines the term "off-balance sheet arrangement" to mean 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 a guarantee contract that has any of the characteristics identified in paragraph 3 of FASB Interpretation No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of

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Indebtedness of Others (November 2002) (“FIN 45”),<sup>1</sup> and that is not excluded from the initial recognition and measurement provisions of FIN 45 pursuant to paragraph 6 or 7 of that Interpretation;

- a retained or contingent interest in assets transferred to an unconsolidated entity or a similar arrangement that serves as credit, liquidity or market risk support to that entity for those assets;
- any contingent or other obligation under a contract that would be accounted for as a derivative instrument except that it is both indexed to the company’s own stock and classified in stockholders’ equity in the company’s statement of financial position, and therefore excluded from the scope of FASB Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities (June 1998),<sup>1</sup> pursuant to paragraph 11(a) of that Statement; or
- any contingent or other obligation arising out of a variable interest, as referenced in FASB Interpretation No. 46, Consolidation of Variable Interest Entities (January 2003),<sup>1</sup> in an unconsolidated entity that is held by and is material to the company, where that entity provides financing, liquidity, market risk or credit risk support to, or engages in leasing, hedging or research and development services with, the company.

Excluded from the definition of off-balance sheet arrangements are contingent liabilities arising out of litigation, arbitration or regulatory actions, among other things.

***How formal must an arrangement be before it has to be disclosed?*** For an off-balance sheet arrangement to exist a contractual relationship must be in place. No disclosure of an arrangement is required until a definitive agreement that is unconditionally binding or subject only to customary closing conditions exists or, if there is no such agreement, when the transaction closes.

***What process does the SEC recommend in assessing the need for MD&A disclosure about the off-balance sheet arrangement?*** First, company management must identify the company’s off-balance sheet arrangements in any of the four categories.

Second, management must assess the likelihood of the occurrence of any known trend, demand, commitment, event or uncertainty that could affect each off-balance sheet arrangement (e.g., performance under a guarantee, or performance of an obligation under a variable interest entity).

- If management determines that the known trend, demand, commitment, event or uncertainty *is not reasonably likely to occur*, then no MD&A disclosure is required.

<sup>1</sup> See Appendix A for a discussion of this accounting pronouncement.

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However, a separate decision will need to be made by the company and its accountants regarding whether disclosure is required in the financial statement footnotes.

- If management cannot make that determination, it must assume that the trend, demand, commitment, event or uncertainty will come to fruition, and objectively evaluate its consequences. Management must provide disclosure unless it determines that a material effect on the company's financial condition, changes in financial condition, revenues, expenses, results of operations, liquidity, capital expenditures or capital resources *is not reasonably likely to occur*.

The “not reasonably likely to occur” standard is the same standard that has historically been applied in making other MD&A disclosure judgments. The Commission has indicated its view that “reasonably likely” is a lower disclosure threshold than “more likely than not.” Years ago, an SEC Commissioner indicated his view that this standard required a conclusion that there was less than a 40% chance of an event occurring. Consistent with other disclosure threshold determinations that management must make in drafting MD&A, the assessment must be objectively reasonable, viewed as of the time the determination is made.

***Where must companies make any required disclosure?*** Companies are required to provide comprehensive explanations of off-balance sheet arrangements in their annual and quarterly reports, in their registration statements and in proxy and information statements that have an MD&A, in each case in a separately captioned section within MD&A. In addition, companies must determine whether the contracts underlying these arrangements are material contracts required to be filed as exhibits.

***If disclosure is required, what information must be provided?*** A company must disclose the following information to the extent necessary to an understanding of its off-balance sheet arrangements and their material effects on the company's financial condition, changes in financial condition, revenues, expenses, results of operations, liquidity, capital expenditures or capital resources:

- the nature and business purpose to the company of its off-balance sheet arrangements;<sup>2</sup>

<sup>2</sup> The disclosure should explain to investors why the company engages in off-balance sheet arrangements. It should also provide the information that investors need to understand the business activities advanced through the off-balance sheet arrangements. For example, a company might indicate that the arrangements enable it to lease certain facilities rather than acquire them, where the latter would require the company to recognize a liability for the financing. A company also might indicate that the off-balance sheet arrangement enables it to obtain cash readily through sales of groups of loans to a trust, or to finance inventory, transportation or research and development costs without recognizing a liability or to lower borrowing costs of unconsolidated affiliates by extending guarantees to their creditors.

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- the importance to the company of the off-balance sheet arrangements in respect of its liquidity, capital resources, market risk support, credit risk support or other benefits;<sup>3</sup>
  - the amounts of revenues, expenses and cash flows of the company arising from these arrangements; the nature and amounts of any interests retained, securities issued and other indebtedness incurred by the company in connection with these arrangements; and the nature and amounts of any other obligations or liabilities (including contingent obligations or liabilities) of the company arising from these arrangements that are or are reasonably likely to become material, and the triggering events or circumstances that could cause them to arise;<sup>4</sup> 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 company, of its off-balance sheet arrangements that provide material benefits to it, and the course of action that the company has taken or proposes to take in response to any these circumstances.<sup>5</sup>

*In addition* to the enumerated information, the discussion must include any other information that the company believes is necessary for an understanding of its off-balance sheet arrangements and the specified material effects. The additional disclosure 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.

<sup>3</sup> This disclosure should provide investors with an understanding of the significance of off-balance sheet arrangements to the company as a financial matter. For example, if a company materially relies on off-balance sheet arrangements for its liquidity and capital resources, a company might be required to disclose how often it securitizes financial assets, to what degree its securitizations are a material source of liquidity, and whether it has materially increased or decreased securitizations from past periods and to explain that increase or decrease. Together with the other disclosure requirements, companies should provide information sufficient for investors to assess the extent of the risks that have been transferred and retained as a result of the arrangements.

<sup>4</sup> This disclosure should provide investors with insight into the overall magnitude of a company's off-balance sheet activities, the specific material impact of the arrangements on the company and the circumstances that could cause material contingent obligations or liabilities to come to fruition.

<sup>5</sup> A company must disclose, for example, any material contractual provisions calling for the termination or material reduction of an off-balance sheet arrangement. The disclosure also should address factors that are reasonably likely to affect the company's material benefits. For example, if a company's credit rating were to fall below a certain level, some off-balance sheet arrangements might require the company to purchase the assets or assume the liabilities of an unconsolidated entity. In addition, a change in a company's credit rating could either preclude or materially reduce the benefits to the company of engaging in off-balance sheet arrangements. In these cases, the company would have to disclose known circumstances that are reasonably likely to cause its credit rating to fall to the specified level and discuss the material consequences of the drop in ratings. In addition, the company would have to discuss the course of action that it has taken or proposes to take in response to a termination or material reduction in the availability of an off-balance sheet arrangement that provides material benefits.

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The disclosure generally must cover the most recent fiscal year, but it also should address changes from the previous year where that discussion is necessary to an understanding of the disclosure.

***Can the MD&A disclosure requirements be satisfied by cross-referencing to financial statement footnotes?*** Yes. The discussion of off-balance sheet arrangements need not repeat information provided in the footnotes to the financial statements, provided that the discussion clearly cross-references to specific information in the relevant footnotes and integrates the substance of the footnotes into the discussion in a manner designed to inform readers of the significance of the information that is not included within the body of that discussion.

***What further guidance does the rule provide for disclosure?*** The rule instructs companies to aggregate off-balance sheet arrangements in groups or categories that provide information in an efficient and understandable manner and to avoid repetition and disclosure of immaterial information. Common or similar effects that may result from a number of different off-balance sheet arrangements must be analyzed in the aggregate to the extent that the aggregation increases understanding. For example, if particular triggering events or circumstances would either require a company to become directly obligated, or to accelerate its obligations, under a number of off-balance sheet arrangements, and the overall obligations would be material, then the rule would require an analysis of the circumstances and their aggregate effect to the extent it increases understanding. Companies should discuss distinctions among aggregated off-balance sheet arrangements if these distinctions are material.

## **II. Disclosure of Contractual Obligations**

Although not specifically directed to do so by the Sarbanes-Oxley Act, the SEC used this release to codify portions of its MD&A guidance from January 2002. In the SEC's view, aggregate information about contractual obligations will improve transparency of a company's short-term and long-term liquidity and capital resource needs. Further, this disclosure will provide an appropriate context for investors to assess the relative role of off-balance sheet arrangements with respect to liquidity and capital resources.

***What does the new rule require companies to disclose?*** The new rule requires public companies (other than small business issuers) to disclose, in the tabular format below, an overview of their known *contractual obligations* specified in the table below as of the latest fiscal year-end balance sheet date. This disclosure will first be required for filings containing financial statements for fiscal years ending on or after December 15, 2003.

Contractual Obligations	Payments Due by Period				
	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 Company's Balance Sheet under GAAP					
Total					

The table must cover at least the periods set forth in the column headings in the table above. It also must provide amounts, aggregated by type of contractual obligation, but a company may disaggregate the specified categories of contractual obligations using other categories suitable to its business, if the presentation includes all of the obligations of the company that fall within the categories specified in the above table. The table should be accompanied by footnotes to describe provisions that create, increase or accelerate obligations, or other pertinent data to the extent necessary for an understanding of the timing and amount of the company's specified contractual obligations.

***How does the SEC define the categories of contractual obligations specified in the table above?*** For companies that present their primary financial statements in accordance with U.S. GAAP, the SEC has defined these categories as follows:

- Long-Term Debt Obligation means a payment obligation under long-term borrowings referenced in FASB Statement of Financial Accounting Standards No. 47, Disclosure of Long-Term Obligations (March 1981);<sup>1</sup>
- Capital Lease Obligation means a payment obligation under a lease classified as a capital lease pursuant to FASB Statement of Financial Accounting Standards No. 13, Accounting for Leases (November 1976);<sup>1</sup>
- Operating Lease Obligation means a payment obligation under a lease classified as an operating lease and disclosed pursuant to FASB Statement of Financial Accounting Standards No. 13, Accounting for Leases (November 1976);<sup>1</sup> and
- Purchase Obligation means 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

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variable price provisions; and the approximate timing of the transaction.<sup>6</sup> If the purchase obligations are subject to variable price provisions, the company must estimate the amount of the payments. In that case, the table should include footnotes to inform investors of the payments that are subject to market risk, if that information is material to investors. In addition, the footnotes should discuss any material termination or renewal provisions to the extent necessary for an understanding of the timing and amount of the company's payments under its purchase obligations.

***Where must companies make the required disclosure?*** The rule requires companies to disclose contractual commitments in their annual reports (typically Form 10-K), registration statements and proxy and information statements that include MD&A. Companies are not required to repeat the full tabular disclosure in their quarterly reports (typically Form 10-Q), but instead need to disclose only material changes outside the ordinary course of their business in the specified contractual obligations during the quarter. Companies must place the required disclosure somewhere in MD&A but the disclosure need not to be separately captioned and, within that section, can be placed where management deems appropriate.

### III. Other Information

***When is the new rule effective?*** Companies must comply with the off-balance sheet arrangement disclosure requirements in registration statements, annual reports and proxy or information statements including financial statements for fiscal years ending on or after June 15, 2003.

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

Companies may voluntarily comply with the new disclosure requirements before the compliance dates.

***Does the rule apply to foreign private issuers and small business issuers?*** Yes, with some exceptions. The new MD&A disclosure requirements, with some definition changes and other modifications, apply to foreign private issuers that file annual reports on Form 20-F or

<sup>6</sup> The definition of "purchase obligations" is designed to capture a company's capital expenditures for purchases of goods or services over a five-year period. The rule requires disclosure of the amounts of a company's purchase obligations without regard to whether notes, drafts, acceptances, bills of exchange or other commercial instruments will be used to satisfy these obligations because those instruments could have a significant effect on the company's liquidity. The purpose of this new disclosure requirement is to obtain enhanced disclosure concerning a company's contractual payment obligations, and the exclusion of commercial instruments would be inconsistent with that objective.



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Form 40-F. However, foreign private issuers are not required to file quarterly reports with the SEC. Thus, unless a foreign private issuer files a Securities Act registration statement that must include interim period financial statements and related MD&A disclosure, it only needs to update the MD&A disclosure annually.

Small business issuers are required to disclose off-balance sheet arrangements but are not required to provide tabular or textual disclosure about contractual obligations beyond the extent of MD&A requirements for small business issuers existing prior to this new rule.

***Do I have any liability protection for statements of future effects?*** Yes. Existing statutory safe harbor provisions to protect forward-looking statements against private legal actions that are based on a material misstatement or omission will be available for forward-looking information about off-balance sheet arrangements and contractual obligations. The rule presumes that all information about off-balance sheet arrangements and contractual obligations (except for historical facts) are forward-looking statements. Disclosures about off-balance sheet arrangements will satisfy the meaningful cautionary statements element of the existing statutory safe harbor if the company satisfies all requirements for off-balance sheet arrangements in the new rule.<sup>7</sup>

Please be aware that the existing statutory safe harbor provisions for forward-looking statements do not apply to forward-looking statements made in financial statements. Accordingly, companies may wish to provide the newly required information in MD&A rather than cross-referencing to the financial statements.

The existing statutory safe harbors do not apply if the MD&A forward-looking statement is made in connection with the following transactions: an IPO, a tender offer, an offering by a partnership or a limited liability company, a roll-up transaction, a going private transaction, an offering by a blank check company or a penny stock issuer, or an offering by an issuer convicted of specified securities violations or subject to certain injunctive or cease and desist actions.

Existing statutory safe harbors provide three separate bases for a company to claim the protection against liability for forward-looking statements made in MD&A.

- A safe harbor will be available if the forward-looking statement is identified as forward-looking and is accompanied by meaningful cautionary statements that identify important factors that could cause actual results to differ materially from those in the forward-looking statement.

<sup>7</sup> Because this provision does not apply to the required table of contractual obligations, companies should tailor the cautionary language to the specific forward-looking statements being made about such obligations.

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- A safe harbor will protect from private liability any forward-looking statement that is not material.
  - A safe harbor will preclude private liability if a plaintiff fails to prove that the forward-looking statement was made by or with the approval of an executive officer of the company who had actual knowledge that it was false or misleading.

Accordingly, the SEC has urged companies to consider the terms, conditions and scope of the statutory safe harbors in drafting their disclosure, and to tailor cautionary language to the specific forward-looking statements being made.

***Is the SEC's January 2002 statement on MD&A still in effect?*** Yes, in part. The SEC's January 2002 statement on MD&A matters presented factors for management to consider in preparing MD&A disclosure about liquidity and capital resources, off-balance sheet arrangements, certain trading activities that include non-exchange traded contracts accounted for at fair value, and transactions with persons or entities that derive benefits from their non-independent relationships with the company or the company's related parties. This guidance remains effective except where it is superceded by the requirements of this new rule. The SEC does not intend further rulemaking with respect to the remaining factors addressed in the January 2002 statement. See our earlier update entitled "[SEC Focus on MD&A Disclosure](#)" for a summary of the SEC statement.

**What if I have more questions?**

Should you have any questions about these new requirements, please feel free to contact any member of your Fenwick & West team. You may also contact Laird Simons ([lsimons@fenwick.com](mailto:lsimons@fenwick.com)), Horace Nash ([hnash@fenwick.com](mailto:hnash@fenwick.com)), Dan Winnike ([dwinnike@fenwick.com](mailto:dwinnike@fenwick.com)) or Eileen Robinett ([erobinett@fenwick.com](mailto:erobinett@fenwick.com)), each of whom contributed to the preparation of this update.

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## Appendix A

### Discussion of Relevant Accounting Pronouncements

This discussion provides general information helpful to an understanding of “off-balance sheet arrangements” and “contractual obligations” as defined by the SEC. It is not a complete or authoritative review of these pronouncements, and does not take the place of consultation with an accountant.

#### Off-Balance Sheet Arrangements

***Obligations Under Guarantee Contracts.*** The definition of “off-balance sheet arrangements” addresses certain guarantees 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. The definition borrows concepts from U.S. GAAP in order to identify the types of guarantee contracts for which disclosure is required. The first element of the definition includes any obligation under a guarantee contract that has any of the following characteristics identified in FASB Interpretation No. 45, Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others (November 2002) (“FIN 45”), and that is not excluded from the initial recognition and measurement provisions of FIN 45 pursuant to paragraph 6 or 7 of that Interpretation:

- Contracts that contingently require the guarantor to make payments (either in cash, financial instruments, other assets, shares of its stock, or provision of services) to the guaranteed party based on changes in an underlying<sup>8</sup> that is related to an asset, a liability or an equity security of the guaranteed party (e.g., a financial standby letter of credit, a market value guarantee, a guarantee of the market price of the common stock of the guaranteed party or a guarantee of the collection of the scheduled contractual cash flows from individual financial assets held by a special purpose entity);
- Contracts that contingently require the guarantor to make payments (either in cash, financial instruments, other assets, shares of its stock, or provision of services) to the guaranteed party based on another entity’s failure to perform under an obligating agreement (e.g., a performance guarantee);
- Indemnification agreements (contracts) that contingently require the indemnifying party (guarantor) to make payments to the indemnified party (guaranteed party) based on changes in an underlying that is related to an asset, a liability or an equity security of the indemnified party (e.g., an adverse judgment in a lawsuit or

<sup>8</sup> An underlying is a “specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable.” The occurrence or nonoccurrence of a specified event (such as a scheduled payment under a contract) is a variable that is considered an underlying under that definition.

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the imposition of additional taxes due to either a change in the tax law or an adverse interpretation of the tax law); or

- Indirect guarantees of the indebtedness of others, which arise under an agreement that obligates one entity to transfer funds to a second entity upon the occurrence of specified events, under conditions whereby (a) the funds become legally available to creditors of the second entity and (b) those creditors may enforce the second entity's claims against the first entity under the agreement (e.g., keepwell agreements - agreements under which a company is, or would be, obligated to provide or arrange for the provision of funds or property to an affiliate or third party).

Paragraphs 6 and 7 of FIN 45 list 14 types of guarantees and contracts that are excluded from the initial recognition and measurement provisions of FIN 45 and therefore are not “off-balance sheet arrangements.” Paragraph 6 of FIN 45 excludes: guarantees issued by insurance and reinsurance companies and accounted for under specialized accounting principles for those companies; a lessee's guarantee of the residual value of leased property in a capital lease; contingent rents; vendor rebates; and guarantees whose existence prevents the guarantor from recognizing a sale or the earnings from a sale. Paragraph 7 of FIN 45 excludes: product warranties; guarantees that are accounted for as derivatives; contingent consideration in a business combination; 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.

***Obligations Under Certain Derivative Instruments.*** FASB Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities (June 1998) (“SFAS 133”), establishes accounting and reporting standards for derivative instruments and for hedging activities. Paragraph 11(a) of SFAS 133 excludes from the definition of “derivative instruments,” and therefore from the accounting standards of SFAS 133, contracts issued or held by the reporting entity that are both indexed to its own stock and classified in stockholders' equity in its statement of financial position.” With a view to plugging the resulting reporting gap, the SEC has included obligations fitting this description within the definition of “off-balance sheet arrangements.”

***Obligations Arising Out of Variable Interests.*** FASB Interpretation No. 46, Consolidation of Variable Interest Entities (January 2003), defines “variable interests” as contractual, ownership or other pecuniary interests in an entity that change with changes in the entity's net asset value. 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

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entity's expected residual returns if they occur. To apply this element of the definition, a company 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 company, in entities that provide financing, liquidity, market risk or credit risk support to the company, or engage in leasing, hedging or research and development services with the company. A wide range of interests in entities may be variable interests, including equity investments, debt instruments, guarantees, certain types of options, derivatives and certain leases.

### **Contractual Obligations**

***Long-Term Debt Obligations.*** A company is required to disclose as long-term debt obligations payment obligations under long-term borrowings referenced in FASB Statement of Financial Accounting Standards No. 47, Disclosure of Long-Term Obligations (March 1981) ("SFAS 47"). SFAS 47 does not provide a definition of long-term borrowings or long-term debt obligations but refers to the following types of long-term borrowings and arrangements:

- take or pay contracts, throughput contracts and other unconditional purchase obligations typically associated with project financing arrangements;
- preferred stock with mandatory redemption requirements; and
- other more traditional long-term borrowings.

For unconditional purchase obligations, a company must disclose the aggregate amount of payments. For mandatorily redeemable preferred stock, a company must disclose the amount of redemption requirements for all issues of capital stock that are redeemable at fixed or determinable prices on fixed or determinable dates. For long-term borrowings, a company must disclose the combined aggregate amount of maturities and sinking fund requirements.

***Capital Lease Obligations/Operating Lease Obligations.*** FASB Statement of Financial Accounting Standards No. 13, Accounting for Leases (November 1976) ("SFAS 13"), separates the universe of leases into capital leases and operating leases. SFAS 13 provides that, if at its inception (as defined in SFAS 13), a lease meets one or more of the four criteria set forth as bullet points below, the lease must be classified as a capital lease; otherwise it will be classified as an operating lease. Italicized terms in the following definitions are defined in paragraph 5 of SFAS 13.

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- the lease transfers ownership of the property to the lessee by the end of the *lease term*;
  - the lease contains a *bargain purchase option*;
  - the *lease term* is equal to 75% or more of the *estimated economic life of the leased property*. However, if the beginning of the *lease term* falls within the last 25% of the total *estimated economic life of the leased property*, including earlier years of use, this criterion may not be used for purposes of classifying the lease; and
  - the present value at the beginning of the *lease term* of the *minimum lease payments*, excluding that portion of the payments representing executory costs such as insurance, maintenance and taxes to be paid by the lessor, including any profit thereon, equals or exceeds 90% of the excess of the *fair value of the leased property* to the lessor at the *inception of the lease* over any related investment tax credit retained by the lessor and expected to be realized by it. However, if the beginning of the *lease term* falls within the last 25% of the total *estimated economic life of the leased property*, including earlier years of use, this criterion may not be used for purposes of classifying the lease. A lessee must compute the present value of the *minimum lease payments* using its *incremental borrowing rate*, unless (i) it is practical for it to learn the implicit rate computed by the lessor and (ii) the implicit rate computed by the lessor is less than the lessee's *incremental borrowing rate*. If both of these conditions are met, the lessee must use the implicit rate.

Appendix C to SFAS 13 provides illustrations of the application of these lease criteria.