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January 2003

The SEC Has Adopted Rules Governing "Pro Forma" ("non-GAAP") Financial Measures

On January 15, 2003, the Securities and Exchange Commission adopted rules to implement Sec. 401(b) of the Sarbanes-Oxley Act ("SOX"), regarding use by public companies [1] of non-GAAP financial measures in public communications and in filings with the SEC. In addition, the SEC adopted rules that require filing of current reports of releases or other announcements of material non-public financial information about completed quarterly and annual accounting periods. The latter rules implement, in part, Sec. 409 of SOX. See Rel. 33-8176. These rules apply to both domestic and foreign companies, with some relief for foreign companies.

These rules will become effective as follows:

- Non-GAAP financial presentations in public communications (Regulation G) – March 28, 2003
- Non-GAAP financial presentations and prohibition of certain non-GAAP financial measures in filings with the SEC – March 28, 2003
- Filing of earnings and other announcements – March 28, 2003

Non-Gap Financial Measures

The SEC long has been troubled by use of non-GAAP financial measures in SEC filings and public communications.

SEC Cautionary Advice. In Rel. 33-8039 (December 4, 2001), Cautionary Advice Regarding the Use of "Pro Forma" Financial Information in Earnings Releases, the SEC provided guidelines for "pro forma" financial presentations in earnings releases, essentially as follows:

- The anti-fraud provisions of the Federal securities laws apply to "pro forma financial presentations";[2]
- A presentation that addresses a limited feature of overall financial results or uses a calculation of overall financial results on a basis other than generally accepted accounting principles ("GAAP") is of concern;
- Financial results that are literally true but omit material information may be misleading; and
- A presentation that deviates from GAAP may not be misleading, if it is accompanied by a "Plain English" explanation of how it deviates from GAAP.

Section 401(b) of SOX and new SEC Regulation G build on that guidance.

Sec. 401(b) of SOX. Section 401(b) required the SEC to adopt rules providing that pro forma financial information (n/k/a "non-GAAP financial measures") included in any periodic report or other report (a current report on Form 8-K, for example) or in any public disclosure or press or other release must be presented in a manner that:

- does not contain an untrue statement of material fact or omit to state a material fact necessary in order to make the pro forma financial information, in light of the circumstances under which it is presented, not misleading; and
- Reconciles the pro forma financial information with the financial condition and results of operation of the "issuer" under generally accepted accounting principles.

[1] Registered investment companies are exempt from those rules by Sec. 405 of SOX.
[2] The new SEC rules use the term "non-GAAP financial measures" rather than "pro forma financial presentations" to avoid confusion with the SEC rules and GAAP requirements for pro forma financial presentations.

SEC rules. The SEC's rules elaborate on, and go beyond, the provisions of Sec. 401(b), in that they prohibit the use of certain non-GAAP financial measures in SEC filings and require filing of certain earnings releases.[3]

Definition. The SEC's rules substitute the term "non-GAAP[4] financial measures" for the term "pro forma financial information" used in the December 2001 cautionary release and Sec. 401(b). The term "non-GAAP financial measures" is defined in Rule 101(a)(1) of Regulation G and Item 10 of Regulations S-B and S-K as a numerical measure of a registrant's historical or future financial performance, financial position or cash flows that:

- Excludes amounts, or is subject to adjustments that have the effect of excluding amounts, that are included in the most directly comparable measure calculated and presented in accordance with GAAP in the statement of income, balance sheet or statement of cash flows (or equivalent statements) of the issuer; or
- Includes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded from the most directly comparable measure so calculated and presented.

This definition would encompass:

- a measure of performance that is different from that presented in the financial statements, such as income or loss before taxes, or net income or loss as calculated in accordance with GAAP; or
- a measure of liquidity that is different from cash flow or cash flow from operations computed in accordance with GAAP.

An example of a non-GAAP financial measure would be a measure of operating income that excludes one or more expense or revenue items that are identified as "non-recurring." Another example would be EBITDA (earnings before interest, taxes, depreciation and amortization), which could be calculated using elements derived from GAAP financial presentations, but is not presented in accordance with GAAP.

An example of the practical consequences of applying this definition of a non-GAAP financial measure, many companies have financial covenants in their credit arrangements that utilize non-GAAP financial measures. Frequently, these covenants utilize GAAP measures with certain items included or excluded as a result of negotiations between the parties. If those companies use numerical disclosures to demonstrate compliance with the covenants (as opposed to a blanket statement that they are in compliance), they will have to include the additional disclosure that the new rules will require.

A non-GAAP financial measure would not include operating and other financial measures and ratios or measures calculated using only:

- Financial measures calculated in accordance with GAAP;
- Operating measures or other measures that are not non-GAAP financial measures; and
- Financial measures required to be disclosed by SEC rule, GAAP or a governmental or SRO system of regulation

For example, non-GAAP financial measures would not include:

- operating and other statistical measures (such as unit sales, numbers of employees, numbers of subscribers, or numbers of advertisers);
- Disclosure of amounts of expected indebtedness, including contracted and anticipated amounts;
- Disclosures or amounts of repayments that have been planned or decided upon but not yet made;
- Disclosures of estimated revenues or expenses of a new product line, so long as such amounts were estimated as GAAP figures; and
- Measures of profit or loss and total assets for each segment required to be disclosed in accordance with GAAP.

Examples of ratios and measures that would not be non-GAAP financial measures with respect to retailers would include sales

[3] These rules do not affect the requirements of the SEC's Regulation S-X, Article 11 or GAAP to provide "pro forma" information in certain circumstances. In circumstances, such as in a merger, pro forma financial information is required to be disclosed in SEC filings. See Article 11 of Regulation S-X for the conditions that require the presentation of pro forma information, as well as the preparation requirements. This pro forma information is intended to disclose the continuing impact of an actual or proposed transaction on the historical GAAP financial statements. Article 11 requires tabular presentation of the balance sheet and income statements, starting with the historical GAAP financial statements, showing the specific adjustments that would have been required by GAAP had the transaction occurred at an earlier time, and ending with the pro forma statements, and also requires disclosure of the assumptions which underlie its preparation. Pro forma information presented pursuant to Article 11 would not be subject to Regulation G or the other new SEC rules. Also, FASB Statement 131, Disclosures about Segments of and Enterprise and Related Information, requires that companies report a measure of profit or loss and total assets for each reportable segment. This tabular information is presented in a note to the audited financial statements and is required to be reconciled to the GAAP measures, with all significant reconciling items separately identified and described. A registrant is required to provide a Management's Discussion & Analysis of segment information if such a discussion is necessary to an understanding of the business. These discussions would generally include the measures reported under FASB Statement 131. This information would not be subject to the SEC's rules regarding non-GAAP financial measures.

[4] GAAP refers to generally accepted accounting principles in the United States, except that in the case of foreign private issuers whose primary financial statements are prepared in accordance with other generally accepted accounting principles, references to GAAP also include the principles under which those primary financial statements are prepared.

per square foot (assuming that the sales figure was calculated in accordance with GAAP) or same store sales (again, assuming the sales figures for the stores were calculated in accordance with GAAP).

An example of a ratio that would be a non-GAAP financial measure would be a measure of operating margin where either the revenue component or the operating income component of the calculation, or both, were not calculated in accordance with GAAP.

Non-GAAP financial measures in public communications and SEC filings. – Regulation G. Rule 100 of Regulation G provides that, whenever a registrant, or a "person acting on its behalf,"[5] "publicly discloses" (including filing with the SEC) material information that includes a non-GAAP financial measure, the registrant must accompany that non-GAAP financial measure with:

- A presentation of the most directly comparable financial measure calculated and presented in accordance with GAAP; and
- A reconciliation (by schedule or other clearly understandable method), which shall be quantitative for historical non-GAAP measures presented, and quantitative, to the extent available without unreasonable efforts, for forward-looking information, of the differences between the non-GAAP financial measure disclosed or released with the most comparable financial measure or measures calculated and presented in accordance with GAAP.

In addition, a registrant, or a person acting on its behalf, may not make public a non-GAAP financial measure that, taken together with the information accompanying that measure and any other accompanying discussion of that measure, contains an untrue statement of a material fact or omits to state a material fact necessary in order to make the presentation of the non-GAAP financial measure, in light of the circumstances under which it is presented, not misleading.

If a non-GAAP financial measure is "made public" (a term not defined in Regulation G) orally, telephonically, by webcast or broadcast or by similar means, the requirements of the Regulation will be satisfied if:

- The information required by Regulation G is provided on the registrant's website at the time the non-GAAP financial measure is made public; and
- The location of the website is made public in the same presentation in which the non-GAAP financial measure is made public.

Prospective non-GAAP financial measures. Forward-looking non-GAAP financial measures are required to be quantitatively reconciled with GAAP only to the extent that the relevant prospective GAAP information is available without unreasonable effort or expense.

Liability Issues. Rule 102 of Regulation G provides a person's compliance or non-compliance with Regulation G shall not affect any person's liability, under section 10(b) of the Exchange Act and Rule 10b-5. However, as provided in Regulation G, non-GAAP financial measure may not be materially misleading and, if they are, they could be subject to both Regulation G and section 10(b) and Rule 10b-5.

Safe harbor. A company's failure to include all of the information required to be included in a public announcement by Regulation G would not affect that registrant's short-form eligibility under the Securities Act or whether there is adequate current public information regarding the registrant for purposes of Securities Act Rule 144(c).

Additional rules applicable to non-GAAP financial measures in SEC filings. The SEC has added Item 10(h) to Regulation S-B and Item 10(e) of Regulation S-K, <u>Use of non-GAAP financial measures in Commission filings</u>,[5] to address the use of non-GAAP financial measures in SEC filings, including prohibiting the use of certain non-GAAP financial measures in these filings. These Items provide that whenever one or more non-GAAP financial measures are included in a filing with the SEC:

- The registrant must include the following in the filing:

  (A) A presentation of the most directly comparable financial measure or measures calculated and presented in accordance with GAAP;

  (B) A quantitative reconciliation (by schedule or other clearly understandable method) of the differences between the non-GAAP financial measure disclosed with the financial measure or measures calculated and presented in accordance with GAAP except that with respect to forward-looking non-GAAP financial measures;

  (C) A statement disclosing the reasons why the registrant's management believes that presentation of the non-GAAP financial measure provides useful information to investors regarding the registrant's financial condition and results of operations;[6] and

  (D) To the extent material, a statement disclosing the additional purposes for which the regis-

[5] The SEC amended General Instruction C(e) of Form 20-F to refer to these Items.

[6] It will not be sufficient in this regard merely to state that management believes that the non-GAAP financial presentation is used by security analysts. The SEC expects that this disclosure will be clear and understandable and must be specific to the non-GAAP financial measures used, the company, the nature of its business and industry and the manner in which the company's management assesses the non-GAAP financial measure and applies to management decisions. *See* Rel. 33-8126, II.B.2. *See also*, SFAS No. 128 <u>Earnings Per Share</u>; and Rel. 33-8176, footnotes 11 and 49.

trant's management uses the non-GAAP financial measure.

If the filing is not an annual report on Form 10-K, 10K-SB or Form 20-F[7] a registrant need not include the information required by (C) and (D) above, if that information was included in its most recent annual report on Form 10, 10-K-SB or Form 20-F or a more recent filing, provided that the required information is updated to the extent necessary to meet the requirements of (C) and (D), at the time of the registrant's current filing.

Prohibitions.[8] A registrant must not in an SEC filing:

- Present the non-GAAP financial measure in a manner that would give it greater authority or prominence than the comparable GAAP financial measure or measures;
- Exclude charges or liabilities that required, or will require, cash settlement, or would have required cash settlement absent an ability to settle in another manner, from non-GAAP liquidity measures (This prohibition does not apply to EBIT or to EBITDA presentations);
- Adjust a non-GAAP performance measure to eliminate or smooth items identified as non-recurring, infrequent or unusual, when the nature of the charge or gain is such that it is reasonably likely to recur in the next two years or there was a similar charge or gain in the past two years;
- Present non-GAAP financial measures on the face of the registrant's financial statements prepared in accordance with GAAP or in the accompanying notes;
- Present non-GAAP financial measures on the face of any pro forma financial information required to be disclosed by Article 11 of Regulation S-X; or
- Use of titles or descriptions of non-GAAP financial measures that are the same as, or confusingly similar to, titles or descriptions used for GAAP financial measures.

Current Reporting of Earnings Releases

The SEC has amended Form 8-K by adding Item 12 Results of Operations and Financial Condition. That item provides that if a registrant, or any person acting on its behalf,[9] makes any public announcement or release (including any update of an earlier announcement or release) disclosing material non-public information regarding the registrant's results of operations or financial condition for a completed quarterly or annual fiscal period, the registrant must briefly identify the announcement or release and "furnish" the text of that announcement or release as an exhibit on Form 8-K within five business days of the release.[10]

This information is not required to be furnished in the case of disclosure of material non-public information that is disclosed orally, telephonically, webcast, or by similar means if:

- The information is provided as part of a presentation that initially occurs within 48 hours after a written announcement or release containing comparable information that is filed on Form 8-K pursuant to Item 12;
- The presentation is accessible to the public by dial-in conference call, webcast or similar technology;
- The financial and other statistical information contained in the presentation is provided on the registrant's website, together with any information that would be required by Regulation G; and
- The presentation was announced by a widely disseminated press release, that included instructions as to when and how to access the presentation and the location on the registrant's website where the information would be available.

Safe harbor Information furnished pursuant to Item 12 is deemed not to be filed for purposes of the liability provisions of section 18 of the Exchange Act, and is not automatically incorporated by reference in Securities Act registration statements or in proxy statements.

Updating. The filing requirement under Item 12 initially is triggered by the disclosure of material non-public information regarding a completed fiscal year or quarter. Item 12 does not apply in the case of a disclosure of material non-public information that is made in a quarterly report filed with the SEC on Form 10-Q (or 10-QSB) or an annual report filed with the SEC on form 10-K (or 10-KSB) or 20-F. Release of additional or updated material non-public information regarding a completed fiscal year or quarter would trigger an additional Item 12 filing requirement.

If a company is required to furnish an earnings release that includes non-GAAP financial measures, the presentation of non-GAAP financial measures will be required to comply with Regulation G, but only the following protions of Item 10 of Regulation S-K:

- The non-GAAP financial measure may not be given greater prominence than the most directly comparable GAAP financial measure;

[7] This provision does not apply to annual reports on Form 40-F filed by certain Canadian companies.

[8] While the SEC determined not to prohibit cash flow per share and similar non-GAAP financial measures in SEC filings, such measures may be prohibited under other standards, paragraph 33 of SFAS No. 95 Statement of Cash Flows, for example.

[9] The term "person acting on its behalf" is not defined in Item12.

[10] The SEC may reduce this to two business days when it acts upon additional proposals with respect to Form 8-K issued in Rel. 33-8106.

- The reconciliation provisions of Item 10 apply; and
- Unless disclosed in the company's annual report, the reasons management believes that the non-GAAP financial measure provides useful information to investors must be disclosed.

This information may be included either in the earnings release or in the Form 8-K.

Relationships to Regulation FD and Regulation G. An earnings release that includes non-GAAP financial measures would be subject both to Regulation G and the requirement to file the release on a Form 8-K.

An earnings release filed pursuant to Item 12 of Form 8-K would only satisfy Regulation FD, the SEC's "fair disclosure" regulation, if filed within the timeframe required by that Regulation. However, a report filed pursuant to satisfy Regulation FD could satisfy Item 12.

Relationships to Regulation M-A and related SEC Rules

Regulation M-A applies to business acquisition transactions. SEC rules 165 under the Securities Act and Rule 14a-12 of the SEC's Proxy Rules and Item 1015 of Regulation M-A require filing of communications made in connection with business combination transactions both before and after any required registration statement or proxy statement is filed with the SEC. These communications often contain non-GAAP financial measures concerning post-combination matters. Communications subject to Rule 165 or Rule 14a-12 or Item 1015, of Regulation M-A will not be required to comply with Regulation G, the prohibitions of Item 10 of Regulations S-K or S-B or the filing requirements of Item 12 of Form 8-K.

Foreign Private Issuers

These rules apply to foreign private issuers, except that these issuers are not subject to the requirement to file Forms 8-K to include earnings releases. Also, the references to "GAAP" in the rules means the company's home country GAAP.

Exception. Regulation G does not apply to a disclosure of a non-GAAP financial measure that is made by or on behalf of a registrant that is a foreign private issuer only if the following conditions are satisfied:

- The securities of the registrant are listed or quoted on a securities exchange or inter-dealer quotation system outside the United States;
- The non-GAAP financial measure and the most comparable GAAP financial measure are not calculated and presented in accordance with U.S. GAAP; and
- The disclosure is made by or on behalf of the registrant outside the United States, or is included in a written communication that is released by or on behalf of the registrant outside the United States and is not targeted to persons located in the U.S. or outside the U.S. and simultaneously in the U.S or afterwards.

The relief applies notwithstanding the existence of one or all of the following circumstances:

- Foreign or U.S. journalists or other third parties have access to the information, so long as the information is disclosed or released by or on behalf of the registrant only outside the United States;
- Following its release or disclosure, the information appears on one or more websites maintained by the registrant, so long as the websites, taken together, are not available exclusively to, or targeted at, persons located in the United States; or
- Following the disclosure or release of the information outside the United States, the information is included in a submission by the registrant to the Commission made under cover of a Form 6-K.

Small Business Issuers

These rules apply to "small business issuers," as defined in applicable SEC rules.

Procedures

Companies will have to develop procedures to:

- Review public communications that include non-GAAP financial measures for compliance with Regulation G. Due to the breadth of the definition of the term "non-GAAP financial measures," this should entail reviewing all public communications containing financial information.
- Review SEC filings to assure that any non-GAAP financial measures included in those filings comply with Item 10 of Regulation S-B or S-K or the requirements of Form 20-F.
- Establish procedures for website presentation of certain information subject to Regulation G and of earnings releases or the filing of earnings releases within five business days of release.
- These procedures should be included in those procedures that form the basis for the certifications by CEOs and CFOs required by Sec. 302 of SOX and the SEC's rules and by Sec. 906 of SOX.

Conclusion

Companies using non-GAAP financial measures will have to be aware of these rules governing presentations of non-GAAP financial measures and the requirements to file earnings releases on Form 8-K within five business days of release or comply with the requirements for the alternative of website disclosure of this information.

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Proskauer's Corporate Governance and Defense Practice consists of a multidisciplinary team of attorneys from our Corporate and Litigation practices, including renowned experts and former SEC and US Attorneys, who bring to bear considerable sophisticated expertise to serve your needs. Our Executive Compensation Practice also has capabilities in the area of Corporate Governance. The following individuals serve as the contact persons and would welcome any questions you might have.

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