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# Client Alert

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## SECURITIES LAW

### Update on the Sarbanes-Oxley Act (Sixth in a Series): SEC Issues Proposed Rules on the Use of Non-GAAP Financial Information

#### Including Proposed Requirement to File Earnings Releases on Form 8-K

Pursuant to the requirements of Section 401(b) of the Sarbanes-Oxley Act of 2002 (the "Act"), and as part of its ongoing response to recent scandals involving inadequate and misleading disclosure by public companies of their financial condition, the SEC recently issued a rule proposal (the "Release") relating to public companies' use of financial measures that are not presented in accordance with generally accepted accounting principles, or GAAP.<sup>1</sup> The Release includes proposed Regulation G, which would apply to *all* communications by public companies of non-GAAP financial measures, and proposes more stringent requirements for issuers that include non-GAAP financial measures in filings made with the SEC. While the SEC was directed to issue these rules by the Act, the SEC's express intention to improve disclosure in this area pre-dates the passage of the Act by several months.

On December 4, 2001, the SEC issued a statement entitled "Cautionary Advice Regarding the Use of 'Pro Forma' Financial Information in Earnings Releases,"<sup>2</sup> which outlined the SEC's concerns that the widespread use by issuers in their public statements of non-GAAP financial information (which term the SEC now prefers to "pro forma" financial information" because of the other contexts in which the term "pro forma" is used in the SEC's reporting literature) "...can mislead investors if it obscures GAAP results." The SEC went on to state that

<sup>1</sup> Proposed Rule, "Conditions for Use of Non-GAAP Financial Measures," Release Nos. 33-8145; 34-46788, dated November 5, 2002. A full copy of the Release is available from the SEC's website at <http://www.sec.gov/rules/proposed/33-8145.htm>.

<sup>2</sup> This document is available from the SEC's website at <http://www.sec.gov/rules/other/33-8039.htm>. Please see also Mintz Levin's Client Advisory on this document at <http://www.mintz.com/newspubs/Bus-Fin&Sec/SecE-Advisory12-19-01.pdf>.

<sup>3</sup> In the December 2001 Statement, the SEC also cautioned issuers releasing non-GAAP information to be aware of the antifraud provisions of the securities laws, which could be implicated if non-GAAP information was presented in a misleading manner or a manner in which material information was obscured or omitted. The SEC also cautioned issuers to disclose clearly the basis of the non-GAAP presentation, the methodologies used in creating the presentation, and the ways in which the non-GAAP measure deviates from a comparable GAAP measure.

“[b]ecause this [non-GAAP] financial information by its very nature departs from traditional accounting conventions, its use can make it hard for investors to compare an issuer’s financial information with other reporting periods and with other companies.”<sup>3</sup>

### What is “Non-GAAP Financial Information”?

As used in the Release, non-GAAP financial information refers to a numerical measure of an issuer’s 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 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 comparable measure so calculated and presented.

A common example of non-GAAP financial information is a measure of a company’s operating income that excludes one or more expense or revenue items that are identified as “non-recurring,” such as expenses related to a restructuring event which is not expected to recur. Another common example of non-GAAP financial information is EBITDA (earnings before interest, taxes, depreciation and amortization). The SEC intends the definition of non-GAAP financial

information to capture all measures that have the effect of depicting either:

- a measure of *performance* that is different from what is presented in the issuer’s 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.

Non-GAAP financial information would *not* include:

- operating and other statistical measures (such as unit sales, numbers of employees, numbers of subscribers, or numbers of advertisers); and
- ratios or measures that are calculated using only:
  - financial measures calculated in accordance with GAAP; and
  - operating measures or other measures that are not non-GAAP financial measures.

In addition, the SEC notes in the Release that non-GAAP financial measures would not include financial information that does not have the effect of providing numerical measures that are different from the comparable GAAP measure. Examples of financial measures to which the proposed rules would not apply include the following:

- disclosure of amounts of expected indebtedness, including contracted and anticipated amounts;
- disclosures of amounts of repayments that have been planned or decided upon but have not yet been made;

- disclosures of estimated revenues or expenses of a new product line, as long as those amounts were estimated as GAAP figures; and
- measures of profit or loss and total assets for each segment that are required to be disclosed in accordance with GAAP.

### What Would Issuers Have to Disclose With Respect to Non-GAAP Financial Information?

The Release proposes new Regulation G, which would apply to any entity required to file reports under Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), except for a registered investment company. Regulation G would apply *whenever* a registrant, or a person acting on its behalf, discloses or releases publicly any material information that includes a non-GAAP financial measure. This would include disclosures made in press releases, oral statements at teleconferences or investor presentations, and other public presentations, and would *not* be limited to statements that are made in SEC filings.

Regulation G, as proposed, would require issuers to provide the following information as part of each disclosure of a non-GAAP financial measure:

- a presentation of the most comparable financial measure that is calculated and presented in accordance with GAAP; and
- a reconciliation, by schedule or other clearly understandable method, of the differences between the non-GAAP financial measure presented and the comparable

financial measure or measures calculated and presented in accordance with GAAP, as long as the reconciliation can be provided without unreasonable effort.

If an issuer releases the non-GAAP financial measure orally, telephonically, in a webcast or broadcast or by similar means, Regulation G would permit the issuer to provide the required information by posting it on the issuer's website. The issuer would be required to disclose the location and availability of the required information during its oral presentation.

In keeping with its earlier cautionary statement, the SEC also reminds issuers that they may not disclose any non-GAAP financial measures that contain an untrue statement of a material fact or omit to state a material fact necessary in order to make the presentation of the non-GAAP financial measures not misleading.

### **What Would Issuers Have to Disclose in SEC Filings With Respect to Non-GAAP Financial Measures?**

In addition to the disclosure required in *all* public communications of non-GAAP financial information described above, the Release would require the following disclosure with respect to the use of non-GAAP financial measures in *all filings* made with the SEC:

- a presentation, with equal or greater prominence, of the most directly comparable financial measure calculated and presented in accordance with GAAP;
- a quantitative reconciliation, by schedule or other clearly understandable method, of the differ-

ences between the non-GAAP financial measure with the most directly comparable measure or measures calculated and presented in accordance with GAAP;

- a statement disclosing the purposes for which the issuer's management uses the non-GAAP financial measure presented; and
- a statement describing the reasons why the issuer's management believes that the non-GAAP financial measures provide useful information to investors.

In addition to these disclosure requirements, the SEC would prohibit the following with respect to non-GAAP financial measures disclosed in SEC filings:

- presenting a non-GAAP financial measure in a manner that gives it greater authority or prominence than the comparable GAAP financial measure;
- excluding from non-GAAP liquidity measures charges or liabilities that required, or will require, cash settlement, or would have required cash settlement absent an ability to settle in another manner;
- adjusting 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;
- presenting non-GAAP financial measures on the face of the issuer's financial statements that are prepared in accordance with GAAP or in the accompanying notes;
- presenting non-GAAP financial measures on the face of any pro-

forma financial information that is required to be disclosed by Article 11 of Regulation S-X;

- using 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; and
- presenting a non-GAAP per-share measure.

These proposed requirements for presentation of non-GAAP financial measures in SEC filings do not contain the exception, as set forth in Regulation G, that would permit issuers to omit the reconciliation to GAAP if that reconciliation cannot be provided without unreasonable effort.

As with disclosures made under Regulation G, issuers would be prohibited from disclosing in any SEC filing any non-GAAP financial measures that contain an untrue statement of a material fact or omit to state a material fact necessary in order to make the presentation of the non-GAAP financial measures not misleading.

### **Will Issuers Have to Disclose This Information in Any Other SEC Filings?**

The Release proposes to require companies to file press releases containing earnings information for completed annual or quarterly periods under cover of a Form 8-K. The proposal would not require companies to issue earnings releases, but if they choose to do so, the releases would have to be filed with the SEC. The proposal would not require issuers to file an 8-K if they release the information orally, via a conference call or webcast, if:

- the disclosure is made within 48 hours of a written release or announcement that is filed on Form 8-K under the new filing requirement;
- the presentation in which the disclosure is made is accessible to the public by dial-in conference call, webcast or similar technology;
- the financial and statistical information contained in the presentation is provided on the registrant's website, together with any information that would be required under proposed 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.

In addition, this filing requirement would not apply to public disclosure of earnings estimates that relate solely to *future or ongoing* fiscal periods, and not with respect to completed fiscal periods.

### **Will These Proposed Rules Apply to Foreign Private Issuers?**

Regulation G would not apply to the public disclosure of a non-GAAP financial measure by or on behalf of a foreign private issuer under the following conditions:

- the issuer's securities are listed or quoted on a securities exchange located outside the United States;
- the non-GAAP financial measure and the most comparable GAAP financial measure are not calculated

and presented in accordance with generally accepted accounting principles in the United States; 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 only outside the United States.

The exception will continue to apply even if:

- foreign or U.S. journalists or other third parties have access to the information, as long as the information is disclosed by the registrant only outside the United States;
- following its release, the information appears on a website maintained by the registrant, as long as the website is not available exclusively to, or targeted at, persons located in the United States; and/or
- following the release of the information outside the United States, the information is included in a filing with the SEC as part of a report on Form 6-K.

If, however, each of the conditions described above is not satisfied, foreign private issuers will be required to comply with Regulation G with respect to their disclosure of non-GAAP financial information.

The proposed requirements relating to disclosure of non-GAAP financial measures in SEC filings would apply to all foreign private issuers who file Annual Reports on Form 20-F to the same degree as they apply to domestic issuers.

### **What Liability Do Issuers Have With Respect to Disclosure Made Under Regulation G?**

Proposed Rule 102 of Regulation G provides that nothing in the new regulation affects any person's liability under Section 10(b) of the Exchange Act or Rule 10b-5 thereunder. However, the SEC notes in the Release that the facts and circumstances surrounding a violation of Regulation G could give rise to a violation of Rule 10b-5 if the disclosures are misleading and obscure the company's actual financial results under GAAP. Accordingly, companies will need to treat disclosures made under Regulation G with the same level of care and diligence as is given to all elements of their public financial disclosure.

### **When Will the Rules Proposed in the Release Take Effect?**

The SEC is required by the Act to issue final rules on this topic by January 26, 2003. The SEC has not yet indicated whether there will be a phase-in period for the rules proposed in the Release, or whether the required disclosures and filing obligations will be effective immediately on January 26.

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*Please contact the Mintz Levin attorney who handles your corporate and securities law matters if you have any questions regarding this information. We are continuing to monitor closely all developments relating to the Act and will notify our clients when the proposed rules become final.*