

# Conditions for Use of Non-GAAP Financial Measures

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PRACTICE AREAS

Corporate/Securities Law

**MEMORANDUM To:** Our Clients and Friends **From:** Olshan Grundman Frome Rosenzweig & Wolosky LLP **Date:** February 5, 2003 **Re:** Conditions for Use of Non-GAAP Financial Measures

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On January 23, 2003, the Securities and Exchange Commission (the "SEC") released final rules implementing Section 401(b) of the Sarbanes-Oxley Act of 2002. The rules regulate the disclosure by public companies [1] of "non-GAAP" financial information. These rules will go into effect on March 28, 2003. To clarify the application of these rules, the SEC has created a new term: "non-GAAP financial measures,"[2] to distinguish such financial measures from "pro forma financial information" as that term is used in Regulation S-X. The SEC's approach to the disclosure of "non-GAAP financial measures" was two-fold:

- New Regulation G was added, which will apply to all subject disclosures on or after March 28, 2003. Regulation G requires issuers that distxt or release non-GAAP financial measures to include, in the disclosure or release, the most directly comparable GAAP financial measure and a reconciliation of the distxted non-GAAP financial measure to the most directly comparable GAAP financial measure.
- Item 10 of Regulations S-K and S-B was amended and will apply to any annual or quarterly report filed with respect to a fiscal period ending after March 28, 2003. The amendments provide additional guidance to those issuers that include non-GAAP financial measures in their filings with the SEC.

The SEC has also amended Form 8-K to add a new requirement to furnish information whenever an issuer publicly issues earnings releases or similar announcements, regardless of whether the releases or announcements include non-GAAP financial measures. The amendment to Form 8-K will go into effect for any releases or announcements made after March 28, 2003.

## *Financial Measures*

### **Regulation G**

Regulation G will apply to any issuer, domestic or foreign, other than a registered investment company, that is subject to SEC periodic reporting requirements (e.g., Forms 10-Q, 10-K). Regulation G provides that a non-GAAP financial measure, taken together with the accompanying information, may not contain an untrue statement of a material fact or omit to state a material fact necessary to make the presentation of the non-GAAP financial measure, in light of the circumstances under which it is presented, not misleading.

Under Regulation G an issuer, when publicly disclosing or releasing material information that includes a non-GAAP financial measure, must provide as part of the disclosure, the following information relating to the non-GAAP financial measure:

- a presentation of the most directly comparable financial measure calculated and presented in accordance with GAAP; and
- a quantitative reconciliation (by schedule or other clearly understandable method) detailing the differences between the non-GAAP financial measure presented and the most directly comparable financial measure or measures calculated and presented in accordance with GAAP.

Oral disclosures of non-GAAP financial measures. *When an issuer publicly distxts a non-GAAP financial measure orally, telephonically, in a webcast or broadcast, or by similar means, Regulation G permits an issuer to provide the required accompanying information by (1) posting that information on the issuer's Internet website at the time it is made public and (2) disclosing the location and availability of the required accompanying information during its presentation.*

Foreign Private Issuers Regulation G also applies to foreign private issuers [3], unless the following conditions are satisfied:

- the securities of the issuer are listed or quoted on a securities exchange or inter-dealer quotation system outside the United States;
- the non-GAAP financial measure is not derived from or based on a measure 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 issuer outside the United States, or is included in a written communication that is released by or on behalf of the issuer only outside the United States.

### **Amendments to Item 10 of Regulation S-K and Regulation S-B**

The SEC has amended Item 10 of Regulations S-K and S-B to address the use of non-GAAP financial measures in SEC filings. These amendments apply to the same categories of non-GAAP financial measures covered by Regulation G, but contain more detailed disclosure requirements, including a statement describing the reasons why the non-GAAP financial measures provide useful information. [4] Foreign private issuers are also subject to the disclosure requirements because the SEC has amended Form 20-F to incorporate Item 10 of Regulation S-K.

## **Business Combination Transactions Excepted**

The requirements of Regulation G and new Item 10(h) do not apply to a non-GAAP financial measure included in disclosures relating to (1) a proposed business combination, (2) the entity resulting from a business combination, or (3) an entity that is a party to a business transaction, if the disclosure is contained in a communication that is subject to the SEC's communications rules applicable to business combination transactions.

## *New Form 8-K Requirements*

The SEC also amended Form 8-K to add a new Item 12. This Item requires issuers to 'furnish' a Form 8-K within five business days of any public announcement or release disclosing material nonpublic information regarding an issuer's results of operations or financial condition for a completed annual or quarterly fiscal period, irrespective of whether this information includes non-GAAP financial measures. The amendment to Form 8-K does not require that companies issue earnings releases. However, such releases and amendments will trigger the requirements of Item 12. Furthermore, Item 12 does not apply to public disclosure of earnings estimates for future or ongoing fiscal periods, unless the estimates are included in an announcement containing information covered by Item 12.

Any non-GAAP financial measure included in information furnished under new Item 12 is subject to the disclosure requirements of Regulation G described above. In addition, issuers must also distxt:

- the reasons why the issuer's management believes that presentation of the non-GAAP financial measures provides useful information to investors regarding the issuer's financial condition and results of operations; and
- to the extent material, the additional purposes if any, for which the issuer's management uses the non-GAAP financial measures that are not otherwise distxtd.

Issuers may satisfy this requirement by including the disclosure in the Form 8-K or in the release or announcement that is included as an exhibit to the Form 8-K. Issuers may also satisfy the requirement to provide this additional information by including the disclosure in their most recent annual report filed with the SEC (or a more recent filing) and by updating those statements, as necessary, no later than the time the Form 8-K is furnished to the SEC.

Because issuers are required only to "furnish," rather than "file," their results of operations or financial condition for annual or quarterly fiscal periods, such information is not subject to (1) the requirements and proscriptions of amended Item 10 of Regulation S-K or S-B or (2) the liability provisions under Section 18 of the Exchange Act, unless the issuer specifically states that the information is to be considered "filed." Furthermore, information that is "furnished" to the SEC is not incorporated by reference into a registration statement, proxy statement or other report unless the issuer specifically incorporates the "furnished" information into those documents by reference.

## **Relationship between Regulation FD and New Item 12**

A Form 8-K furnished to the SEC would satisfy an issuer's obligation under both Regulation FD and new Item 12 only if the issuer furnishes the Form 8-K within the required timeframes and indicates that it is being furnished under both Item 9 and Item 12.

The Regulation FD disclosure requirements could be satisfied by public disclosure other than through the furnishing of

an Item 9 Form 8-K; in that case, a Form 8-K furnished in accordance with Item 12 would be required to be filed within the timeframe set forth in Item 12.

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These are only brief descriptions of the SEC's new rules. This memorandum provides general information only and does not constitute legal advice that may be applied to any particular situation. Please contact the Partners in our Corporate Department for further advice and assistance.

**Annex A**

A "non-GAAP financial measure" is a numerical measure of an issuer's historical or future financial performance, financial position or cash flows that:

(1) 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

(2) includes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded in the most directly comparable measure so calculated and presented. Non-GAAP financial measures do not include financial information that does not have the effect of providing numerical measures different from the comparable GAAP measure.

Examples of non-GAAP financial measures include:

(1) a measure of operating income that excludes one or more expense or revenue items that are identified as "non-recurring;"

EBITDA (earnings before interest, taxes, depreciation and amortization), which could be calculated using elements derived from GAAP financial presentations but, in any event, is not presented in accordance with GAAP; and

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.

**Exclusions**

Non-GAAP financial measures do not include:

(1) operating and other statistical measures (such as unit sales, numbers of employees, numbers of subscribers, or numbers of advertisers);

(2) ratios or measures that are calculated using exclusively one or both of:

- financial measures calculated in accordance with GAAP; and

- operating measures or other measures that are not non-GAAP financial measures.

(3) financial measures required to be distxtd by GAAP, the SEC's rules, or any other system of regulation of a government, governmental authority or self-regulatory organization that is applicable to the issuer.

Examples of financial measures to which Regulation G would not apply include measures providing financial information that is consistent with GAAP measures, such as:

- (1) disclosure of amounts of expected indebtedness, including contracted and anticipated amounts;
- (2) disclosures of amounts of repayments that have been planned or decided upon but not yet made;
- (3) disclosures of estimated revenues or expenses of a new product line, so long as such amounts were estimated in the same amount as would be computed under GAAP;
- (4) measures of profit or loss and total assets for each segment required to be distxtd in accordance with GAAP;
- (5) sales per square foot (assuming that the sales figure was calculated in accordance with GAAP); and
- (6) same store sales (again assuming that the sales figures for the stores were calculated in accordance with GAAP).

Additionally, measures such as capital or reserves calculated pursuant to a regulatory or legal requirement would not be covered.

## **Annex B**

In addition to the mandated disclosure requirements described above, amended Item 10 of Regulations S-K and S-B prohibit the following:

- excluding 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, other than the measures EBIT and EBITDA;
  - adjusting a non-GAAP performance measure to eliminate or smooth items identified as non-recurring, infrequent or unusual, when (1) the nature of the charge or gain is such that it is reasonably likely to recur within two years, or (2) there was a similar charge or gain within the prior two years;
  - presenting non-GAAP financial measures on the face of the registrant's financial statements prepared in accordance with GAAP or in the accompanying notes;
  - presenting non-GAAP financial measures on the face of any pro forma financial information required to be distxtd by Article 11 of Regulation S-X; and
  - 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.
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[1] Foreign private issuers are generally subject to these rules, subject to a limited exception.

[2] See Annex A for an explanation "non-GAAP financial measures."

[3] In the case of foreign private issuers whose primary financial statements are prepared in accordance with other generally accepted accounting principles, references to GAAP refer to the principles under which those primary financial statements are prepared. However, for purposes of the application of Regulation G, U.S. GAAP will apply to any non-GAAP financial measure derived from a measure calculated in accordance with U.S. GAAP.

[4] See Annex B for the types of disclosures prohibited by amended Item 10.