

SEC PROPOSED RULES ON CONDITIONS FOR USE OF NON-GAAP FINANCIAL MEASURES

The Securities and Exchange Commission (the “SEC”) recently proposed rules¹ to implement Section 401(b) of the Sarbanes-Oxley Act of 2002 (the “Act”). Section 401(b) seeks to improve the transparency and quality of public disclosures containing pro forma financial information. Toward this end, the SEC proposes to:

- Adopt Regulation G requiring companies² publicly communicating non-GAAP financial measures to include in such communications a presentation of the most comparable GAAP financial measure and a reconciliation of the disclosed non-GAAP financial measure to the most comparable GAAP financial measure.
- Adopt certain additional limitations on the use of non-GAAP financial measures in filings under the Securities and Exchange Act of 1934 (the “Exchange Act”).

In addition, as mandated by Section 409 of the Act, the SEC has proposed rules that would require public companies to promptly file their earnings releases or similar announcements with the SEC under Exchange Act Form 8-K.

The SEC has requested that comments on these proposed rules be received on or before December 13, 2002.

Commentary:

- The Act requires that the SEC issue final rules regarding pro forma financial information by January 26, 2003. Therefore, absent any special transition provisions, the applicable proposed rules could apply to annual reports for fiscal year 2002.
- The proposed rules relating to the filing of earnings releases are part of an ongoing SEC effort to expand the list of items requiring accelerated disclosure under Form 8-K. Previous SEC rule proposals on this subject have not yet been finalized.

¹ SEC Release No. 33-8145 (November 5, 2002).

² The proposed rules apply to domestic and foreign companies required to file reports under Sections 13(a) or 15(d) of the Exchange Act, excluding registered investment companies.

- The proposed rules seek a broad array of comments on a host of issues. It is therefore quite possible that the final rules will differ markedly from the proposed rules.

Use of Non-GAAP Financial Measures

Section 401(b) of the Act requires the SEC to issue rules requiring that “pro forma financial information” contained in any SEC filing or public disclosure be presented in a manner that does not contain an untrue statement or omission of a material fact necessary to render the information not misleading. In addition, such information must be “reconciled” with GAAP financial measures.

The SEC has attempted to implement its statutory mandate by proposing a two-part approach to the disclosure of non-GAAP financial measures.³ First, it has proposed new Regulation G containing disclosure requirements that would apply whenever a company publicly communicates material information that includes a non-GAAP financial measure. Second, it has proposed certain more detailed requirements when such non-GAAP financial measures are used in SEC filings.

Disclosure Requirements

In general, a company publicly disclosing material information that includes a non-GAAP financial measure must accompany that measure with the following:

- 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) of the differences between the non-GAAP financial measure and the most directly comparable GAAP financial measure.

The SEC has indicated that, in the context of public communications, the reconciliation must be “quantitative” for presentation of historical non-GAAP measures and “quantitative to the extent available without unreasonable efforts” for forward-looking non-GAAP measures. With regard to the reconciliation of forward-looking non-GAAP financial measures, the schedule or other presentation must detail the differences between the forward-looking non-GAAP financial measure and the appropriate forward-looking GAAP financial measure. If the GAAP financial measure is not available on a forward-looking basis, the company must disclose that fact, explain why it is not available and provide any reconciling information that is available without

³ While Section 401(b) of the Act refers to “pro forma financial information,” the SEC has adopted the term “non-GAAP financial measure” to identify the type of information targeted by Section 401(b), noting that the term “pro forma financial information” has also been used by the SEC in other contexts in which its meaning varies.

unreasonable effort. The company must identify any information that is unavailable and disclose its probable significance. Companies unable to satisfy this requirement would be precluded from using the forward-looking non-GAAP financial measure in their public communications.

Definition of “Non-GAAP Financial Measure”

The proposed rule defines a “non-GAAP financial measure” as a numerical measure of a company’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 comparable GAAP measure in the company’s income statement, balance sheet or statement of cash flows; or
- Includes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded from the comparable GAAP measure so calculated and presented.

The SEC has made clear that it intends for the definition of non-GAAP financial measure to capture all measures that have the effect of depicting either:

- 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.

Under the proposed rules, the term “non-GAAP financial measure” would not include financial information that does not have the effect of providing numerical measures that are different from the comparable GAAP measure. Thus, (i) financial measures calculated in accordance with GAAP; and (ii) operating or other statistical measures,⁴ would not be deemed “non-GAAP financial measures.”

- SEC examples of non-GAAP financial measures include (i) measures of operating income that exclude one or more expense or revenue items that are identified as “non-recurring,” and (ii) presentations of EBITDA, which would typically be calculated using elements derived from GAAP financial measures but are otherwise not recognized GAAP measures. Measures of operating margin where either the revenue component or the operating income component of the

⁴ In its commentary, the SEC includes unit sales, number of employees, number of subscribers and number of advertisers as examples of operating or other statistical measures not included in the definition of non-GAAP financial measures.

calculation, or both, were not calculated in accordance with GAAP, would be examples of ratios that are non-GAAP financial measures.

- Examples of measures or ratios that would not be deemed non-GAAP financial measures include:
 - Calculations of sales per square foot or same-store sales (assuming, in either case, that the sales figures for the stores were calculated in accordance with GAAP);
 - Disclosures of amounts of expected indebtedness, including contracted and anticipated amounts;
 - Disclosures of 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.

Commentary:

- The SEC distinguishes between “income or loss before taxes,” which it considers to be a GAAP financial measure, and “earnings before interest, taxes, depreciation and amortization” or “EBITDA,” which it considers to be a non-GAAP financial measure. The former is a line item disclosure that is recognized in the accounting literature, the latter is not.
- Certain industries are likely to be especially impacted by the proposed rule. For example, REITs customarily use “funds from operations” or “FFO,” a non-GAAP financial measure of cash flow, as a principal performance benchmark. Reconciling this benchmark to a comparable GAAP financial measure, such as GAAP income or cash flow, may be complicated since FFO includes certain non-cash charges but excludes others.

Antifraud Liability

The SEC notes that the new disclosures are not intended to affect or implicate any aspect of the antifraud regime currently in place. Accordingly, the proposed rules specify that a person’s compliance or non-compliance with Regulation G would not affect the person’s liability under Section 10(b) of the Exchange Act and Rule 10b-5 promulgated by the SEC thereunder. However, the facts and circumstances surrounding a violation of Regulation G may give rise to a

Section 10(b) and Rule 10b-5 violation if all the elements for such a violation are otherwise present.

The proposed rules would, however, introduce a new prohibition under the Exchange Act. The proposed rules prohibit a company from using 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 was presented, not misleading⁵. Section 3(b) of the Act provides that violations of the Act or the SEC's rules thereunder are to be treated as violations of the Exchange Act.⁶

Special Procedures for Unwritten Public Communications

Regulation G applies to the use of non-GAAP financial measures in all forms of public communication, including unwritten communications. If a non-GAAP financial measure is made public orally, telephonically, via webcast or broadcast or by similar means, the disclosure provisions will be satisfied if the information required to be disclosed is posted 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 course of the presentation.

Use of Non-GAAP Financial Measures in SEC Filings⁷

Under the proposed rules, companies⁸ using non-GAAP financial measures in filings with the SEC would, in addition to satisfying the general disclosure requirements described above, be required to include the following:

1. A presentation with equal or greater prominence of the most directly comparable GAAP financial measure;⁹

⁵ This prohibition would apply to the use of non-GAAP financial measures either in public communications or in SEC filings.

⁶ If a company or person acting on its behalf violates this prohibition, they could face SEC enforcement action among other consequences.

⁷ The proposed disclosures would be included as Item 10 of Regulation S-K (general instruction for Exchange Act filings of all issuers other than small business issuers), Item 10 of Regulation S-B (general instruction for Exchange Act filings of all small business issuers) and in Instruction C of Form 20-F (annual report of foreign private issuers).

⁸ These proposed rules would similarly apply to domestic and foreign companies required to file reports under Sections 13(a) or 15(d) of the Exchange Act, but would not apply to registered investment companies.

2. A quantitative reconciliation (by schedule or other clearly understandable method) of the differences between the non-GAAP financial measure and the GAAP financial measure;
3. A statement disclosing the purposes for which the company's management uses the non-GAAP financial measure;¹⁰ and
4. A statement disclosing why the company's management believes that presentation of the non-GAAP financial measure provides useful information regarding the company's financial condition and results of operations.¹¹

In addition, companies would be prohibited from including the following in their filings with the SEC:

- Presentation of a non-GAAP financial measure in a manner that would give it greater authority or prominence than the comparable GAAP financial measures.
- Exclusion from non-GAAP liquidity measures of charges or liabilities that required, or will require, cash settlement, or would have required cash settlement if an alternative settlement option were not available.
- Adjustment of non-GAAP performance measures to eliminate or smooth items identified as non-recurring, infrequent or unusual, when the nature of the charges or gains is such that they are reasonably likely to recur.
- Presentation of non-GAAP financial measures on the face of the registrant's GAAP financial statements or in the accompanying notes.

⁹ The "equal or greater prominence" requirement is present in the proposed rules amending Item 10 of Regulation S-B, which relates to small business issuers, but not in those amending Item 10 of Regulation S-K, relating to all other issuers. In its commentary, however, the SEC makes no reference to such a distinction, noting that filings with the SEC in general will be subject to the "equal or greater prominence" requirement in the presentation of comparable GAAP financial measures.

¹⁰ A company need not include the information required in this item (3) or in item (4) if the filing is not an annual report on Form 10-K or Form 20-F and the information was included in the company's most recent annual report on Form 10-K or Form 20-F or a more recent filing, provided that the information is updated to the extent necessary at the time of the current filing.

¹¹ The SEC notes that the fact that the non-GAAP financial measure is used by or useful to analysts cannot be the sole support for its presentation. Rather, the justification for the use of the measure must be otherwise "substantive."

- Presentation of non-GAAP financial measures on the face of any pro forma financial information required to be disclosed in the context of certain merger transactions.
- 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.
- Presentation of a non-GAAP per-share measure.

As noted above, public disclosures of forward-looking non-GAAP financial measures have to be accompanied by a reconciliation that is “quantitative to the extent available without unreasonable effort.” In the context of SEC filings, however, the reconciliation would have to be “quantitative,” without any qualification for “unreasonable efforts” required to compile such information.

Special Provisions Relating to Foreign Private Issuers

Certain special provisions would be applicable to foreign private issuers under the proposed rules:

- Whether or not an item would be deemed a “non-GAAP” financial measure would, in the case of a foreign private issuer, be determined with reference to the generally accepted accounting principles used in preparing such issuer’s primary financial statements, notwithstanding that these accounting principles may differ from generally accepted accounting principles in the United States.
- The disclosure requirements in Regulation G applicable to public communications using non-GAAP financial measures would not apply to a foreign private issuer if the following conditions are met:
 - The issuer’s securities 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 public communication is made outside of the United States, or is included in a written communication that is released by the registrant only outside the United States.

The proposed rules note that this exception for foreign private issuers will apply even in one or more 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 the issuer only outside the United States;
 - Following its release or disclosure, the information appears on one or more websites maintained by the issuer, so long as the websites, taken together, are not available exclusively to, or targeted at, persons located in the United States; and/or
 - Following the disclosure or release of the information outside the United States, the information is included in a Form 6-K filed by the issuer with the SEC.
- The prohibitions associated with the use of non-GAAP financial measures in SEC filings would not apply to a foreign private issuer if:
 - The non-GAAP financial measure is expressly permitted under the generally accepted accounting principles used in the issuer's primary financial statements filed with the SEC; and
 - The non-GAAP financial measure is included in the annual report prepared by the foreign private issuer for use in the jurisdiction in which it is domiciled, incorporated or organized or for distribution to its security holders.

Required Filing of Earnings Releases

Filing Requirement

The SEC has previously proposed expanding the list of circumstances that would require a current filing on Exchange Act Form 8-K and accelerating the timetable for submitting the Form to two business days following the occurrence of the triggering circumstance.¹² The SEC has now proposed adding corporate earnings releases to the list of triggering circumstances,¹³ which would include all public announcements or releases (including updates of earlier announcements or releases) disclosing material non-public information regarding a company's results of operations or financial condition for an annual or quarterly fiscal period that has ended.

¹² See SEC Release No. 33-8106 (June 17, 2002) and Release No. 33-8128 (September 5, 2002).

¹³ The disclosure would be included in a new Item 1.04 entitled "Disclosure of Results of Operations and Financial Condition." The disclosure would briefly identify the announcement or release, and the text of the announcement or release would be filed as an exhibit.

- The proposal would not require the issuance of earnings releases or similar announcements. Any such releases and announcements would, however, trigger the new proposed filing requirement.
- The proposal applies only to earnings releases containing material non-public information. Repetition of information previously disclosed in a different form (for example, in an interim or annual report to shareholders) would not trigger an additional filing, unless the release incorporated additional or updated material non-public information.
- The proposal would not apply in the case of disclosures made via quarterly reports on Forms 10-Q (or 10-QSB) or annual reports on Forms 10-K (or 10-KSB) filed with the SEC under the Exchange Act. Companies that issue earnings releases in interim or annual reports to shareholders would be permitted to specify the portion of the report that contains the information required to be filed under the proposed rule.
- The proposal applies only to releases covering completed fiscal periods. Public disclosure of earnings estimates for future fiscal periods would therefore not trigger the required filing¹⁴ unless the estimates were included in a release covering a completed fiscal period.¹⁵
- Unlike disclosures “furnished” under Form 8-K to satisfy the requirements of Regulation FD, filings of earnings releases under the proposed rule would always be considered “filed” with SEC for liability purposes under Section 18 of the Exchange Act and for purposes of incorporation by reference into registration statements and proxy statements. Information “furnished” under Regulation FD would not satisfy the filing requirement of the proposed rule. On the other hand, information “filed” under the proposed rule, if filed within the time frame established by Regulation FD, would satisfy the requirements of Regulation FD.

¹⁴ Forward-looking information (as defined in Section 21E of the Exchange Act) publicly disclosed under Regulation FD could continue to be furnished under Form 8-K Item 9 (proposed to be renumbered as Item 6.01). If furnished under Item 6.01, such forward-looking information would not be deemed “filed” under the Exchange Act for purposes of Section 18 liability and incorporation by reference in registration statements and proxy statements. Forward-looking information could be filed voluntarily under proposed Item 1.04, in which case it would, if filed within the appropriate time frame, satisfy the requirements of Regulation FD.

¹⁵ In such case, the forward-looking information may either be filed as part of the Item 1.04 or may instead be identified specifically and furnished under Item 6.01 in the same Form 8-K that contains the historical information filed pursuant to Item 1.04.

- The proposed rules relating to the use of non-GAAP financial measures in SEC filings would apply to earnings releases required under the proposed rule to be filed on Form 8-K.

Commentary:

- The proposal deems an “earnings release” to be one that discloses previously undisclosed information relating to a company’s results of operations or financial condition for an annual or quarterly fiscal period, even if the company has previously filed a formal earnings release for the applicable fiscal period. Information disclosed outside of the framework of a formal earnings release, such as in the context of an analysts’ call, could therefore be deemed an “earnings release” requiring a separate Form 8-K filing. As noted above, furnishing the script of the analysts’ call under Form 8-K pursuant to Regulation FD would not satisfy the proposed filing requirement.
- Because the proposed rules prohibiting the use of certain non-GAAP financial measures in SEC filings would apply to all earnings releases required to be filed on Form 8-K, these prohibited non-GAAP financial measures (e.g., EBITDA or FFO per share) could not be used in any public communication that could be deemed an “earnings release” under the proposed rules. This could effectively preclude the use of these non-GAAP financial measures in analysts’ calls. The proposed rule may therefore have far-reaching effects on financial presentations of companies in industries, like the REIT industry, in which non-GAAP financial measures are key benchmarks of performance.

Special Procedures for Unwritten Earnings Releases

An earnings release issued orally, telephonically, via webcast or by similar means would not trigger the proposed filing if:

1. The unwritten release initially occurs within 48 hours of a related, written announcement or release that is filed under the proposed rule;
2. The presentation is accessible to the public by dial-in conference call, webcast or similar technology;
3. The financial and statistical information contained in the presentation is provided on the company’s website, together with any information that would be required under proposed Regulation G; and

4. 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 company's website where the information would be available.

* * * * *

If you wish to obtain additional information regarding these new proposals or other initiatives, or assistance in developing a detailed program to help ensure compliance, or copies of any of our previous client memoranda, in New York please contact John S. D'Alimonte (212-728-8212, jd'alimonte@willkie.com), Yaacov M. Gross (212-728-8225, ygross@willkie.com), Jeffrey S. Hochman (212-728-8592, jhochman@willkie.com), and in London please contact Gregory Astrachan (44-207-696-5442, gastrachan@willkie.com) or the partner who regularly works with you.

Willkie Farr & Gallagher is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000, and our facsimile number is (212) 728-8111. Our website is located at www.willkie.com.

November 15, 2002