

SEC Releases Final Rules for Use of Non-GAAP Financial Measures

The SEC recently released final rules to implement Section 401(b) of the Sarbanes-Oxley Act of 2002 regarding public disclosure of pro forma financial information, which the rules define as “non-GAAP financial measures”. Although the final rules are substantially similar to the proposed rules summarized in a previous Securities Alert, the SEC made several important changes and clarifications that are described below.

The new rules apply one set of regulations (new Regulation G) to all public disclosures of non-GAAP financial measures by issuers and another, more stringent set when these disclosures are included in any SEC filings. The rules do not apply to registered investment companies. In addition, the SEC released final rules requiring that public companies file on Form 8-K any earnings release or announcement disclosing material non-public financial information about a completed fiscal year or quarter. A summary of the rules follows:

Definition of “Non-GAAP Financial Measure”

The rule defines “non-GAAP financial measure” as a numerical measure of a company’s historical or future financial performance 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; or
- includes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded from the comparable GAAP measure.

Examples of non-GAAP financial measures include:

- EBITDA; and
- measures of operating income that exclude expense or revenue items that are identified as “non-recurring”.

Non-GAAP financial measures do not include such things as:

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

- financial measures that are required to be disclosed by GAAP, SEC rules or a system of regulation that is applicable to the issuer.¹

Disclosure of “Non-GAAP Financial Measures”

New Regulation G requires that, whenever a company publicly discloses or releases material information that includes a “non-GAAP financial measure,” the company must accompany it 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) of the differences between the non-GAAP financial measure presented and the comparable financial measure or measures calculated and presented in accordance with GAAP. The reconciliation must be quantitative both for historical measures and, to the extent available without unreasonable efforts, for forward-looking measures.

If the appropriate GAAP financial measure is not accessible on a forward-looking basis, the company must identify this fact and disclose its probable significance.

Regulation G also provides a general requirement that a non-GAAP financial measure, taken together with the accompanying information, may not misstate a material fact or omit to state a material fact necessary to make the presentation of the non-GAAP financial measure not misleading, in light of the circumstances under which it is presented.

Regulation G does not apply to any disclosure of a non-GAAP financial measure relating to a proposed business combination if the disclosure is contained in a communication that is subject to the rules applicable to business combination transactions.²

If a non-GAAP financial measure is released orally, telephonically or in a webcast, an issuer may comply with Regulation G by posting the required comparative information on its website, provided that the location of the website and the availability of the comparative information is made public during the presentation of the non-GAAP financial measure.

Limited Exception For Foreign Private Issuers

Regulation G would apply to foreign private issuers, except for those to which all of the following conditions apply:

- its securities 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 U.S. GAAP, and

¹ This exclusion was not part of the original proposal.

² This exception, which was not part of the SEC’s original proposal, exempts disclosures of non-GAAP financial measures that represent projections or forecasts of results of proposed business combinations.

- the disclosure is made outside the United States, or is made inside the United States contemporaneously with or after it is released outside the United States, and the disclosure is not otherwise targeted at persons located in the United States.³

For a foreign private issuer, GAAP refers to the primary GAAP under which the foreign private issuer prepares its financial statements.⁴

Use on Non-GAAP Financial Measures in SEC Filings

The rules⁵ require more disclosure than Regulation G for non-GAAP financial measures in SEC filings. They require:

- a presentation, with equal or greater prominence, of the most directly comparable financial measure calculated and presented in accordance with GAAP;
- a reconciliation (by schedule or other clearly understandable method) which shall be quantitative for historical measures and, to the extent available without unreasonable efforts, for forward-looking measures, of the differences between the non-GAAP financial measure disclosed with the most directly comparable measure calculated and presented in accordance with GAAP (the company must identify any forward-looking information that is unavailable and disclose its probable significance);⁶
- a statement describing why management believes the non-GAAP financial measures provide useful information to investors; and
- to the extent material, a statement disclosing the additional purposes, if any, for which management uses the non-GAAP financial measure.⁷

In addition, the amendments prohibit:

³ The final rules clarify that foreign private issuers who release non-GAAP financial information in the United States do not need to comply with Regulation G if the information is not released in the United States before it is released outside the United States and the information is not otherwise available exclusively to, or targeted at, persons located in the United States.

⁴ The final rule included this clarification so that a foreign private issuer would not have to reconcile a non-GAAP financial measure to both GAAP in its home country and U.S. GAAP. But, if the disclosed non-GAAP financial measure is derived from or based on a measure calculated in accordance with U.S. GAAP, then the reconciliation would have to be made to the most directly comparable U.S. GAAP financial measure.

⁵ The rules amend Item 10 of Regulation S-K, Item 10 of Regulation S-B and Form 20-F.

⁶ The SEC revised its original proposal so the reconciliation requirement for SEC filings contains the same exception for forward-looking non-GAAP financial measures as in Regulation G, which requires quantitative reconciliation for forward-looking non-GAAP financial measures if the information is available without unreasonable efforts. The original proposal for SEC filings did not include the “unreasonable effort” exception.

⁷ The SEC’s original proposal would have required a company to state both why management believes the non-GAAP financial measure provides useful information to investors and why management uses such non-GAAP financial measure. Recognizing that the reasons would likely be the same, the final amendment only requires a statement of management’s purposes for using the non-GAAP financial measure to the extent that it is material and different from why management considers the measure useful to investors.

- 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;⁸
- 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 within two years or there was a similar charge or gain within the prior two years;⁹
- presenting non-GAAP financial measures on the face of GAAP financial statements or their footnotes;
- presenting non-GAAP financial measures on the face of any pro forma financial information required to be disclosed by Article 11 of Regulation S-X; and
- using titles or descriptions for the non-GAAP financial measures that are confusingly similar to those for GAAP financial measures.¹⁰

The amendments do not apply to disclosures of non-GAAP financial measures relating to business combinations if the disclosure is contained in a communication that is subject to the rules applicable to business combination transactions.¹¹

No Exemption for Foreign Private Issuers

The amendments do not provide an exception for filings by foreign private issuers, except to the extent that the non-GAAP financial information is required or expressly permitted by the foreign GAAP used in the issuer's primary financial statements.¹²

Amendment to Form 8-K Requiring Filing Certain Releases and Announcements

The SEC's new rules require public companies to furnish within five business days¹³ of any release or public announcement of material non-public financial information about a completed fiscal year or quarter, a Form 8-K containing such release or announcement. The requirement to furnish on Form 8-K would apply whether or not the release or announcement included disclosure of non-GAAP financial measures. Regulation G applies to these releases and announcements but, because the information is required to be

⁸ The SEC's original proposal did not exempt EBIT and EBITDA, which are now expressly permitted so long as they are reconciled to their most directly comparable GAAP financial measures. The SEC expects that a company, in its discussion of why EBIT and EBITDA are useful to investors, will discuss why investors would find the measures useful, given the excluded items.

⁹ The two-year limitation was not part of the SEC's original proposal.

¹⁰ The amendment deletes the prohibition on the use of "non-GAAP per-share financial measures" that was part of the SEC's original proposal, although per-share measures that are specifically prohibited under GAAP will continue to be prohibited in materials filed or furnished to the SEC.

¹¹ This exception is identical to the exception in Regulation G.

¹² The SEC clarified that this exception is intended only to cover situations where a non-GAAP financial measure is required or expressly permitted by the applicable foreign GAAP standards, and not situations where the measure is merely not prohibited.

¹³ The SEC's original proposal would have required the Form 8-K to be furnished within 2 business days. The SEC indicated that it may shorten the deadline when it finalizes its other Form 8-K proposals.

“furnished” rather than “filed,” the more stringent rules applicable to the use of non-GAAP financial measures in SEC filings do not apply.¹⁴ However, for any non-GAAP financial measures presented in the release or public announcement, the following must be disclosed in either the Form 8-K or the release or announcement in addition to the requirements of Regulation G:

- a statement describing why management believes such non-GAAP financial measures provide useful information to investors; and
- to the extent material, a statement disclosing the additional purposes, if any, for which management uses the non-GAAP financial measure.¹⁵

The rule does not require furnishing of financial information for a completed fiscal period that is disclosed orally, telephonically, by webcast or broadcast if:

- the presentation occurs within 48 hours of a related, written release that has been furnished to the Commission before the presentation, even though the related, written release is not required to be furnished until 5 business days after its release;
- the presentation is broadly accessible to the public by dial-in conference call, webcast or similar technology;
- the financial and statistical information contained in the presentation is posted on the company’s website together with any information that would be required under Regulation G; and
- the presentation was announced by a widely disseminated press release that included instructions on how to access the presentation and the location of the company’s website where the information would be available.

These new requirements are in addition to the requirements of Regulation FD. However, a Form 8-K furnished within the timeframe required by Regulation FD and otherwise satisfying the requirements of both existing Item 9 of Form 8-K for the purposes of Regulation FD and new Item 12 of Form 8-K could be furnished to the Commission once, indicating that it is being furnished under both Item 9 and Item 12 to satisfy both requirements. The requirements do not apply to announcements and disclosures made only in filed 10-Qs. Furthermore, the new requirements do not apply to public disclosure of earnings estimates, unless the estimates are included in a public disclosure of material non-public financial information about a completed fiscal year or quarter, although Regulation FD will continue to apply to the disclosure of earnings estimates.

¹⁴ The SEC’s original proposal would have required that the Form 8-K be “filed with,” rather than “furnished to,” the Commission. Other significant implications of the change from “filing” to “furnishing” are (1) furnished information is not subject to the liability provisions of Section 18 of the Exchange Act unless the issuer specifically states that the information is to be considered “filed” and (2) furnished information is not incorporated by reference into a registration statement, proxy statement or other report unless the issuer specifically incorporates that information into those documents by reference.

¹⁵ These disclosure requirements, which are contained in the instructions to Item 12 of Form 8-K, are intended to provide some of the protections that would apply to filed documents.

Comment Process and Effective Date

Regulation G and the requirement to furnish earnings releases on Form 8-K will become effective on March 28, 2003. The rules regarding non-GAAP financial measures in SEC filings will apply to any annual or quarterly report filed with respect to a fiscal period ending after March 28, 2003.¹⁶

Contact Information

If you have any questions or would like to learn more about the proposed rules, please contact the lawyer who normally represents you.

¹⁶ Accordingly, these rules do not apply to any Form 10-K filed for fiscal years ending on December 31, 2002.