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SECURITIES LAW

Non-GAAP Financial Measures

Pursuant to Section 401(b) of the Sarbanes-Oxley Act of 2002 (the "Act"), the Securities and Exchange Commission (SEC) recently issued final rules¹ governing the disclosure, either in SEC filings, press releases, or other means of public dissemination, of material information that includes a "non-GAAP financial measure."² *As discussed in more detail below, these rules will become effective on March 28, 2003.*

What is a "non-GAAP financial measure"?

A non-GAAP financial measure is 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 most directly comparable measure that is calculated and presented in accordance with generally accepted accounting principles, or GAAP, in the company's statement of income, balance sheet or statement of cash flows (or equivalent statements); or
- *includes* amounts, or is subject to adjustments that have the effect of including amounts, that are *excluded* from the most directly comparable GAAP-based measure.³

Non-GAAP financial measures would *not* include:

- statistical and operating measures, such as unit sales, numbers of employees, or numbers of customers;
- ratios or statistical measures that are calculated using exclusively one or both of:
 - GAAP-based financial measures; and
 - operating or other measures that are not non-GAAP financial measures;
- disclosure of amounts of expected indebtedness;
- disclosure of amounts of repayments that have been planned or decided upon but not yet made;

¹ These final rules are available on the SEC's website at <http://www.sec.gov/rules/final/33-8176.htm>.

² Please see our Client Alert dated December 9, 2002, entitled "Update on the Sarbanes-Oxley Act (Sixth in a Series): SEC Issues Proposed Rules on the Use of Non-GAAP Financial Information," available at <http://www.mintz.com/newspubs/Bus-fin&Sec/SECClientAlert12902.pdf>, for a description of these rules as originally proposed.

³ The SEC noted in the release relating to the proposed rules on this topic that it would use the phrase "non-GAAP financial measures," rather than the phrase "pro forma financial information," to identify the types of information targeted by Section 401(b) of the Act. The SEC noted that it would do so in order to avoid confusion, because its rules and regulations use the phrase "pro forma financial information" in other contexts, particularly in Regulation S-X, to denote other types of information than the types that are regulated by these rules (such as financial statements that are prepared following a significant acquisition or disposition).

- disclosure of estimated revenues or expenses of a new product line, so long as such amounts were estimated in the same manner as would be computed under GAAP;
- measures of profit or loss and total assets for each segment of a company's business that are required to be disclosed in accordance with GAAP; or
- financial measures that a company is required to disclose by GAAP, SEC rules or a separate system of regulation that is applicable to a company, such as insurance regulations that require disclosure of particular financial measures that may not be calculated in accordance with GAAP.

The use by a company of figures such as EBITDA (earnings before interest, taxes, depreciation and amortization), income before restructuring charges, income before special items, or a measure of operating income that excludes expense or revenue items that are identified as "non-recurring," however, *would* be considered to be non-GAAP financial measures. In addition, the SEC notes that it intends for the definition of a non-GAAP financial measure to capture 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.

Contrary to the SEC's initial rule proposals issued in November 2002, the final rules will not apply to a non-GAAP financial measure that is included in disclosure relating to a proposed business combination,

such as a merger or acquisition, if the disclosure is part of a communication that is subject to the SEC's communications rules that are applicable to business combination transactions. For example, if a public company enters into an agreement to acquire another company, the public company issues a press release relating to the proposed transaction in which it includes projected non-GAAP financial information reflecting the business combination, and the public company is required to file the press release with the SEC pursuant to Rule 425 under the Securities Act of 1933, as amended, the company will not have to comply with these rules with respect to the projected non-GAAP financial information included in the press release.

When will we need to include the disclosure required by these rules?

The rules as adopted contain one set of provisions (set forth in an amendment to Item 10 of Regulation S-K) to be followed by companies when they disclose non-GAAP financial measures in *filings made with the SEC*, and another, somewhat less extensive set of provisions, under new Regulation G, to be followed when companies make *any public disclosure* that includes a non-GAAP financial measure.

Regulation G: rules apply to *any public disclosures or releases*

Under Regulation G, whenever a company makes *any public disclosure or release* of material information that includes a non-GAAP financial measure:

- the company must also present the most directly comparable financial measure that is calculated and presented in accordance with GAAP;
- the company must provide a clearly understandable quantitative reconciliation of the differences between the

non-GAAP financial measure and the most directly comparable GAAP financial measure; and

- no material misstatements or omissions may be made that would make the presentation of the non-GAAP financial measure, under the circumstances in which it is made, misleading.

If a non-GAAP financial measure is released orally, telephonically, by web cast, by broadcast, or by similar means, the company may provide the information required by Regulation G by: (1) posting that information on the company's website;⁴ and (2) disclosing during the presentation where the required information may be found.

Amended Item 10 of Regulation S-K: rules apply *only* to SEC filings

When a company includes a non-GAAP financial measure *in a filing with the SEC*, it must:

- present, *with equal or greater prominence*, the most directly comparable financial measure that is calculated and presented in accordance with GAAP;
- provide a clearly understandable quantitative reconciliation of the differences between the non-GAAP financial measure and the most directly comparable GAAP financial measure;
- state why the company's management believes that the non-GAAP financial measure provides useful information to investors regarding the company's financial condition and results of operations;⁵ and
- to the extent material, disclose any additional purposes for which the company's management uses the non-GAAP financial measure.

⁴ The SEC suggests, but does not require, that companies provide website access to this information for at least 12 months.

⁵ The SEC noted that management's belief as to the usefulness of the non-GAAP financial measure to investors cannot be based solely on the fact that the measure may be used by or useful to securities analysts. Management must present an independent, substantive justification for the use of the measure.

In addition to these disclosure requirements, the new rules also flatly prohibit companies from doing the following in filings made with the SEC:

- 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) the company had a similar charge or gain within the prior two years;
- presenting non-GAAP financial measures on the face of the company’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 required to be disclosed by Article 11 of Regulation S-X (such as those required to be prepared following a significant business combination); and
- using titles or descriptions of non-GAAP financial measures that are the same as, or confusingly similar to, titles or descriptions that are used for GAAP financial measures.

In response to comments on the proposed rules, the SEC eliminated its proposed requirement that companies not be allowed to include non-GAAP per share financial measures, such as per share EBITDA or EBIT presentations, in filings with the SEC.

The SEC also cautioned companies not to use “boilerplate” language for the statements regarding the purposes for which they use the non-GAAP financial measures and the utility of the information to management. These statements should be written clearly and understandably, and should be specific to the non-GAAP financial measure used, the company, the nature of the company’s business and industry, and the manner in which management uses the non-GAAP financial measure and applies it to management decisions. The requirement to include these statements may be satisfied by including the disclosure in the company’s most recent annual report filed with the SEC, or by an update in a more recent SEC filing.

What liability do companies have for disclosures made under these rules?

The SEC cautioned companies that materially deficient disclosure under Regulation G may, in addition to constituting a violation of Regulation G, give rise to a violation of Section 10(b) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), or Rule 10b-5 issued thereunder (in that, among other things, non-GAAP financial measures could mislead investors if they obscure the company’s GAAP results). Prior to the adoption of Regulation G, the SEC had demonstrated its longstanding concern about the use by companies of misleading non-GAAP financial information when it imposed a cease-and-desist order against Trump Hotels & Casino Resorts, Inc.⁶ In that action, the SEC found that Trump Hotels had issued a materially misleading press release in violation of Section

10(b) and Rule 10b-5 when it included a net income figure in the press release without revealing that part of the net income amount was comprised of a one-time gain, even though the release did note the exclusion of a one-time charge. Accordingly, the SEC has made it clear that it is monitoring companies’ use of non-GAAP financial information, and will bring enforcement actions if such disclosure is materially misleading.

Although the SEC did not expressly address this point in the release, it appears that companies would incur liability for materially false or misleading non-GAAP financial measures that are included in SEC filings under existing liability provisions of the Exchange Act, including Sections 10(b) and 18(a), and Rule 10b-5.

On a positive note, however, a company’s failure to include all of the information required to be included in a public disclosure or release by Regulation G would not affect either the company’s eligibility to use particular registration statement forms under the Securities Act of 1933 or whether there is adequate current public information regarding the company for purposes of Securities Act Rule 144(c).

Who is subject to the rules on non-GAAP financial measures?

These rules apply to any entity that files reports under Section 13(a) or 15(d) of the Exchange Act, including small business issuers and foreign private issuers (subject to the limited exception described below), other than a registered investment company.

⁶ *In the Matter of Trump Hotels & Casino Resorts, Inc.*, Release No. 34-45287 (Jan. 16, 2002). The SEC had previously cautioned issuers about the potential for investor confusion arising from the use of non-GAAP financial information in Accounting Series Release No. 142 (Release No. 33-5337), dated March 15, 1973, and in “Cautionary Advice Regarding the Use of ‘Pro Forma’ Financial Information in Earnings Releases,” Release No. 33-8039, dated December 4, 2001.

What provisions in these rules are specific to foreign private issuers?

Regulation G

Regulation G does apply to companies that are foreign private issuers, subject to a limited exception. Specifically, Regulation G does not apply to public disclosure of a non-GAAP financial measure by, or on behalf of, a foreign private issuer if:

- the securities of the foreign private 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 that is calculated and presented in accordance with United States GAAP; and
- the disclosure is made by or on behalf of the foreign private issuer outside the United States, or is included in a written communication that is released by or on behalf of the foreign private issuer outside the United States.

This exception for foreign private issuers will continue to apply *even where* any one or more of the following circumstances are present:

- a written communication is released in the United States as well as outside the United States, so long as the communication is released in the United States contemporaneously with or after the release outside the United States and is not otherwise targeted at persons located in the United States;
- foreign journalists, U.S. journalists or other third parties have access to the information;
- the information appears on one or more websites maintained by the company, 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 to the SEC made under cover of a Form 6-K.

In the case of foreign private issuers whose primary financial statements are not prepared in accordance with U.S. GAAP, Regulation G provides that the term “GAAP” as it applies to those issuers refers to the principles under which the company’s primary financial statements are prepared. However, in the case of foreign private issuers that include a non-GAAP financial measure that is derived from or based on a measure that is calculated in accordance with U.S. GAAP, Regulation G makes clear that, in that instance, the term “GAAP” refers to U.S. GAAP for purposes of the application of the requirements of Regulation G to the disclosure of that measure.

SEC Filings (non-Regulation G)

In addition, foreign private issuers will be subject to the same requirements as domestic issuers with respect to the use of non-GAAP financial measures in their filings with the SEC on Form 20-F. However, filers on Form 40-F under the Multi-Jurisdictional Disclosure System are not subject to those requirements.

The definition of a non-GAAP financial measure is the same for foreign private issuers as it is for domestic issuers. However, a non-GAAP financial measure that would otherwise be prohibited will be permitted by foreign private issuers in a Form 20-F filing if the measure is:

- required or expressly permitted by the standard-setter that establishes the system of GAAP that is used in the foreign private issuer’s primary financial statements, and
- included in the foreign private issuer’s annual report or financial statements used in its home country jurisdiction or market.

This exception only covers situations where the foreign organization has affirmatively acted to require or permit the measure, and not situations where the measure was merely “not prohibited.”

When will these rules take effect?

These rules will become effective on March 28, 2003. The disclosures required by Regulation G must be included in public releases as of that date. The disclosures required for non-GAAP financial measures included in SEC filings will apply to annual and quarterly reports filed with respect to a fiscal period ending after March 28, 2003.

What effect will these rules have on the process for issuing public statements including non-GAAP financial measures?

The requirement to provide a reconciliation to GAAP, in all public statements that include a non-GAAP financial measure, will require companies to devote more time and resources to the preparation of the financial information in their press releases. Accordingly, investor relations and internal financial personnel should be made aware of these substantive requirements and the need for additional preparation time for these kinds of releases. In addition, companies may want to have these disclosures reviewed by their independent public accountants and a member of their audit committee prior to the public release of the information, in light of the heightened scrutiny being given to non-GAAP financial information. Finally, companies should take particular care in crafting the disclosure in SEC filings relating to the reasons that management uses the non-GAAP financial measures, in order to avoid “boilerplate” disclosure.

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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.