

Conditions for Using Non-GAAP Financial Measures and Publicizing Earnings

As part of its implementation of the Sarbanes-Oxley Act of 2002, the Securities and Exchange Commission recently issued final rules that govern the use of “non-GAAP financial measures” and the conditions under which public companies may publicize earnings. Release No. 33-8176 (Jan. 22, 2003) <http://www.sec.gov/rules/final/33-8176.htm>.

Background

The last decade witnessed a rising tide in the use of financial information derived using methods differing from generally accepted accounting principles. Non-GAAP financial information, also known informally as pro forma financial information, permitted alternative measures of a company’s financial condition and results. These measures were particularly popular among young companies riding the wave of the new economy. However, when that wave crashed in the late 1990’s, public doubts surfaced about the wisdom of emphasizing non-GAAP financial information. Congress responded to these concerns by instructing the SEC, in Section 401(b) of the Sarbanes-Oxley Act, to adopt rules regulating the use of non-GAAP financial information. Under Section 409, Congress also instructed companies to make such real time disclosures of material information as the SEC shall require.

Based on these mandates, the SEC has adopted new rules in three main areas. First, the SEC has added a new disclosure requirement, Regulation G,¹ prohibiting the use of non-GAAP financial information outside of SEC filings without complementary disclosure of the most directly comparable GAAP financial measure and a reconciliation of the two measures. Second, the SEC has amended Item 10 of Regulation S-K (and Regulation S-B) to cover the use of non-GAAP financial measures in SEC filings. Third, the SEC has added a new Item 12 to Form 8-K that requires registrants to furnish earnings releases or similar announcements to the SEC with a Form 8-K, regardless of whether these communications contain non-GAAP financial measures.

The new rules were proposed by the SEC last November. Release No. 33-8145 (Nov. 5, 2002) <http://www.sec.gov/rules/proposed/33-8145.htm>. They were revised slightly in response to comments from the public and adopted by the SEC on January 22, 2003. The rules take effect on March 28, 2003. Regulation G will apply to all covered disclosures made in releases or other public statements on or after that date. The amendments to Item 10 of Regulation S-K (and Regulation S-B) will apply to annual and quarterly report filings regarding fiscal periods ending after that date. The new Item 12 of Form 8-K will apply to earnings releases and announcements made on or after March 28, 2003.

¹ Regulation G consists of three new rules: Rule 100 (general rule), Rule 101 (definitions), and Rule 102 (no effect on fraud liability). See 17 C.F.R. § 244.100 *et seq.*

Non-GAAP Financial Measures in Public Statements

What Does Regulation G Require?

Regulation G addresses concerns about the use of “non-GAAP financial measures” in earnings releases and other corporate announcements. It sets forth a general rule that a registrant may not make public a non-GAAP financial measure that, in light of any accompanying information and discussion, includes a false statement of material fact or omits one that is needed to render the use of the non-GAAP financial measure not misleading.²

Regulation G also contains a specific requirement. Whenever a registrant, or person acting on its behalf, publicly discloses material information that includes a non-GAAP financial measure, the registrant must add to that presentation the following two-part complementary presentation:

- a presentation of the “most directly comparable” financial measure according to GAAP; and
- a reconciliation of the differences between the two measures, i.e. GAAP and non-GAAP.³

If the non-GAAP financial measure is released orally or by telephone, webcast, broadcast or similar media, then the registrant may satisfy the specific requirement by posting the complementary presentation on its website and, during the presentation, informing the audience of the availability and location of that additional information.

What Is a Non-GAAP Financial Measure?

Regulation G defines a non-GAAP financial measure as “a numerical measure of a registrant’s historical or future financial performance, financial position or cash flow” that either excludes amounts that “the most directly comparable GAAP measure” would have included or, alternatively, includes amounts that the comparable GAAP measure would have excluded.⁴ The definition seeks to circumscribe all measures that, in effect, portray (a) a measure of performance that is different from that presented in the financial statements as calculated under GAAP or (b) a measure of liquidity that differs from cash flow or cash flow from operations calculated under GAAP.

The definition expressly excludes financial and statistical measures calculated using exclusively either or both of financial measures calculated in accordance with GAAP and operating or other measures that are not non-GAAP financial measures.⁵ The definition also excludes financial measures that must be disclosed to satisfy “GAAP, Commission rules, or a system of regulation of a government or governmental authority or self-regulatory organization that is applicable to the registrant.”

² See 17 C.F.R. § 244.101(b).

³ *Id.* at § 244.101(a). In general, this reconciliation must be quantitative, for both the historical information and any forward-looking information presented. However, recognizing the difficulty that may arise in so reconciling the latter category, the SEC softens this rule by requiring quantitative reconciliation of forward-looking information only “to the extent available without unreasonable efforts.” 17 C.F.R. § 244.100(a)(2). Separately, the registrant must identify what information is not available and disclose its probable significance.

⁴ In its proposing release, the SEC asserted its preference for the term “non-GAAP financial measure,” rather than “pro forma financial information,” so as to avoid confusion with the use of the latter term in other contexts, including Article 11 of Regulation S-X.

⁵ 17 C.F.R. § 244.101. The SEC adopting release cites the following examples of measures that would fall outside the definition: statistics such as unit sales and numbers of employees, subscribers, or advertisers; disclosure of expected indebtedness amounts; disclosure of amounts of planned-but-unmade repayments; disclosure of estimated revenues or costs of a new product line (if those amounts were estimated in the same way as under GAAP); and measures of profit, loss, or total assets for each segment that must be disclosed under GAAP.

To Whom Does Regulation G Apply?

Regulation G applies to any entity required to file reports under Section 13(a) or 15(d) of the Securities Exchange Act of 1934, except for registered investment companies. Regulation G is triggered whenever such a registrant publicly releases or discloses any material information that includes a non-GAAP financial measure. The rule, however, does not cover disclosure of non-GAAP financial measures if the disclosure is part of a communication that is subject to the SEC's rules for communications regarding business combination transactions.

How Does Regulation G Relate to Anti-Fraud Rules?

Regulation G is strictly a reporting requirement. Its new Rule 102 expressly provides that neither compliance nor non-compliance with Regulation G in itself affects any person's liability under the anti-fraud rules under Section 10(b) of the Exchange Act or under Rule 10b-5.

Foreign private issuers are generally subject to Regulation G, unless they qualify for an exemption by satisfying the following three conditions:

- the securities of the foreign private issuer are listed on an exchange (or quoted on an inter-dealer quotation system) outside the United States;
- the non-GAAP financial measure is not based on a measure calculated and presented according to U.S. GAAP; and
- the disclosure is made (or released in a written communication) by or on behalf of the foreign private issuer outside the United States.

The SEC indicated in its adopting release that it believes the conditions to this exemption appropriately accommodate the interests of U.S. investors and foreign companies in the context of facilitating enhanced global communications. Accordingly, the SEC noted, the exemption for foreign private issuers extends far enough to embrace any of the following situations:

- a written communication, which is not targeted at persons located in the United States, is released both inside and outside the U.S., provided that U.S. dissemination does not precede release outside the country;
- foreign or U.S. journalists or other third parties have access to the information;
- the information appears on one or more of the registrant's websites that as a whole are not exclusively available in the United States or targeted at persons therein; or
- after dissemination outside the U.S., the registrant submits the information to the SEC as part of a Form 6-K.

Non-GAAP Financial Measures in SEC Filings

Final rule amendments to Item 10 of Regulation S-K (and Regulation S-B) govern the use of non-GAAP financial measures in SEC *filings*. The amendments define non-GAAP financial measures the same way that Regulation G does, but they impose requirements and prohibitions that are more extensive than those of Regulation G.

What Do the Amendments Require?

In essence, the amendments require registrants using non-GAAP financial measures in filings to include the identical complementary presentation required under Regulation G (i.e. the most directly comparable GAAP measures and a reconciliation).⁶ In addition, a registrant must include a statement detailing why its management believes each non-GAAP financial measure is useful to investors, as well as a second statement of the additional purposes (if any, and only to the extent material and not elsewhere disclosed) for which management uses each measure.

If accompanied by the complementary presentation and justifying statements described above, non-GAAP financial measures generally may be used in filings. However, the amendments prohibit the following:

- exclusion of charges or liabilities requiring cash settlement (or that would have required such settlement without an alternative means of settlement) from non-GAAP liquidity measures, except for EBIT and EBITDA measures (which can be used);
- adjustment of non-GAAP performance measures to remove or smooth items described as infrequent or non-recurring if either (1) the type of charge or gain is reasonably likely to recur within two years or (2) a similar charge or gain occurred within the previous two years;
- presentation of non-GAAP financial measures on the face of the registrant's GAAP financial statements or corresponding notes;
- presentation of non-GAAP financial measures on the face of any pro forma financial information that must be disclosed to satisfy Article 11 of Regulation S-X; and
- use of titles or descriptions of non-GAAP financial measures that are identical or confusingly similar to those used for GAAP financial measures.⁷

To Whom Do the Amendments Apply?

The amendments apply to registrants, except registered investment companies, that make filings with the SEC. Foreign private issuers are not generally exempt from these amendments. Form 20-F has been amended to incorporate Item 10 of Regulation S-K, thus providing equal treatment to both U.S. and foreign issuers. A foreign private issuer, however, may use an otherwise-prohibited non-GAAP financial measure in a Form 20-F filing if that measure is (1) required or expressly permitted by the standard-setter that sets forth the generally accepted accounting principles employed in that issuer's primary financial statements and (2) included in the foreign private issuer's annual report or financial statements employed in the issuer's home country or market.

⁶ The presentation of the most directly comparable GAAP measures must be at least as prominent as the non-GAAP counterparts.

⁷ In response to significant comment, the SEC dropped from this list of prohibitions the use of non-GAAP per share measurements. Nevertheless, per share measures that are prohibited specifically under GAAP or other SEC rules remain prohibited in SEC filings.

“Furnishing” Earnings Releases To the SEC

What Is the New Requirement?

The amendment to Form 8-K adds a new Item 12, entitled “Disclosure of Results of Operations and Financial Condition.” In general, this item requires that, whenever a registrant publicly releases material non-public information about results of operation or financial condition for a completed quarterly or annual period, the registrant must *furnish* (not “file”) that release to the SEC with a Form 8-K within five business days.⁸ This furnishing obligation does not arise unless a registrant makes a public earnings release or announcement, which Item 12 does not require.

Furnishing vs. Filing

The proposed rule would have required “filing” of the information on Form 8-K, but the SEC modified the proposal in response to comments that the amount and quality of information provided to investors would otherwise suffer. Information “furnished”—as opposed to filed—enjoys certain advantages from a registrant’s perspective. It is not subject to Section 18 of the Exchange Act (unless the registrant states otherwise); it is not incorporated by reference into a registration statement, proxy statement, or other report (unless the registrant states otherwise); and it is not subject to the requirements in amended Item 10 of Regulation S-K (and Regulation S-B).

When Does the Furnishing Obligation NOT Apply?

In its adopting release, the SEC clarified that the general rule to furnish information with new Item 12 would not apply under certain circumstances. For example, Item 12 is not triggered by mere repetition of information previously disclosed to the public, by old information repackaged in a different form or by new accompanying information that is not material.⁹ Item 12 also does not apply to issuers that make earnings announcements only in their periodic filings with the SEC. And, because Item 12 only applies to completed periods, public disclosures of earnings estimates that relate only to future or ongoing periods are not covered.

Item 12 also includes an exception for release of complementary presentations that relate back to recent Item 12 reports. Under this exception, the complementary presentation must be made by oral communication, telephone, webcast, broadcast or similar media and occur 48 hours after the release of related information that was furnished to the SEC under Item 12. In addition, under this exception, the complementary presentation must be

- widely available to the public by means of an open conference call, webcast, etc.;
- posted on the registrant’s website, along with any additional information necessary under Regulation G if the presentation includes non-GAAP financial information; and
- announced by a broadly distributed press release that indicates when and precisely where on the registrant’s website the information is posted.

How Does Item 12 Interact with Other Rules?

The requirement of Item 12 of Form 8-K to furnish releases or announcements applies irrespective of whether they contain any non-GAAP financial measures. But if non-GAAP financial measures *are* included, they trigger Regulation G and two additional requirements of Item 12: the same

⁸ If Item 12 applies, the registrant must briefly identify the announcement or release and attach it as an exhibit to the Form 8-K.

⁹ In contrast, the release of additional or updated material non-public information (about a completed quarter or year) does trigger an Item 12 obligation.

two statements of reasons and purposes that are mandated by amended Item 10 of Regulation S-K (and Regulation S-B). Registrants may comply with these extra requirements by (1) including the complementary information in the Form 8-K or in the attached release or announcement or (2) adding the two explanatory statements to their most recent annual report filed with the SEC, and updating them as needed until the Form 8-K is furnished.

Earnings releases and like disclosures that are subject to Item 12 are likewise subject to Regulation FD, a rule that prohibits selective disclosure of material information absent contemporaneous broad, non-exclusionary dissemination. Such dissemination can be achieved by furnishing the information to the SEC under Item 9 of Form 8-K. Although Regulation G and Regulation FD apply differently to Form 8-K, under certain circumstances, a Form 8-K could be furnished once and satisfy both regulations. The Form 8-K would have to be furnished within the timeframes required by both regulations, indicate that it was being furnished under both Items 9 and 12, and otherwise satisfy the requirements of both items.

Conclusion

One clear result of these new rules is that public companies will now regularly be furnishing earnings releases to the SEC. The implications of Regulation G and of the conditions on the use of non-GAAP financial measures in filings with the SEC are less clear. All public statements and SEC filings that utilize non-GAAP financial measures will now be saddled with complementary presentations. For some, the additional disclosure requirement may cause a reduction in the use of non-GAAP financial measures, particularly if GAAP-based and other operating metrics are sufficient to present a registrant's picture clearly. Some companies, however, are likely to continue to use non-GAAP financial measures believing that these measures provide useful insight into performance and condition. This will especially be the case in industries in which analyst models are heavily dependent on such measures. In these cases, whether or not investors or analysts will heed the required complementary presentations is an open question.

*David B.H. Martin
John M. Smith*

If you would like to learn more about the Securities Practice Group at Covington & Burling, please call any of the following:

| | | |
|---------------|--------------------|-----------------|
| Washington | David B.H. Martin | 202.662.5128 |
| | D. Michael Lefever | 202.662.5276 |
| New York | Bruce C. Bennett | 212.841.1060 |
| San Francisco | Andi Vachss | 415.591.7069 |
| London | Kelly Vance | 44.20.7067.2040 |

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