

## The Sarbanes-Oxley Act of 2002: Non-GAAP Financial Measures and Changes to the Rules Relating to the Use of *Pro Forma* Financial Information

### Overview

The Sarbanes-Oxley Act of 2002 ("SOX") imposed on the Securities and Exchange Commission tight deadlines for the adoption of a number of new rules intended to restore investor trust and confidence in the public markets. One of the perceived abuses that SOX was designed to address was the widespread public disclosure of *pro forma* financial information in a manner that was often viewed to be misleading. To address these concerns, Congress included as Section 401(b) of SOX a requirement that the SEC promulgate rules relating to the use of *pro forma* financial information. On January 22, 2003, the SEC adopted the new rules required by this section. These rules create a new term, "non-GAAP financial measures," to refer to financial information that differs from GAAP financial information, and impose a number of new requirements and prohibitions on disclosure of these measures in press releases and SEC filings. However, the SEC went beyond the requirements of Section 401(b) and created a new Form 8-K filing requirement, which is triggered by a public announcement or release disclosing material non-public information regarding a company's completed quarterly or annual financial results, whether or not the press release or other disclosure contains non-GAAP financial measures. This Cooley Alert provides a summary of these new rules.

### Definition of Non-GAAP Financial Measures

A "non-GAAP financial measure" is generally defined as a numerical measure of a company's historical or future financial performance, financial position or cash flows that either includes or excludes amounts or adjustments that would be required in the most directly comparable GAAP measure. The SEC intends that the definition of non-GAAP financial measure capture all measures that have the effect of presenting alternatives to GAAP measures of financial performance, but not measures that do not have this effect, such as operating or statistical measures (e.g., numbers of employees) and ratios and statistical measures calculated either directly from GAAP measures or from measures other than non-GAAP financial measures.

The new rules define GAAP to be either U.S. GAAP or, for foreign private issuers with primary financial statements prepared in accordance with non-U.S. GAAP, the non-U.S. GAAP. However, if a foreign private issuer presents a non-GAAP financial measure derived from a U.S. GAAP financial measure, then GAAP refers to U.S. GAAP for the disclosure of that measure.

### Exception

The term non-GAAP financial measure does not include a financial measure

required to be disclosed by GAAP, SEC rules or a governmental or self-regulatory agency applicable to the company, provided that, when made in filings with the SEC, the measure is reported only outside the financial statements unless required to be reported in the financial statements or expressly permitted (as opposed to not prohibited) by the standard setter for the financial statements.

### New Regulation G

#### Application

The new rules create Regulation G, which applies whenever a company publicly discloses or releases material information that includes a non-GAAP financial measure. Regulation G expressly provides that a non-GAAP financial measure, combined with the accompanying related information, may not contain materially misleading misstatements or omissions. In addition, Regulation G requires that a company provide the following information as part of the disclosure or release of a non-GAAP financial measure:

- 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 most

directly comparable financial measure or measures calculated in accordance with GAAP. For forward-looking, as opposed to historical, measures, this quantitative reconciliation is required only to the extent available without unreasonable efforts. Although not specified in Regulation G itself, the release states that if the GAAP financial measure is not available on a forward-looking basis, the company must disclose that fact, identifying the information that is unavailable and its probable significance, and provide reconciling information that is available without unreasonable effort. For example, if a company forecasts EBIT, but is unable to forecast what its taxes will be (*e.g.*, because it does not know whether it will be able to use significant tax credits or NOLs), then the company would not be required to provide a quantitative forecast of net income, but would need to disclose the reason why it cannot provide this forecast and discuss the probable significance of the tax information.

If a non-GAAP financial measure is released orally, telephonically, in a webcast or broadcast or by similar means, Regulation G permits the company to provide the required accompanying information, such as a quantitative reconciliation, by posting it on the company's website at the time it is made public. The company is required to disclose the location and availability of the required accompanying information during its presentation. The SEC suggests, but does not require, that companies provide website access to the information for at least 12 months.

The rules do not require that any specific measures be deemed the "most directly comparable" GAAP financial measures, but, as general guidance, the SEC's view is that:

- non-GAAP financial measures that measure cash or funds generated from operations (liquidity) should be balanced with disclosure of amounts from the statement of cash flows; and
- non-GAAP financial measures that depict performance should be balanced with net income, or income from continuing operations, taken from the statement of operations.

## Exceptions

Regulation G provides two exceptions from its application. The first exception is for disclosures by foreign private issuers when (a) the company's securities are listed on a non-U.S. exchange or quotation system, (b) the non-GAAP financial measure is not derived from or based on a measure calculated and presented in accordance with U.S. GAAP, and (c) the non-GAAP financial measure is disclosed or released outside of the U.S. prior to or contemporaneously with its release in the U.S. and is otherwise not targeted at people located in the U.S. The second exception provides that Regulation G does not apply to disclosures related to a business combination, the parties to the combination or the entity resulting from the combination, if the disclosure is contained in a communication that is subject to the SEC's communications rules applicable to business combination transactions.

## Consequences of Violation

A violation of Regulation G could give rise to an SEC enforcement action against a company, or a person acting on its behalf, under both Regulation G and the anti-fraud rules.

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## New Regulations Governing SEC Filings

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### Application

The new rules also add to Item 10 of each of Regulations S-K and S-B a new section governing the disclosure of non-GAAP financial measures in documents filed with the SEC. In addition, some of the provisions of Regulation G, such as the prohibition on misleading non-GAAP information, would also be applicable to SEC filings. The requirements of these new sections are more extensive than Regulation G and require that companies using non-GAAP financial measures in SEC filings provide:

- a presentation, *with equal or greater prominence*, of the most directly comparable financial measure calculated and presented in accordance with GAAP;

- a quantitative reconciliation (by schedule or other clearly understandable method) of the differences between the non-GAAP financial measure presented and the most directly comparable financial measure or measures calculated in accordance with GAAP. Again, with respect to forward-looking measures, the quantitative reconciliation is required only to the extent available without unreasonable efforts. Although not specified in amended Item 10, the release states that if the GAAP financial measure is not available on a forward-looking basis, the company must disclose that fact, identifying the information that is unavailable and its probable significance, and provide reconciling information that is available without an unreasonable effort;
- a statement describing the reasons why the company's management believes the presentation of non-GAAP financial measures provides useful information to investors, referred to as a "statement of utility" (*e.g.*, net income excluding proceeds from an unusually large and non-recurring litigation settlement may permit investors to better compare results from period to period and to more accurately assess the company's prospects); and
- to the extent material, a statement disclosing the additional purposes, if any, for which management uses the non-GAAP financial measure, if not otherwise disclosed, referred to as a "statement of purpose" (*e.g.*, for purposes of analyzing and allocating resources within the company).

Companies are advised to avoid boilerplate and to craft these statements to be as specific to the company and its management as possible.

In addition to these mandated disclosure requirements, Item 10 of Regulations S-K and S-B prohibits an issuer from:

- 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 EBIT and EBITDA (which must still be reconciled to GAAP);
- 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 when there was a similar charge or gain *within the prior two years*;

- presenting non-GAAP financial measures on the face of the company'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 disclosed 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.

If the non-GAAP financial measure is presented in a filing other than an annual report on Form 10-K or Form 20-F (the form used by foreign private issuers), the statements of utility and purpose may be omitted from that filing if they have been included in the most recent annual report of the company (or a more recent filing) and updated, as necessary, in subsequent filings.

### Exception

As with Regulation G, the new amendments to Item 10 are not applicable to disclosures related to business combinations, the parties to the combination or the entity resulting from the combination, if the disclosure is contained in a communication that is subject to the SEC's communications rules applicable to business combination transactions.

### Consequences of Violation

Information presented in documents "filed" under the Exchange Act is incorporated by reference into registration statements, proxy statements or other reports, and is therefore subject to the anti-fraud prohibitions applicable to statements made in these documents as if made directly in those documents. For example, if the statement is incorporated into a registration statement, then the statement will be subject to Section 11 liability under the Securities Act, which is easier to prove than Section 10 liability under the Exchange Act.

## New Addition to Form 8-K

### Application

The SEC's release on the use of non-GAAP financial measures adds to Form 8-K a new Item 12, which requires companies to "furnish" (as opposed to "file") the announcement of previously non-public, material earnings information for a completed annual or quarterly period, whether or not non-GAAP financial measures appear in the release. Generally, the Form 8-K submission is due five business days from the date of the release of the information.

The new item of Form 8-K would require the company to identify briefly the earnings announcement or release and include the announcement or release as an exhibit to the Form 8-K. In addition, if non-GAAP financial measures appear in the earnings announcement or release, the company will be required to comply with the presentation (including prominence) and reconciliation mandates, and disclose the statements of purpose and utility, comparable to those required under Item 10 of Regulations S-K and S-B (described above). The statements of purpose and utility may be disclosed either in the Form 8-K, in the release or announcement that is included as an exhibit to the Form 8-K or in the most recent annual report filed with the SEC (or a more recent filing) and updated, as necessary, no later than the time the Form 8-K is furnished to the SEC.

The requirement to furnish a Form 8-K, however, would not be triggered by:

- public disclosure of earnings estimates for future or ongoing fiscal periods (that do not include material non-public information regarding an annual or quarterly fiscal period that has ended);
- repetition of information that was publicly disclosed previously;
- the release of the same information in a different form (*e.g.*, in an interim or annual report to shareholders); or
- accompaniment of the repeated information with information that was not material, whether or not already public.

However, release of *additional or updated* material non-public information regarding the company's results of operations or financial condition for a completed fiscal year or quarter would trigger an additional Item 12 obligation. If the information is included in an interim or annual report to shareholders, companies could specify in the Form 8-K which portion of the report contains the information required to be furnished under Item 12. In addition, the Form 8-K requirement would not apply if the announcement or disclosure is made only in a Form 10-Q or 10-QSB, or Form 10-K or 10-KSB.

### Exception

No Form 8-K is required to be furnished for oral, telephonic, webcast or broadcast announcements if:

- the information is provided as part of a presentation that is complementary to, and initially occurs within 48 hours after, a related, written announcement or release that has been furnished on Form 8-K pursuant to Item 12 *prior to the presentation*;
- the presentation is broadly accessible to the public by dial-in conference call, by webcast, by broadcast or by similar means;
- the financial and other statistical information contained in the presentation is provided 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 as to when and how to access the presentation and the location on the company's website where the information would be available.

As a result, companies that conduct earnings calls will, for all practical purposes, need to file their press releases, not within five business days, but almost immediately, and at least before the call, in order to avoid having to furnish the text of the call on a Form 8-K. The SEC cautions that this exception is intended only to permit current practices, not to foster changes in practice that would shift disclosure from the written release to the complementary oral presentation.

## Consequences of Violation

The Item 12 Form 8-K may be “furnished” rather than “filed” with the SEC, with the result that the information in the Form 8-K is not incorporated by reference into registration statements, proxy statements or other reports (unless the company specifically states that the information is to be considered “filed” or specifically incorporates that information) or subject to the requirements of amended Item 10 of Regulations S-K or S-B. These disclosures, even if furnished but not filed, still remain subject to the general anti-fraud rules.

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## Effective Date of the Rules

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Regulation G will apply as of March 28, 2003. The requirement to furnish a Form 8-K will apply to earnings releases and similar announcements made after March 28, 2003. The amendments to Item 10 of Regulations S-K and S-B and to Form 20-F will apply to any annual or quarterly report filed with respect to a fiscal period ending after March 28, 2003. Companies will need to consider, however, whether documents that were filed before the effective date, but incorporated by reference into registration statements or other documents filed after the effective date, need to be updated to comply with the new rules, such as the reconciliation requirement of Regulation G.

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## Conclusion

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The new rules regarding the disclosure of non-GAAP financial measures will have a far-reaching effect on how public companies disclose their quarterly and annual financial information. Public companies may curtail the use of non-GAAP financial measures in their earnings releases, or discontinue the use of these measures completely, to reduce or avoid the need to describe why they use these measures. In addition, some companies may find that the prohibition on certain “smoothing” adjustments in non-GAAP financial measures may limit the utility of

these measures in many cases. If public companies continue to use non-GAAP financial measures in their earnings releases, they will have to provide significantly more information than they do now. In addition, more preparation will be required for earnings calls so that the required information can be posted on the company’s website, and the Form 8-K furnished to the SEC, in advance of the earnings call in order to avoid having to furnish the text of the call on a Form 8-K. ■

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