

**SEC ADOPTS FINAL RULES REGARDING  
CONDITIONS FOR USE OF NON-GAAP FINANCIAL MEASURES  
AND NEW FILING REQUIREMENTS UNDER FORM 8-K**

**February 5, 2003**

On January 22, 2003, the Securities and Exchange Commission (the "SEC") adopted final rules implementing Sections 401(b) and 409 of the Sarbanes-Oxley Act of 2002 (the "Act").<sup>1</sup> The final rules address (1) conditions for use of non-GAAP financial measures and (2) new filing requirements under Form 8-K applicable to earnings releases. The effective date for these final rules is March 28, 2003. See "Compliance Dates" below.

Section I of this memorandum highlights several of the more significant distinctions between the final rules, as adopted, and the rules proposed for comment on November 4, 2002.<sup>2</sup> Sections II and III summarize the material terms of the final rules.

**I. Significant Changes from the Proposals**

The final rules are substantially similar to the rules proposed in November 2002; however, there are several important differences reflecting the SEC's attempt to address the many concerns raised in comment letters submitted over the past two months. The differences that are most important to our clients include:

Regulation G

Regulation G will not apply to non-GAAP financial measures included in a disclosure that is already subject to the SEC's communications rules governing business combinations.

Amendment to Item 10 of Regulation S-K and Regulation S-B

- Like Regulation G, Item 10 of Regulations S-K and S-B will not apply to non-GAAP financial measures included in a disclosure that is already subject to the SEC's communications rules governing business combinations.
- The use of non-GAAP per share measures in documents filed with the SEC will not be prohibited.

<sup>1</sup> Final Rule: Conditions for Use of Non-GAAP Financial Measures, Release Nos: 33-8176; 34-47226; FR-65 (January 22, 2003) (available at <http://www.sec.gov/rules/final/33-8176.htm>).

<sup>2</sup> Proposed Rule: Conditions for Use of Non-GAAP Financial Measures, Release Nos. 33-8145 (November 5, 2002) (available at <http://www.sec.gov/rules/proposed/33-8145.htm>).

- The required quantitative reconciliation will include the same exception for forward-looking non-GAAP financial measures as in Regulation G.
- The measures EBIT and EBITDA are specifically exempted from the prohibitions on excluding cash-based charges and liabilities from non-GAAP liquidity measures.
- The prohibition on adjusting a non-GAAP performance measure to eliminate or smooth non-recurring, infrequent or unusual items has been clarified. Such adjustments are now prohibited only when (1) the nature of the charge or gain is such that it is reasonably likely to recur within two years, or (2) there was a similar charge or gain within the prior two years.

#### Item 12 of Form 8-K

Earnings releases and announcements subject to the requirements of Item 12 of Form 8-K need only be “furnished” to the SEC, not “filed.”

#### Definition of “Non-GAAP Financial Measure”

The definition of “non-GAAP financial measure” will not include financial measures that are required to be disclosed by GAAP, the SEC or a system of regulation that is applicable to the company.

## **II. Conditions for Use of Non-GAAP Financial Measures**

Section 401(b) of the Act directs the SEC to adopt rules requiring that any public disclosure or release of non-GAAP financial measures by a company filing reports under Section 13(a) or 15(d) of the Exchange Act be presented in a manner that:

- does not contain an untrue statement of a material fact or omit to state a material fact necessary in order to make the non-GAAP financial measure, in light of the circumstances, not misleading; and
- reconciles the non-GAAP financial measure with the financial condition and results of operations of the company under GAAP.

One of the objectives of Congress in passing the Act was to address issues relating to public companies' use of “pro forma financial information”, or financial information not presented in accordance with GAAP. Over the years, the SEC has also expressed concerns about possible investor confusion arising from the use of pro forma financial information. Most recently, in December 2001, the SEC issued cautionary advice regarding the use of pro forma financial information in earnings releases, warning of its potential for misleading investors if it obscures GAAP results.<sup>3</sup>

In order to implement Section 401(b) of the Act and further its own initiatives in this area, the SEC has adopted a two-part approach to address its concerns relating to the use of “pro forma financial information.” First, the SEC has adopted a new disclosure regulation, Regulation G, which

---

<sup>3</sup> Cautionary Advice Regarding the Use of “Pro Forma Financial Information” in Earnings Releases, Release No. 33-8039 (December 4, 2001) (available at <http://www.sec.gov/rules/other/33-8039.htm>).

applies whenever a company publicly discloses or releases material information that includes a non-GAAP financial measure. Second, the SEC has adopted amendments to Item 10(e) of Regulation S-K<sup>4</sup> to address the use of non-GAAP financial measures in documents filed with the SEC. The types of non-GAAP financial measures covered by Regulation G and Item 10 of Regulation SK are identical. However, the disclosure requirements for filings subject to Item 10 are more extensive and detailed than the requirements for disclosures or releases subject to new Regulation G.

#### Definition of “Non-GAAP Financial Measure”

For purposes of both Regulation G and the amendments to Item 10 of Regulation S-K, a “non-GAAP financial measure” is defined 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 most directly comparable GAAP measure in the statement of income, balance sheet or statement of cash flows (or equivalent statements) of the company; or
- includes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded from the most directly comparable GAAP measure.

What the Definition Includes: The SEC said it intends for this definition to capture all measures that have the effect of depicting either:

- a measure of performance that is different from net income or loss, or income or loss before taxes, or some other measure presented in the financial statements 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.

An example of a non-GAAP financial measure is a measure of operating income that excludes one or more expense or revenue items that are identified as “non-recurring.” Another example is EBITDA (earnings before interest, taxes, depreciation and amortization), which could be calculated using elements derived from GAAP financial presentations but is not presented in accordance with GAAP.

What the Definition Does Not Include: The definition of “non-GAAP financial measure” does not include:

- operating and other statistical measures (such as unit sales, numbers of employees, numbers of subscribers or number of advertisers); and
- ratios or statistical measures calculated using exclusively one or both of: (1) financial measures calculated in accordance with GAAP and (2) operating measures or other measures that are not non-GAAP financial measures.

---

<sup>4</sup> The SEC also adopted amendments to Item 10(h) of Regulation S-B, applicable to small business issuers, which are identical to the amendments to Item 10 of Regulation S-K. The balance of this memo will refer only to Item 10 of Regulation S-K.

An example of ratios and statistical measures that would not be non-GAAP financial measures would be sales per square foot or same store sales (assuming the sales figures were calculated in accordance with GAAP). An example of a ratio that would not be a non-GAAP financial measure would be a measure of operating margin that is calculated by dividing revenues into operating income, where both revenue and operating income are calculated in accordance with GAAP. (Conversely, an example of a ratio that would be a non-GAAP financial measure would be a measure of operating margin that is calculated by dividing revenues into operating income, where either revenue or operating income, or both, were not calculated in accordance with GAAP.)

Furthermore, non-GAAP financial measures do not include financial measures that do not have the effect of providing numerical measures that are different from comparable GAAP measures. Examples of measures not covered by the new rules include:

- disclosure of amounts of expected indebtedness, including contracted and anticipated amounts;
- disclosure of amounts of repayments that have been planned or decided upon but not yet made;
- 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; and
- measures of profit or loss and total assets for each segment required to be disclosed in accordance with GAAP.

To address concerns raised by commentators, the SEC departed from its original proposal and excluded from the definition of “non-GAAP financial measure” financial measures that are required to be disclosed by GAAP, the SEC or a system of regulation that is applicable to the company (for example, pro forma financial statements under Article 11 of Regulation S-X and capital or reserves calculated for regulatory purposes).

### Regulation G

Regulation G applies whenever a company that is subject to the filing requirements of Sections 13(a) or 15(d) of the Exchange Act, or a person acting on its behalf, publicly discloses or releases any material information that includes a non-GAAP financial measure.

Required Disclosure under Regulation G: Regulation G requires any public disclosure or release of a non-GAAP financial measure to be accompanied by the following information:

- 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), quantitative for historic measures and, to the extent available without unreasonable efforts, for prospective measures, of the differences between the non-GAAP financial measure

presented and the most directly comparable financial measure or measures calculated and presented in accordance with GAAP.<sup>5</sup>

The SEC has said it intends to allow companies flexibility in satisfying the “most directly comparable GAAP measure” requirement. However, the SEC also has expressed its view that (1) non-GAAP financial measures that measure liquidity should be presented and compared with amounts from the statement of cash flows (for example, cash flows from operating, investing and financing activities); and (2) non-GAAP financial measures that measure performance should be presented and compared with amounts taken from the statement of operations (for example, net income or income from continuing operations).

Consistent with the directive of Section 4.01(b) of the Act, Regulation G prohibits a company from publicly disclosing a non-GAAP financial measure that contains an untrue statement of a material fact or omits to state a material fact necessary to make the presentation of the non-GAAP financial measure not misleading. For example, the SEC has cautioned that changes in a company’s method of calculating or presenting a non-GAAP measure from period to period, without a thorough explanation of the change and its effect, may violate Regulation G.

If the public disclosure or release of a non-GAAP financial measure is transmitted orally, telephonically, by webcast or by similar means, Regulation G permits a company to satisfy the disclosure requirements by posting the accompanying information on its website. In addition, the company must disclose the location and availability of the required accompanying information during the presentation in which such non-GAAP financial measure was released. The SEC encourages companies to provide on-going website access to that information for at least one year.

Exclusion for Disclosures Relating to Business Combination Transactions: As originally proposed, Regulation G would have applied to non-GAAP projections or forecasts for proposed business combination transactions. Recognizing the chilling effect this could have on the flow of information in connection with such transactions, the SEC included an exception in Regulation G for non-GAAP financial measures in a communication subject to the SEC’s rules applicable to business combinations (Rule 425).

Liability under Regulation G: Failure to comply with Regulation G could result in SEC enforcement action. In addition, compliance with Regulation G does not affect a person's potential liability under Rule 10b-5. Therefore, a disclosure satisfying Regulation G may still give rise to liability under Rule 10b-5. Failure to include all requisite Regulation G disclosures would not, however, affect a company's eligibility to use short-form registration statements under the Securities Act or the determination whether there is adequate current public information about the company for Rule 144 purposes.

---

<sup>5</sup> If the most directly comparable GAAP financial measure is not available on a prospective or forward-looking basis, the company must disclose that fact and provide reconciling information that is available without unreasonable effort. In addition, the company must identify the information that is not available and disclose its significance.

## Amendments to Item 10 of Regulation S-K<sup>6</sup>

Like Regulation G, the amendments to Item 10 of Regulation S-K apply to companies that are subject to the filing requirements of Section 13(a) and 15(d) of the Exchange Act. In contrast to Regulation G, the Regulation S-K amendments apply only when companies use non-GAAP financial measures in documents filed with the SEC.

Required Disclosure under Item 10 of Regulation S-K: Under amended Item 10 of Regulation S-K, a company using a non-GAAP financial measure in a document filed with the SEC must include in the filing:

- 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 non-GAAP measures presented and, to the extent available without unreasonable efforts, for forward-looking information, of the differences between the non-GAAP financial measure disclosed with the most directly comparable GAAP measure or measures;<sup>7</sup> and
- a statement disclosing the reasons why the company's management believes that presentation of the non-GAAP financial measure provides useful information to investors regarding the company's financial condition and results of operations, and to the extent material and not covered by the preceding statement, a statement disclosing the additional purposes, if any, for which the company's management uses the non-GAAP financial measure that are not otherwise disclosed.<sup>8</sup>

In addition to imposing the affirmative disclosure requirements above, the amendments to Item 10 of Regulation S-K prohibit the following:

- 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;<sup>9</sup>

---

<sup>6</sup> The SEC also adopted amendments to Item 10 of Regulation S-B, applicable to small business issuers, which are identical to the amendments to Item 10 of Regulation S-K. The balance of this memo will refer only to Item 10 of Regulation S-K

<sup>7</sup> As with the quantitative reconciliation required by Regulation G, if the most directly comparable GAAP financial measure is not available on a prospective or forward-looking basis, the company must disclose that fact and provide reconciling information that is available without unreasonable effort. In addition, the company must identify the information that is not available and disclose its significance. This "unreasonable effort" exception was not provided for in the amendments to Item 10 of Regulations S-K and S-B as originally proposed.

<sup>8</sup> The SEC cautions that these required statements should not be boilerplate. Further, the required statements should be specific to the non-GAAP financial measure used, to the company, and to the nature of the company's business. The SEC notes that a statement that the non-GAAP measure is used by or useful to analysts is not sufficient by itself. The justification of the measure's usefulness must be substantive.

<sup>9</sup> In response to concerns expressed by several comment letters that the prohibition related to non-GAAP liquidity measures would prohibit the use of the non-GAAP financial measure EBITDA, and in recognition of EBITDA's wide use, the final rules provide a specific exemption from this provision for EBIT and EBITDA. Although exempted from the prohibition, a company using EBIT or EBITDA must still provide a reconciliation to the most directly comparable GAAP measure. In addition, the company must provide a statement of why investors would find the measure valuable in the context in which it is presented, given the excluded items.

- 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) 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.

As originally proposed, the amendments to Item 10 of Regulation S-K included a prohibition on the use of non-GAAP per share financial measures; however, in recognition of the usefulness to investors of certain non-GAAP per share measures, and the fact that other requirements of Item 10 would provide adequate protection, the final rules omit this prohibition. Although this prohibition has been omitted from Item 10, filings with the SEC remain subject to prohibitions on per share measures specified in other SEC rules or in GAAP (for example, the prohibition on presenting cash flow per share).

The prohibition on adjusting a non-GAAP performance measure to eliminate or smooth items identified as non-recurring received substantial comment. Several commentators criticized the provision as unclear. For example, if the provision bars adjustments that are reasonably likely to occur only if they are identified as non-recurring, then the reason for the prohibition is apparent and understandable. However, if the provision is designed to prohibit all adjustments that are reasonably likely to occur, the effect on pro forma disclosures would be significant and in many cases counterproductive. The SEC did not respond to these particular criticisms, stating only that the prohibitions are generally consistent with positions the staff has taken in commenting on registration statements and Exchange Act filings.

*Exclusion for Disclosures Relating to Business Combination Transactions:* As with Regulation G, the amendments to Item 10 of Regulation S-K, as originally proposed, would have applied to non-GAAP projections or forecasts for proposed business combination transactions. Recognizing the chilling effect this could have on the flow of information in connection with such transactions, the SEC included an exception in Item 10 of Regulation S-K for non-GAAP financial measures in a communication subject to the SEC's rules applicable to business combinations (Rule 425).

### **III. Amendment to Form 8-K**

Section 409 of the Act obligates public companies to “disclose to the public on a rapid and current basis such additional information concerning material changes in the financial condition or operations of the issuer, . . .as the [SEC] determines by rule, is necessary or useful. . . .”

In order to implement Section 409's mandate, the SEC amended Form 8-K to add a new Item 12 ("Disclosure of Results of Operations and Financial Condition").<sup>10</sup> New Item 12 requires a company to "furnish" a Form 8-K to the SEC within five business days<sup>11</sup> of any public announcement or release disclosing material non-public information regarding the company's results of operations or financial condition for an annual or quarterly period that has ended. The new item requires the company to briefly identify the announcement or release in the Form 8-K and attach the text as an exhibit. Item 12 does not apply to issuers who make earnings announcements or releases only in their quarterly or annual reports filed on Form 10-Q (or 10-QSB) or 10-K (or 10-KSB).

Item 12 does not require companies to issue earnings releases or similar announcements. Nor does Item 12 apply to public disclosures of earnings estimates for future or ongoing fiscal periods unless those estimates were included in a release of material non-public information concerning an annual or quarterly fiscal period that has ended. The release of information previously disclosed or released publicly does not trigger Item 12 (for example, in an interim report or annual report to shareholders), even where such information is accompanied by new information, so long as the new information is not material. However, a release of information that contains additional or updated non-public material information concerning a quarterly or annual period that has ended does trigger Item 12. Item 12 applies whether or not a non-GAAP financial measure is used in the release or announcement.

#### "Furnishing" versus "Filing"

Item 12 of Form 8-K requires the company to "furnish" a Form 8-K to the SEC, not "file" it. This distinction has three consequences. Information that is "furnished" (as opposed to "filed") in a Form 8-K is not:

- subject to liability under Section 18 of the Exchange Act unless the company expressly states that it is to be considered "filed";
- automatically incorporated by reference into a registration statement, proxy statement or other report; and
- subject to the non-GAAP financial measure provisions of Item 10 of Regulation S-K.

Although disclosures under Item 12 of Form 8-K are not subject to the requirements of Item 10 of Regulation SK, certain of the protections of Item 10 have been included in Item 12 of Form 8K. Specifically, any earnings release or announcement furnished under Item 12 of Form 8-K, and containing a non-GAAP financial measure, must contain statements concerning the usefulness of the information to investors and the purposes for which the company's management uses the non-GAAP financial measure. A company may comply with this requirement by including the disclosure in either a Form 8-K or exhibit thereto or the company's most recently filed annual report (or a more recent filing) and by updating those statements, as necessary, no later than the time the Form 8-K is furnished to the SEC. Regulation G would also apply since the release or announcement constitutes a public disclosure.

---

<sup>10</sup> The SEC previously proposed substantial revisions to Form 8-K in Release No. 33-8106 (July 17, 2002). The SEC expects to move forward on those proposals shortly. One expected consequence of the revisions is the renumbering of all the items in Form 8-K, including Item 12.

<sup>11</sup> As originally proposed, Item 12 required a company to file the Form 8-K within two business days after the earnings release or announcement. This was consistent with the SEC's proposal, in Release No. 33-8106, to shorten the deadline for all Form 8-K filings. In the footnotes to the current release, the SEC has indicated that it may shorten the Item 12 deadline when it addresses the remainder of its Form 8-K proposals.

### Exception to Item 12 of Form 8-K

If material non-public information is disclosed orally, telephonically or by webcast, broadcast or other similar means, Item 12 would not require companies to file a Form 8-K so long as:

- the information is provided as part of a presentation that is complementary to, and initially occurs within 48 hours after, a related, written release or announcement has been furnished to the SEC under Item 12 of Form 8-K prior to the presentation;
- 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 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.

### Relationship of Item 12 to Regulation FD

Earnings releases and announcements that trigger the requirements of Item 12 under certain circumstances would also be subject to the requirements of Regulation FD. The Item 12 requirements must always be satisfied in the manner and time prescribed in Item 12, while issuers may comply with Regulation FD using a number of public disclosure methods. A Form 8-K furnished within the time frame required by Regulation FD and otherwise satisfying the requirements of both Item 9 and Item 12 may be furnished to the Commission once, indicating that is being furnished under both Item 9 and 12, and thus would satisfy both requirements.

### **IV. Compliance Dates**

Regulation G will apply to public disclosures or releases as of March 28, 2003. Item 12 of Form 8-K will apply to earnings releases and announcements made after March 28, 2003. The amendments to Item 10 of Regulation S-K will apply to quarterly or annual reports filed with respect to a fiscal period ending after March 28, 2003.

If you have any questions about the final rules discussed in this memorandum or if we can be of further assistance, please contact the Womble Carlyle attorney with whom you work or any one of the lawyers listed in our [Contacts](#).

***This memorandum is a summary for general information only. It is not a full analysis of the matters presented and may not be relied upon as legal advice.***