

## SEC Staff Publishes Guidance Regarding the Use of Non-GAAP Financial Measures

The SEC's Division of Corporate Finance recently issued guidance in the form of 33 Frequently Asked Questions ("FAQs") on the new rules governing the use of non-GAAP financial measures. A summary of the more significant points discussed in the FAQs follows.

We have previously sent a Securities Alert that describes these rules, which include Regulation G, Item 10(e) of Regulation S-K and Item 12 of Form 8-K. The Securities Alert is available on our web site at [www.ropesgray.com](http://www.ropesgray.com) under "News and Events."

### Transition Issues

Regulation G applies to all public disclosures of non-GAAP financial measures made after March 28, 2003. Item 10(e) of Regulation S-K applies to disclosures in SEC filings covering fiscal periods ending after March 28, 2003. Several of the FAQs address questions about the interaction of filings made before and after that date.

- *Incorporation by Reference of Pre-Regulation G Filings.* If a registration statement filed after March 28, 2003 (other than on Form S-8) incorporates by reference a pre-March 28 report that contains non-GAAP financial measures:
  - The non-GAAP financial measures must be supplemented to comply with Regulation G. The supplemental disclosure can be made by amending the underlying report to include the required reconciliation, by including the reconciliation in the registration statement, or by filing a Form 8-K that includes the reconciliation.
    - The staff will not require supplemental reconciling information for a Registration Statement filed on Form S-8.
  - If the non-GAAP financial measure relates to a period ended before March 28, 2003, the additional management statements required by Item 10(e) would not be required since Item 10(e) of Regulation S-K applies only to financial information for periods ended after March 28, 2003.
    - The additional management statements required by Item 10(e) would be required to the extent the earlier disclosure was a projection that related to a period ending after March 28.
- *Amendments of Pre-Regulation G Filings.* If a pre-March 28, 2003 filing is amended after March 28, a non-GAAP financial measure in the earlier filing does not need to be supplemented to comply with Regulation G unless the non-GAAP measure itself is directly added to, revised, amended or updated in the amendment or a new non-GAAP financial measure is included in the amendment. The staff warned that each company must consider whether its disclosure would be rendered misleading if it does not supplement the other non-GAAP financial measures in the original filing to comply with Regulation G.

- *Pre-Regulation G Documents Posted on Website.* Companies that have posted documents containing non-GAAP financial measures on their websites before March 28, 2003 do not need to supplement or remove those documents unless the non-GAAP financial measure is added to, amended, revised or updated.

## Business Combination Transactions

Although Regulation G and Item 10(e) of Regulation S-K do not apply to a non-GAAP financial measure contained in written communications, such as press releases, that are subject to the Regulation M-A rules applicable to business combination transactions, the new rules do apply to any non-GAAP financial measures (even if previously included in an exempted written communication) in a registration statement, proxy statement or tender offer statement filed in connection with the transaction.

Reconciliation of a non-GAAP financial measure to a pro forma measure prepared in accordance with Regulation S-X rather than GAAP would be permitted if the pro forma measure is the most directly comparable measure.

## Item 10(e) of Regulation S-K

- *Adjustments to Smooth “Recurring” Items Not Permitted.*
  - Item 10(e) prohibits adjusting a non-GAAP financial performance measure in an SEC-filed document to eliminate items identified as *non-recurring*, infrequent or unusual, when the item is reasonably likely to recur within two years or there was a similar item within the prior two years. While there is no *per se* prohibition against adjusting for *recurring* items in SEC documents, a non-GAAP financial measure can never be used to smooth earnings and companies must demonstrate the usefulness of a non-GAAP financial measure that excludes recurring items.
  - Under Item 10(e), management must include a statement as to why a non-GAAP financial measure provides useful information to investors, which may be difficult to do if management does not reasonably believe it is probable that the financial impact of a recurring item (e.g. a pattern of restructuring charges) will disappear or become immaterial within a near-term finite period.
  - In addition to the explanation of why the non-GAAP financial measure provides useful information to investors, the staff suggested that any use of a non-GAAP financial measure in SEC filings that eliminates a recurring item should be accompanied by:
    - a description of how management uses the measure and the economic substance behind the decision to use the measure;
    - disclosure of the material limitations associated with use of the non-GAAP financial measure as compared to the use of the most directly comparable GAAP financial measure; and
    - disclosure of how management compensates for those limitations.
- *Use of Non-GAAP Financial Measures that Adjust for Recurring Items in Press Releases and Other Non-SEC Filings.* Although Regulation G does not require that management include an explanation of why the non-GAAP financial measure provides useful information to investors, the staff cautioned companies to consider whether press releases and other non-SEC filings should include a similar explanation.
- *Discussion of Non-Recurring and Recurring Charges in MD&A.* The question of whether an item must be discussed in MD&A is different from whether it may be eliminated or adjusted in connection with a

non-GAAP financial measure. Even if GAAP numbers may not be adjusted for recurring or non-recurring items, it may be necessary to identify, discuss and analyze material charges in the MD&A, including their recurring or non-recurring nature, their significance to an investor in evaluating the company's financial condition and results and whether they relate to material known trends, events or uncertainties that must be disclosed.

- *Per Share Measures of Cash Flow and Liquidity.* GAAP prohibits the use of per share measures of cash flow and liquidity. Other non-GAAP per share measures may be used, but should be accompanied by a discussion of how they are used by management and why they provide meaningful information to investors, as well as a reconciliation of the measure to the GAAP financial measure of earnings per share.
- *Use of "Free Cash Flow" Measures Permitted.* Disclosure of "free cash flow" (typically calculated as GAAP cash flows from operating activities less capital expenditures) is not prohibited under Item 10(e). However, because the term "free cash flow" has no universal definition, it should be accompanied by a clear description of how the measure is calculated and the necessary reconciliation. Companies should also disclose the material limitations of the measure.
- *Discussion in MD&A of Credit Agreement Covenants Containing Liquidity Measures Otherwise Prohibited by Item 10(e).* Item 10(e) prohibits "excluding charges or liabilities that required, or will require, cash settlement, ... from non-GAAP liquidity measures," other than EBIT and EBITDA. Measures of liquidity contained in a covenant in a company's credit agreement, such as "Adjusted EBITDA," although prohibited by Item 10(e), may still need to be discussed in MD&A if management believes that the credit agreement is a material agreement, that the covenant is a material term and that information about the covenant is material to an investor's understanding of the company's financial condition and/or liquidity, even if the measure is calculated using an adjusted measure of net income. In order to avoid misleading investors, the staff believes the disclosure should include a discussion of the materiality of the credit agreement and the covenant, the amount or limit required for compliance and the actual or reasonably likely effects of compliance or non-compliance with the covenant on the company's financial condition and liquidity.

## EBIT and EBITDA

Item 10(e) does not define the term "earnings." The staff clarified that EBIT and EBITDA measures must be calculated from and reconciled to GAAP net income, not operating income or any other adjusted measure of net income.

## Segment Information

- Segment information presented in conformity with FASB Statement 131 (including financial statement footnotes) is not a non-GAAP financial measure under Regulation G and Item 10(e) of Regulation S-K.
- The presentation of a table illustrating a breakdown of revenues by product will not be considered a non-GAAP financial measure if the aggregate revenues for each product sum to the revenue amount presented in the company's financial statements. The revenue must not be adjusted in any manner.

- The presentation of a table illustrating a breakdown of revenue by geographic location where the GAAP revenue for international operations is adjusted to exclude the effects of changes in foreign exchange rates associated with the current fiscal period will not be considered a non-GAAP financial measure if the table also presents the related foreign currency effect for the period and the aggregate revenues presented for each geographic location sum to the revenue amount presented in the company's financial statements. The presentation of the foreign exchange adjusted measure by itself would be considered a non-GAAP financial measure.
- If a company's first discussion of its segment profit or loss in a disclosure document precedes the financial statement presentation, the company should provide a cross reference in the discussion to the FASB Statement 131-required information in the footnote to the financial statements, or present such required information in the section of the report containing the discussion.

### Item 12 of Form 8-K

Item 12 of Form 8-K requires that releases containing information for a completed fiscal period must be furnished on a Form 8-K. Item 12 contains an exception for financial information for a completed fiscal period that is disclosed orally, telephonically, by webcast, by broadcast or by similar means if, among other conditions, the presentation is broadly accessible and complementary to a prior written release that, within the preceding 48 hours, has been furnished on a Form 8-K, and 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.

- *Audio Replay of Initial Webcast.* An audio replay of an initial webcast of the presentation accessible through the company's website will satisfy the posting condition if it contains all material financial and other statistical information included in the initial webcast presentation that was not previously disclosed, including any such information provided in a question and answer session.
  - *Presentations by Means Other than Webcast.* If the initial presentation was made by means other than a webcast (e.g., a conference call that is not simultaneously webcast), slides or a similar presentation containing the information posted on the company's website at the time of the presentation will also satisfy the condition.
  - Information that is not provided in the slides but that is disclosed unexpectedly in connection with a question and answer session must be posted on the company's website promptly after it is disclosed.
- *Item 12 Information Required in Form 8-K.* If a Company discloses previously undisclosed financial information covered by Item 12 in an oral, webcast or other presentation that has not been preceded by a written release furnished to the SEC on Form 8-K within the prior 48 hours, so the company is not entitled to the exception from the Item 12, Form 8-K requirement, it must furnish a transcript of the portion of the conference call or slides (or similar presentation) which contains the material undisclosed information, including any such information disclosed in the Q&A portion of the call, on a Form 8-K. Only the portion that discloses the material information must be provided, not the entire transcript. The Company should also consider any Regulation FD implications to the disclosure.

- *Earnings Releases Filed with Form 10-Q Satisfies Item 12.* A company that files an earnings release as an exhibit to its Form 10-Q before holding a conference call, rather than furnishing the release on Form 8-K, may rely on the Item 12 exemption for the conference call, provided that all other conditions for the exemption are met.
- *S-3 Eligibility Not Affected by Late Item 12, Form 8-K.* A late Item 12, Form 8-K will not affect a company's eligibility to use Form S-3 because such a Form 8-K is "furnished" rather than "filed," but the failure would constitute a violation of Section 13(a) of the Exchange Act.

## Voluntary Filers

Reports filed with the SEC by "voluntary filers" are subject to the requirements of Regulation S-K. Accordingly, these reports are subject to the requirements of Item 10(e). Although voluntary filers are not technically subject to Regulation G because they are not "required to file reports under Section 15(d)," the staff suggests that continued voluntary filing of reports with the SEC by such filers can give the impression to investors that public communications other than SEC filings made by these companies are subject to Regulation G and that the failure of such a company to comply with all requirements (including Regulation G) applicable to a Section 15(d)-reporting can raise significant issues regarding the company's compliance with the anti-fraud provisions of the federal securities laws. Accordingly, voluntary filers should strongly consider voluntary compliance with the requirements of Regulation G.

## Foreign Private Issuers

- A foreign private issuer may include in its SEC filings non-GAAP financial measures that are "expressly permitted" by the standard setter responsible for establishing the GAAP used in the company's primary financial statements. The staff clarified that a measure is "expressly permitted" if it is clearly and specifically identified as an acceptable measure by the standard setter. The staff further clarified that the "expressly permitted" condition does not prohibit the inclusion of additional caption detail about the financial measure that is permitted by the standard setter but is not required to be included.
- A foreign private issuer who furnishes a press release on Form 6-K that includes non-GAAP financial measures can choose to incorporate by reference into a registration statement only the specific portions of the press release that do not contain non-GAAP financial measures. It can do so either by specifying in the Form 6-K which portions of the press release are to be incorporated by reference or by furnishing two Form 6-K reports, one containing the full press release and the other containing the portions that would be incorporated by reference.

## Contact Information

If you have any questions or would like to learn more about the FAQs or the use of non-GAAP financial information, please contact the lawyer who normally represents you.