

June 15, 2003

**SEC STAFF PUBLISHES “FREQUENTLY ASKED QUESTIONS”
GUIDANCE ON RULES REGARDING USE OF NON-GAAP
FINANCIAL MEASURES AND ITEM 12 REQUIREMENTS UNDER
FORM 8-K**

To Our Clients and Friends:

On Friday, June 13, the staff of the SEC’s Division of Corporation Finance issued interpretations in the form of “Frequently Asked Questions” (“FAQs”) on recently adopted Regulation S-K Item 10(e) and Regulation G, which address the use of non-GAAP financial measures in the context of and outside of SEC filings, and new Item 12 of Form 8-K, which requires disclosures of material non-public financial information regarding a completed fiscal quarter or year to be furnished to the SEC on a Form 8-K. The FAQs address transition questions as they relate to disclosures that were made prior to the effective date of the foregoing rules, permissible and impermissible non-GAAP financial presentations under Item 10(e), disclosure of segment and business combination financial information, the applicability of and means of satisfying Form 8-K Item 12 in various contexts, and the applicability of these regulations to “voluntary filers” and to foreign private issuers.

The FAQs are important to read because, in our opinion, on some issues they reflect a more restrictive view of the circumstances under which non-GAAP financial measures can be used and a more expansive view of the disclosures required to accompany non-GAAP financial measures than is apparent from the text of the rules and the SEC’s release adopting those rules. The FAQs appear at <http://www.sec.gov/divisions/corpfin/faqs/nongaapfaq.htm>.

I. Overview of Regulation S-K Item 10(e), Regulation G and Form 8-K Item 12.

The FAQs address a series of rules that were adopted by the SEC on January 22, 2003 and generally became effective on March 28, 2003. The adopting release for these rules is set forth at <http://www.sec.gov/rules/final/33-8176.htm>. These rules are significant because they not only restrict the use of non-GAAP financial measures in SEC filings, but because they also regulate reporting companies’ public disclosures outside of the context of SEC filings.

Item 10(e) of Regulation S-K provides that whenever a company uses a “non-GAAP financial measure” in a document filed with the SEC, the filing must include:

- i. a presentation with equal or greater prominence of the most directly comparable financial measure calculated and presented in accordance with GAAP;
- ii. a reconciliation of the non-GAAP financial measure to the most directly comparable GAAP financial measure;
- iii. a statement disclosing why management believes the presentation of the non-GAAP financial measure provides useful information to investors; and
- iv. if material, a statement of the purposes, if any, for which management uses the non-GAAP financial measure.

Item 10(e) also prohibits the use of certain non-GAAP financial measures in SEC filings, as discussed below.

Regulation G imposes some of these same conditions on the use of non-GAAP financial measures outside of the context of SEC filings. Under Regulation G, every time a company that is a reporting company under Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended (“Exchange Act”), or a person acting on its behalf, publicly discloses any material information that includes a “non-GAAP financial measure,” the non-GAAP financial measure taken together with the accompanying information cannot be misleading, and the disclosure must be accompanied by a presentation of the most directly comparable GAAP financial measure and a reconciliation of the non-GAAP financial measure to the most directly comparable GAAP financial measure.

For purposes of Item 10(e) of Regulation S-K and Regulation G, a non-GAAP financial measure is a numerical measure of a company’s historical or future financial performance, financial position or cash flows that either:

- i. excludes amounts that are included in the most directly comparable GAAP measure in the company’s income statement, balance sheet or statement of cash flows; or
- ii. includes amounts that are excluded from the most directly comparable GAAP measure presented.

A ratio or statistic that is derived from a non-GAAP financial measure also itself constitutes a non-GAAP financial measure.

Non-GAAP financial measures *do not* include:

- i. operating and other statistical measures (such as unit sales and number of employees);
- ii. ratios or statistical measures that are calculated using exclusively one or both of: (a) financial measures calculated in accordance with GAAP, and (b) operating measures or other measures that are not non-GAAP financial measures;
- iii. financial measures that do not have the effect of providing numerical measures that are different from the comparable GAAP measure (such as amounts of expected indebtedness or amounts of repayments that have been planned but not yet made); or
- iv. financial measures required to be disclosed by GAAP, SEC rules, or governmental or self-regulatory rules that are applicable to a company.

New Item 12 of Form 8-K (Results of Operations and Financial Condition) requires that, whenever a company, or a person acting on its behalf, issues an earnings release or otherwise makes any public announcement or release disclosing material nonpublic information regarding the company’s results of operations or financial condition for a completed quarterly or annual fiscal period, the company must briefly identify the announcement or release on a Form 8-K furnished to the SEC and attach the text of the announcement or release as an exhibit to the Form 8-K. If any non-GAAP financial measure is used in that announcement or release, then the requirements of Regulation G are triggered and, in addition, Item 12 of Form 8-K requires that the most directly comparable GAAP financial measure be presented with equal or greater prominence and that an explanation be included in the Form 8-K report (or in the release or announcement) as to why management believes the non-GAAP financial measure is useful to investors. Item 12(b) of Form 8-K provides an exemption from the Form 8-K reporting requirements for earnings conference calls and other disclosures of results of operations or financial condition for completed fiscal periods that are made orally, telephonically, by webcast, by broadcast or by similar means shortly after and

that relate to an earlier written announcement or release that has been furnished to the SEC on an Item 12 Form 8-K, provided that certain conditions of the exemption are satisfied.

II. Discussion of the Frequently Asked Questions.

The FAQs provide important guidance on the application of the foregoing regulations in a variety of contexts and insight on the staff's view of various disclosure practices.

A. Transition Issues.

Regulation G applies to disclosures made after March 28, 2003. Item 10(e) applies to disclosures with respect to fiscal periods ending after March 28, 2003. A number of questions have arisen as to how these effective dates interact with past disclosures. The FAQs take the position that:

- Because Item 10(e) applies only to fiscal periods ending after March 28, 2003, in the event that a registration statement on Form S-2, Form S-3, Form S-4 or S-8 is filed after March 28, 2003 under the Securities Act of 1933 ("Securities Act") and incorporates by reference non-GAAP financial measures included in SEC reports that were filed prior to March 28, 2003 and that relate to fiscal periods ending before March 28, 2003, the disclosures and prohibitions of Item 10(e) will not be triggered.
 - However, as discussed below, in this context Regulation G will apply.
 - Nevertheless, companies should carefully review the non-GAAP disclosures that are incorporated by reference and consider whether additional disclosures are warranted, because the Item 10(e) prohibitions reflect long-held staff views regarding disclosures that are potentially misleading.
 - In the unlikely event that non-GAAP financial measures in a pre-March 28 filing relate to a period ending after March 28, 2003 (for example, if they included projections), then Item 10(e) prohibits that information from being incorporated by reference into any newly filed registration statement.
- If a Securities Act registration statement on Form S-2, Form S-3 or Form S-4 is filed after March 28, 2003 and incorporates by reference non-GAAP financial measures included in SEC reports that were filed prior to the March 28, 2003 effective date of Regulation G and that relate to fiscal periods ending before March 28, 2003, then the pre-March 28, 2003 disclosure must be supplemented to the extent necessary to comply with Regulation G.
 - For example, if a Form 10-K that was filed prior to March 28, 2003 contains non-GAAP financial measures pertaining to the 2002 fiscal year, at the time a Form S-3 is filed that incorporates by reference that Form 10-K, the registrant must provide the most directly comparable GAAP financial measure and a reconciliation of the non-GAAP financial measure to that most directly comparable GAAP financial measure. This supplemental disclosure can be made through an amendment of the Form 10-K, a newly filed Form 8-K or disclosure in the Form S-3.
- The staff will not object if Form S-8s are filed that incorporate pre-March 28, 2003 non-GAAP disclosures relating to fiscal periods ending prior to March 28, 2003, without the need to comply with Regulation G.
- If an Exchange Act report or a Securities Act registration statement that was filed prior to March 28, 2003 included non-GAAP financial measures, and an amendment to that report or registration statement is filed after March 28, 2003, the non-GAAP financial measures that were included in the

original filing must be supplemented to comply with Regulation G only if they are directly added to, revised, amended or updated in the post-March 28, 2003 amendment. Any non-GAAP financial measure included in the amendment must also comply with Regulation G and, to the extent it relates to a fiscal period ending after March 28, 2003, with Item 10(e).

- While not explicitly addressed in the FAQs, these interpretations appear to confirm that takedowns from existing Securities Act registration statements that involve only the filing of a prospectus supplement do not trigger Regulation G or Item 10(e), except to the extent that non-GAAP financial measures are included in the supplement.
- Companies should carefully review the non-GAAP disclosures that are incorporated by reference into any registration statements used after March 28, 2003 and consider whether additional disclosures are warranted to ensure that the prior disclosures are not considered misleading in light of the new disclosure standards adopted under Item 10(e) and Regulation S-K.
- The FAQs state that companies need not revise or remove documents or disclosures that were posted on their websites prior to March 28, 2003 that contain non-GAAP financial measures, but they must comply with Regulation G if the non-GAAP financial measures included in any such document or disclosure are added to, amended, revised or updated and posted on the website after March 28, 2003. For example, non-GAAP financial measures included in investor presentations that are archived on a company's investor relations web site need not be amended or removed, but if the company now revises the non-GAAP financial measures included in the presentation it must comply with Regulation G. In other contexts, senior staff from the Division of Corporation Finance have stated that a company also may continue to distribute documents that were produced prior to March 28, 2003 that include non-GAAP financial measures, without having to supplement those documents with the disclosures required under Regulation G. For example, a company can continue to distribute a glossy annual report to shareholders that was initially distributed before March 28, 2003, even if the report includes non-GAAP financial measures.

B. Item 10(e) Prohibitions.

Item 10(e) prohibits the use of certain non-GAAP financial measures in SEC filings, including (i) a prohibition on presenting non-GAAP liquidity measures that exclude cash-settled charges or liabilities, other than EBIT or EBITDA, and (ii) a prohibition on non-GAAP financial measures that eliminate or smooth items identified as non-recurring, infrequent or unusual, when the nature of such items is such that it is reasonably likely to recur within two years or there was a similar charge or gain within the prior two years. The FAQs elaborate on the scope of these prohibitions.

- The FAQs confirm that the new regulations do not create a *per se* prohibition against using non-GAAP financial measures that eliminate a recurring item. Instead, Item 10(e) only prohibits eliminating or smoothing an item and calling it “non-recurring,” “unusual” or a similar term.
- However, the FAQs state that companies must satisfy “the burden” of demonstrating the usefulness of any non-GAAP financial measure that excludes recurring items. The staff has not enunciated standards by which companies will be evaluated in satisfying this standard, but instead states that the acceptability of eliminating a recurring item or items from the most directly comparable GAAP financial measure depends on all of the facts and circumstances. It is not a new practice for the staff to review disclosures that appear in documents filed with the SEC and to comment on the acceptability of certain presentations. However, we believe these statements reflect the fact that Item 10(e) may push the staff more into what may be described as merit regulation with respect to disclosures of non-GAAP financial measures, where the staff is

the arbiter of whether a company has sufficiently justified its desire to present a non-GAAP financial measure. This in turn may result in a greater divergence between disclosures that appear inside and outside of SEC-filed documents, as companies struggle to present information that they may view as useful or responsive to their investors, and yet which may not meet the staff's standards of acceptability.

- The FAQs confirm that Regulation G does not override the requirements of Item 303 of Regulation S-K prescribing what must be addressed in Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A"). However, the fact that an item may be separately addressed in the MD&A does not mean that it may be eliminated or adjusted in order to present a non-GAAP financial measure.
- In light of these statements, we believe that companies should carefully review their reasons for and goals in disclosing non-GAAP financial measures that have the effect of eliminating the effect of recurring items so that they can be clearly articulated and, if necessary, defended.
- The FAQs state that one instance in which it may be permissible to eliminate recurring items is when management reasonably believes that the item will become immaterial or disappear in the near term. In contrast, the FAQs express the staff's view that it will rarely be acceptable to exclude restructuring charges as part of a non-GAAP financial measure if the company has a pattern of incurring restructuring charges in the past and cannot demonstrate that such charges will not continue in the future.
- The FAQs also state that, when it is permissible to use a non-GAAP financial measure that eliminates a recurring item or items within an SEC-filed document or in an Item 12 report on Form 8-K, the staff may view additional disclosures as necessary in order for the presentations to not be misleading. Specifically, the staff states it may be necessary to disclose:
 - i. the manner in which management uses the non-GAAP measure to conduct or evaluate its business;
 - ii. the economic substance behind management's decision to use such a measure;
 - iii. 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;
 - iv. the manner in which management compensates for these limitations when using the non-GAAP financial measure; and
 - v. the substantive reasons why management believes the non-GAAP financial measure provides useful information to investors.
- The FAQs confirm that it does not violate Item 10(e) to disclose a measure of "free cash flow." Questions had arisen as to this issue because the measure could be seen as involving the deduction of cash flows for capital expenditures from the GAAP financial measure of cash flow from operating activities. However, the FAQs caution that companies should take care to explain how free cash flow is calculated and to provide the reconciliation that is required by Regulation G.
- The FAQs state that companies should disclose any material limitations on the use of "free cash flow" as a liquidity measure. This statement reflects a common concern of the staff that investors understand the judgments and uncertainties that underlie financial presentations – similar to the goal of using a discussion of "critical accounting estimates" to disclose limitations on and assumptions underlying the use of certain GAAP financial presentations.

- We recommend that when a company presents free cash flow in a manner that reflects adjustments to operating income or other items that are not commonly expected to be reflected in that financial presentation, the non-GAAP financial measure should be labeled with a term such as “adjusted free cash flow” or “modified free cash flow” and the variance be clearly highlighted. This same recommendation applies equally to disclosures of a variation to any other “common” non-GAAP financial measure.
- The FAQs confirm that companies may disclose measures of EBIT and EBITDA in SEC-filed documents only if they are calculated from net income as presented in the statement of operations under GAAP and not from an “adjusted” net income number. The FAQs state that a company may present a variation of EBIT or EBITDA if required to satisfy MD&A disclosure requirements, provided that certain explanations accompany the disclosure, but the FAQs do not suggest that a reconciliation to GAAP must accompany the disclosure. The FAQs state that use of the adjusted EBIT or EBITDA measures in the SEC filing for other purposes would violate Item 10(e). The FAQs also note that when EBIT or EBITDA is presented as a performance measure – as opposed to being utilized as a measure of liquidity – it should be reconciled to net income as presented in the statement of operations under GAAP. The staff does not view operating income as the most directly comparable GAAP financial measure.

C. Information on Segments and Business Combinations.

The definition of “non-GAAP financial measure” excludes financial measures required to be disclosed by GAAP, SEC rules, or governmental or self-regulatory rules that are applicable to a company. The SEC release adopting these regulations identifies segment financial information required by FASB Statement No. 131 as an example of disclosures that do not trigger Item 10(e) or Regulation G. FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*, requires that companies report a measure of profit or loss and total assets for each reportable segment. This tabular information is presented in a note to the audited financial statements and is required to be reconciled to the GAAP measures, with all significant reconciling items separately identified and described. A registrant is required to provide a discussion in MD&A of segment information if necessary to an understanding of the company’s business. Item 10(e) of Regulation S-K also has an exclusion for the use of non-GAAP financial information in certain documents relating to business combinations.

- The FAQs take a narrow position on the scope of these exclusions by expressing caution or placing conditions on presentations outside the context of the financial statements. For example, the FAQs state that when a company’s filings discuss segment profit or loss before presenting the consolidated financial statements, the disclosure should include a cross-reference to its financial statement footnote that presents and reconciles segment results to the company’s consolidated results or should present the Statement 131-required reconciliation in the text of the disclosure.
- We believe that this guidance also generally reflects a practice that should be considered when a company seeks to satisfy the requirement under Regulation G that the nearest comparable GAAP financial measure and a reconciliation “accompany” the disclosure of a non-GAAP financial measure. For example, when a company first uses a non-GAAP financial measure in an investor presentation, we recommend that there be a cross-reference to the location in the presentation of the comparable GAAP financial measure and the reconciliation that is required by Regulation G.

- If a company discusses segment profitability in its MD&A on a basis that differs from consolidated operating profit as defined by GAAP or that excludes the effects of items attributable to the segment, the FAQs state that the company should discuss the reconciling items in the MD&A.
- Likewise, the FAQs state that the exception for disclosures of non-GAAP financial measures in certain documents distributed in connection with proposed business combinations does not permit use of those same disclosures in other SEC filings or public disclosures.

D. Item 12 of Form 8-K.

An Item 12 Form 8-K is required to be “furnished” (instead of “filed”) with the SEC whenever a company, or a person acting on its behalf, makes any public announcement or release disclosing material nonpublic information regarding the company’s results of operations or financial condition for a completed quarterly or annual fiscal period, regardless of whether the disclosure includes a non-GAAP financial measure. Item 12(b) of Form 8-K provides an exemption from the Form 8-K reporting requirements for earnings conference calls and other presentations that are made orally, telephonically, by webcast, by broadcast or by similar means and include disclosures of material nonpublic information regarding the company’s results of operations or financial condition for completed fiscal periods, 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 this 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 registrant’s web site, 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 registrant’s web site where the information would be available.

The FAQs address the timing, manner and implications of the foregoing requirements.

- The FAQs confirm that, because an Item 12 Form 8-K is “furnished” to the SEC instead of being “filed,” a late filing does not affect a company’s eligibility to use Form S-3 or Rule 144.
- The FAQs confirm that it is not possible to satisfy the exemption under Item 12(b) if the SEC’s Edgar system is closed between the time when a company issues its earnings release and conducts its earnings conference call. For example, if a company issues its earnings release after 5:30 p.m. Eastern time, and holds its earnings conference call that evening or before 8:00 a.m. Eastern time the next morning, then the company cannot satisfy the requirement of the Item 12(b) exception of having furnished its press release on a Form 8-K prior to the commencement of its conference call. In this case, if a person speaking on behalf of the company discloses material nonpublic information regarding the company’s results of operations or financial condition for the completed fiscal period during the conference call (including disclosures in response to questions), then it is necessary to attach a transcript of those disclosures to an Item 12 Form 8-K.

- Significantly, however, the FAQs reflect the varying goals of Item 12 from those of Regulation FD, by confirming prior staff statements that the Item 12(b) exemption is available for disclosures that were not planned as long as they are made publicly accessible on a company's website "promptly after" the information is disclosed.
- The FAQs confirm that a company may satisfy the website posting condition of the Item 12(b) exemption by posting an audio replay of the presentation that includes all of the financial and other statistical information that was first publicly disclosed in the Item 12(b) presentation. The FAQs also confirm that the Item 12(b) exemption covers slides or similar information posted on a company's website within the time frame required, provided that the other conditions of Item 12(b) regarding content, accessibility and notice are satisfied.

E. Applicability to Foreign Private Issuers and Voluntary Filers.

Item 10(e) of Regulation S-K and Regulation G applies to companies that are subject to Section 13(a) or 15(d) of the Exchange Act, including foreign private issuers. However, there is an exception for disclosures of non-GAAP financial measures that are required or expressly permitted by the standard setter that is responsible for establishing GAAP used in the company's primary financial statements.

- The FAQs acknowledge that "voluntary filers" (i.e., companies – typically ones that have publicly offered only debt securities – that continue to file Exchange Act reports even though not required to do so) are not technically subject to Regulation G. However, the staff notes that because the marketplace may expect such companies to comply with the federal securities law disclosure requirements, "the failure of such a company to comply with all requirements (including Regulation G) applicable to a Section 15(d)-reporting company can raise significant issuers regarding that company's compliance with the anti-fraud provisions of the federal securities laws." As a result, we expect that voluntary filers will seek to comply with Regulation G in their disclosures or otherwise address the staff's anti-fraud concerns through adequate disclosures with respect to any non-GAAP financial presentations that are publicly disclosed by the company.
- Among other guidance, the FAQs address methods a foreign private issuer may use to incorporate by reference into a Securities Act registration statement only a portion of a press release containing non-GAAP financial measures when that press release is filed on a Form 6-K. The FAQs state selective incorporation by reference may be accomplished either by specifically referring to the parts of the press release that are to be incorporated by reference, or by filing one Form 6-K with the full press release and a second Form 6-K containing only the disclosures intended to be incorporated by reference, and then explicitly stating that only the second Form 6-K is to be incorporated by reference into the Securities Act registration statement. The staff states that it believes the second of these two approaches may result in the clearer presentation for investors. This guidance should also be available with respect to disclosures by domestic companies that is "furnished" on a Form 8-K.



Gibson, Dunn & Crutcher lawyers are available to assist clients in addressing any questions they may have regarding these issues. Please contact the corporate securities lawyer with whom you work if you have questions. In addition, questions about this client alert may be addressed to [Stephen Glover](mailto:Stephen.Glover@gibsondunn.com) (202-955-8593), [Amy Goodman](mailto:Amy.Goodman@gibsondunn.com) (202-955-8653), [Brian Lane](mailto:Brian.Lane@gibsondunn.com) (202-887-3646), [Ron Mueller](mailto:Ron.Mueller@gibsondunn.com) (202-955-8671) or [John Olson](mailto:John.Olson@gibsondunn.com) (202-955-8522). To contact any of these attorneys by e-mail, use the first letter of the attorney's name, followed by the attorney's last name, followed by "@gibsondunn.com"

The enclosed materials have been prepared for general informational purposes only and are not intended as legal advice.

Copyright © 2003 Gibson, Dunn & Crutcher LLP