

**THE STAFF OF THE SEC ANSWERS FREQUENTLY ASKED QUESTIONS  
REGARDING THE USE OF NON-GAAP FINANCIAL MEASURES  
AND EARNINGS RELEASES**

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On January 22, 2003, the Securities and Exchange Commission adopted final rules, regulations and amendments (the “Rules”) relating to “non-GAAP financial information” and disclosure of financial information for any completed fiscal period.<sup>1</sup> The Rules comprise a new Regulation G, amendments to Regulations S-K and S-B (which are referred to as “Item 10(e)”) and Item 12 of Form 8-K. On June 13, 2003, the staff of the Division of Corporation Finance of the SEC (the “Staff”) released responses to frequently asked questions concerning the Rules (the “FAQs”).<sup>2</sup> The interpretive positions of the Staff contained in the FAQs address application of Regulation G and Item 10(e) to:

- recently filed documents;
- business combination transactions;
- the adjustment of a non-GAAP financial measure to exclude recurring items;
- the presentation of EBIT, EBITDA and non-GAAP liquidity and per share measures;
- segment information;
- foreign private issuers; and
- voluntary filers.

In addition, the FAQs contain further guidance on the application of Item 12 of Form 8-K.

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<sup>1</sup> SEC Release Nos. 33-8176 and 34-47226 (Jan. 22, 2003) (the “Release”).

<sup>2</sup> The FAQs are available at <http://www.sec.gov/divisions/corpfin/faqs/nongAAPfaq.htm>.

This memorandum describes certain of the more significant interpretative positions expressed by the Staff in the FAQs. This memorandum supplements our earlier memoranda regarding the Sarbanes-Oxley Act of 2002, including our March 27, 2003 memorandum (the “March 27<sup>th</sup> Memorandum”) entitled [\*SEC Adopts Final Rules Under the Sarbanes-Oxley Act: Non-GAAP Financial Measures and Earnings Releases\*](#),” copies of which are available upon request or at our website at [www.simpsonthacher.com](http://www.simpsonthacher.com).<sup>3</sup>

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#### RECENTLY FILED DOCUMENTS

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#### **Securities Act Registration Statements Filed After March 28, 2003 (Questions 1 and 2 in the FAQs)**

The Staff confirmed that any registration statement filed under the Securities Act of 1933, as amended, after March 28, 2003 that incorporates by reference any non-GAAP financial measures must comply with Regulation G with respect to those non-GAAP financial measures.<sup>4</sup> The company may provide the required reconciliation in one or more of the following ways:

- amend the previously filed report (with the amended filing then incorporated by reference into the registration statement);
- include a section within the registration statement that identifies the non-GAAP financial measures that are contained in the incorporated reports and sets forth the required reconciliations; or
- file a current report on Form 8-K or a periodic report that identifies the non-GAAP financial measures that are contained in the incorporated reports and provides the required reconciliations (with that Form 8-K or periodic report incorporated by reference into the registration statement).

The Staff further confirmed that non-GAAP financial measures with respect to a fiscal period ended prior to March 28, 2003 which are incorporated by reference in a registration statement filed after March 28, 2003 are not subject to Item 10(e). However, if the incorporated document included a non-GAAP financial measure calculated for a fiscal period ended after March 28, 2003 (for example, a projection), Item 10(e) would apply.

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<sup>3</sup> If you would like to be added to our mailing list, please e-mail [sbussy@stblaw.com](mailto:sbussy@stblaw.com).

<sup>4</sup> The Staff indicated, however, that in order to ease the transition to the new requirements, it will not object where a registration statement on Form S-8 filed after March 28, 2003 does not include the required reconciliation of non-GAAP financial measures included in a document filed before March 28, 2003 and incorporated by reference into that registration statement on Form S-8.

**Amendments to Documents Initially Filed Before March 28, 2003**  
*(Questions 3 and 4 in the FAQs)*

If a non-GAAP financial measure is included (either directly or through incorporation by reference) in a Securities Act registration statement or a document filed under the Securities Exchange Act of 1934, as amended, that was filed before March 28, 2003, and an amendment to the registration statement or Exchange Act document is filed after March 28, 2003, the Staff will not object if the use of that non-GAAP financial measure does not comply with Regulation G. The Staff advised, however, that if any non-GAAP financial measure is added to, revised, amended or updated in the amendment to the filed document then the disclosure must comply with Regulation G.

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**BUSINESS COMBINATION TRANSACTIONS**

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*(Question 6 in the FAQs)*

As discussed in our March 27<sup>th</sup> Memorandum, Regulation G and Item 10(e) contain limited exemptions for disclosure of non-GAAP financial measures in connection with business combination transactions provided that such communications are made pursuant to or in compliance with specified rules.<sup>5</sup> The Staff has clarified that these exemptions do not extend beyond communications that are subject to those rules. Accordingly, if the same non-GAAP financial measure that was included in a communication filed under one of those rules is also disclosed in a Securities Act registration statement or an Exchange Act proxy statement or tender offer statement, the exemption would be inapplicable to that disclosure, other than disclosure that is subject to Item 1015 of Regulation M-A relating to reports, opinions or appraisals.

The Staff has confirmed that where reconciliation of a non-GAAP financial measure is required and the most directly comparable measure is a “pro forma” measure prepared and presented in accordance with Article 11 of Regulation S-X, companies may use the pro forma measure for reconciliation purposes in lieu of a GAAP financial measure.

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<sup>5</sup> Rules 165 and 425 under the Securities Act (relating to offers made in connection with a business combination transaction) or Rules 14a-12 (relating to solicitation before furnishing a proxy statement) or 14d-2(b)(2) (relating to pre-commencement communications) under the Securities Exchange Act of 1934, as amended. These exemptions also apply to communications subject to Rule 14d-9(a)(2) (relating to pre-commencement communications).

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**ADJUSTMENT OF A NON-GAAP FINANCIAL  
MEASURE TO EXCLUDE RECURRING ITEMS**

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*(Questions 8 and 9 in the FAQs)*

As discussed in our March 27<sup>th</sup> Memorandum, Item 10(e) prohibits adjusting a non-GAAP financial performance measure to eliminate items identified as “non-recurring” when the nature of the charge or gain 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 “identified as non-recurring” portion of the rule left open the question of whether a charge or gain that was likely to recur could be excluded so long as it was identified as a “recurring item”.

In the FAQs, the Staff explained that, while companies should never use a non-GAAP financial measure in an attempt to smooth earnings, there is no *per se* prohibition against excluding a properly captioned recurring item — although companies must meet the burden of demonstrating the usefulness of any measure that excludes recurring items, especially if the non-GAAP financial measure is used to evaluate performance. Indeed, the Staff indicated that it is permissible and may well be necessary to identify, discuss, and analyze such items as material restructuring charges, regardless of whether such charges are recurring or non-recurring, in Management’s Discussion and Analysis of Financial Condition and Results of Operations.

The Staff also indicated that non-GAAP financial measures that eliminate a recurring item or items would be more likely to be permissible if management reasonably believes it is probable that the financial impact of the item will disappear or become immaterial within a near-term finite period. In the FAQs, the Staff confirmed that management should consider the substantive nature of the item when determining whether to classify it as recurring or non-recurring and that merely labeling an item as non-recurring does not affect the analysis. The Staff also advised that inclusion of a non-GAAP financial measure that eliminates a recurring item may be misleading absent disclosure of:

- the manner in which management uses the non-GAAP measure to conduct or evaluate its business;
- the economic substance behind management’s decision to use such a measure;
- 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;
- the manner in which management may compensate for these limitations when using the non-GAAP financial measure; and

- the substantive reasons why management believes the non-GAAP financial measure provides useful information to investors.

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**PRESENTATION OF EBIT, EBITDA AND  
NON-GAAP PER SHARE AND LIQUIDITY  
MEASURES**

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**Presentation of EBIT and EBITDA**  
*(Questions 14 and 15 in the FAQs)*

The Staff explained that where the Release describes EBIT as “earnings before interest and taxes” and EBITDA as “earnings before interest, taxes, depreciation and amortization”, the term “earnings” is intended to mean net income as presented in the statement of operations under GAAP. Accordingly, operating income would not be considered the most directly comparable GAAP financial measure because EBIT and EBITDA make adjustments for items that are not included in operating income.

**Presentation of Adjusted EBITDA and Covenant Compliance EBITDA**  
*(Question 10 in the FAQs)*

Item 10(e) prohibits “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. In the FAQs, the Staff addressed the situation where a company wishes to present the non-GAAP financial measure “Adjusted EBITDA” in the context of discussing a credit agreement that contains a material covenant regarding this measure. The Staff explained that, despite the prohibition in Item 10(e), the rules relating to MD&A require disclosure of material items affecting liquidity and, if management believes that the disclosure is material, the company may be required to disclose the measure as calculated by the debt covenant as part of its MD&A. In these circumstances, the Staff indicates that disclosure regarding the covenant may be misleading absent a discussion of:

- the materiality of the credit agreement and the covenant;
- the amount or limit required for compliance with the covenant; and
- the actual or reasonably likely effects of compliance or non-compliance with the covenant on the company's financial condition and liquidity.

Discussion of the non-GAAP financial measure for other purposes would not be permitted unless otherwise allowable under Item 10(e).

**Presentation of Non-GAAP Per Share Measures**  
*(Questions 7 and 11 in the FAQs)*

In the FAQs, the Staff reiterated the SEC's concern about the presentation of per share data presented on any basis other than earnings. The Staff acknowledged, however, that Item 10(e) presumes that certain non-GAAP per share measures may be meaningful from an operating viewpoint. Disclosure that explains how these measures are used by management and the way in which they may provide meaningful information to investors is critical if such disclosure is to be included in a filing. The Staff also reconfirmed that the presentations of cash flow per share and other per share measures of liquidity continue to be prohibited.<sup>6</sup>

**Presentation of Non-GAAP Liquidity Measures**  
*(Questions 12 and 13 in the FAQs)*

In the FAQs, the Staff confirmed its historical practice requiring the prominent presentation of cash flow from operations, cash flow from investing activities and cash flow from financing activities when a non-GAAP liquidity measure is presented.

In discussing the presentation of "free cash flow," the Staff confirmed that the deduction of cash flows for capital expenditures from the GAAP financial measure of cash flows from operating activities would not ordinarily violate the prohibitions in Item 10(e)(1)(ii). The Staff stated that a clear description of how "free cash flow" is calculated, as well as the necessary reconciliation, should accompany the measure when it is used. To avoid confusion, and the need for additional explanatory disclosure, we believe companies should consider using titles, such as "Cash Flow From Operations minus Capital Expenditures" rather than "free cash flow".

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SEGMENT INFORMATION

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**Presentation of Revenues by Product or Geographic Location**  
*(Questions 16 and 17 in the FAQs)*

The Staff confirmed that if a company presents a table illustrating a breakdown of revenues by product or geographic location, such a table would not be considered a non-GAAP financial

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<sup>6</sup> The Staff also clarified a footnote to the Release which indicated that companies may use "funds from operations per share" in earnings releases and materials that are filed or furnished to the SEC, subject to the requirements of Regulation G and Item 10(e) or Regulation S-K. The Staff has confirmed that this reference is to be narrowly interpreted and contemplated only the measure "funds from operations" defined and clarified, as of January 1, 2000, by the National Association of Real Estate Investment Trusts and did not contemplate measures that contain modifications from the measure "funds from operations" as so defined and clarified.

measure if the aggregate revenues presented for each product or geographic location sum to the revenue amount presented on the company's financial statements.

Furthermore, if a company adjusts its GAAP revenue measure for its international operations in a table which includes the GAAP measure to exclude the effects of changes in foreign exchange rates associated with the current fiscal period, the adjusted amounts would not constitute a non-GAAP financial measure. However, if the company presents the foreign exchange adjusted measure by itself, the presentation would constitute disclosure of a non-GAAP financial measure.

**Presentation of Segment Information in Conformity with FASB Statement 131**  
**(Questions 18-21 in the FAQs)**

In the FAQs, the Staff expressly confirmed that segment information presented in conformity with FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information*, is not a non-GAAP financial measure. In addition, the Staff confirmed that segment measures that are adjusted to include amounts excluded from, or to exclude amounts included in, the FASB Statement 131 segment information are non-GAAP financial measures. The Staff advised, however, that if a company totals the profit or loss for the individual segments as part of the FASB Statement 131-required reconciliation, the presentation of such a "consolidated" segment profit or loss measure in any context other than the FASB Statement 131-required reconciliation in the footnote would constitute the presentation of a non-GAAP financial measure.

The Staff also explicitly affirmed that a company may discuss segments or other subdivisions of its business in the MD&A, and may be required to do so if such a discussion is necessary to an understanding of the business. Such a discussion generally would include the measures reported in the footnotes to the company's consolidated financial statements in accordance with FASB Statement 131. The Staff advised that if the first discussion of the segment profit or loss measure in a company's disclosure document precedes the financial statements — for example, in the MD&A — the company should either present the FASB Statement 131-required information in the MD&A or include a cross reference to the applicable note in the financial statements.

The Staff also noted that where a company, as permitted under FASB Statement 131, determines segment profitability on a basis that differs from consolidated operating profit as defined by GAAP and discusses segment profitability in this manner in its MD&A, the company also should include a complete discussion of the reconciling items that apply to the particular segment being discussed.

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FOREIGN PRIVATE ISSUERS

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**Incorporation by Reference into a Foreign Private Issuer's Securities Act Registration Statement**

*(Questions 29, 31 and 32 in the FAQs)*

The Staff confirmed that if a foreign private issuer furnishes a press release that includes a section with non-GAAP financial measures on a Form 6-K, the foreign private issuer may incorporate by reference into a Securities Act registration statement only those portions of the furnished press release that do not include the non-GAAP financial measures should it so wish. In order to accomplish such incorporation, the foreign private issuer should either: (1) specify in the Form 6-K those portions of the press release to be incorporated by reference, or (2) furnish two Form 6-K reports, one that contains the full press release and another that contains the portions that would be incorporated by reference (and specifies that the second Form 6-K is so incorporated). The Staff expressed its belief that the second method may provide more clarity for investors.

If a foreign private issuer (including a Canadian issuer) publishes a non-GAAP financial measure for a period ending on or after March 28, 2003 that does not have to comply with Regulation G and then furnishes the information in a report on Form 6-K that the company chooses to incorporate into a registration statement (other than an MJDS registration statement) filed after March 28, 2003, the Staff advised that the company must comply with all of the provisions of Item 10(e) of Regulation S-K. By contrast, if a Canadian company includes a non-GAAP financial measure in an annual report on Form 40-F and files a non-MJDS Securities Act registration statement that incorporates by reference the Form 40-F, the Staff advised that information included in a Form 40-F is not subject to Regulation G or Item 10(e).

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VOLUNTARY FILERS

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*(Question 33 in the FAQs)*

The Staff advised that because Regulation S-K and Regulation S-B are applicable to all filings with the SEC, "voluntary filers" (that is, companies that file reports with the SEC but that are not required to do so by statute because they have fewer than 300 holders and have not filed a registration statement within the past year) that are making filings must comply with Regulation S-K or Regulation S-B, or Form 20-F, as applicable, in their filings.

While Regulation G by its terms does not apply to voluntary filers, the Staff expressed its view in the FAQs that the failure of a voluntary filer to comply with all requirements (including Regulation G) applicable to a Section 15(d)-reporting company can raise significant issues regarding that company's compliance with the anti-fraud provisions of the federal securities laws. Consistent with the advice contained in our March 27<sup>th</sup> Memorandum, we strongly



recommend that voluntary filers endeavor to comply with Regulation G in all their public communications, including all SEC filings and submissions.

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ITEM 12 OF FORM 8-K

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**Exemption From Obligation to Furnish Additional Form 8-Ks for Earnings Calls**  
*(Questions 22-24 in the FAQs)*

As discussed in our March 27<sup>th</sup> Memorandum, a U.S. reporting company would not be required to furnish a current report on Form 8-K under Item 12 if material, non-public information regarding results of operations or financial condition is disclosed orally, telephonically, by webcast, broadcast or similar means, 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 or as an exhibit to a Form 10-Q 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 registrant's website where the information would be available.

In the FAQs, the Staff confirmed that an audio file of the initial webcast of a company's earnings call will satisfy the condition that a company provide on its website any financial and other statistical information contained in the presentation, together with any information that would be required by Regulation G, provided that: (1) the audio file contains all material financial and other statistical information included in the presentation that was not previously disclosed, and (2) investors can access it and replay it through the company's website. Alternatively, slides or a similar presentation posted on the website at the time of the presentation containing the required, previously undisclosed, material financial and other statistical information would satisfy the condition. Importantly, the Staff clarified that this information must appear on a

company's website at the time an oral presentation is made.<sup>7</sup> Accordingly, if an earnings call includes any material non-public historical financial and statistical information, we believe a U.S. registrant will be required to webcast its earnings call "real time" and immediately provide the ability to replay the call on or through its website if it wishes to avail itself of this exemption with respect to the call and does not wish to post the information to its website prior to the call.

The Staff also confirmed that if a company cannot rely on the exemption from the obligation to furnish the information in its earnings call on a Form 8-K, filing a transcript of the portion of the call or slides or a similar presentation that included material non-public historical financial information will satisfy the requirements of Item 12 of Form 8-K.

**Eligibility to Use Form S-3**  
*(Question 26 in the FAQs)*

Form S-3 requires the company using the form to have filed in "a timely manner all reports required to be filed in twelve calendar months and any portion of a month immediately preceding the filing of the registration statement ...." The Staff confirmed that because an Item 12 Form 8-K is furnished to the SEC rather than filed, failure to furnish such a Form 8-K in a timely manner would not affect a company's eligibility to use Form S-3. Failure to comply with Item 12 of Form 8-K would, of course, be a violation of Section 13(a) of the Exchange Act and the rules thereunder.

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This memorandum is for general information purposes only and should not be regarded as legal advice. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as additional memoranda regarding recent corporate governance developments, can be obtained from our website, [www.simpsonthacher.com](http://www.simpsonthacher.com).

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<sup>7</sup> In the case of information that is not provided in the presentation itself but, rather, is disclosed unexpectedly in connection with the question and answer session that was part of the oral presentation, the information must be posted on the company's website promptly after it is disclosed. A webcast of the oral presentation would be sufficient to meet this requirement.