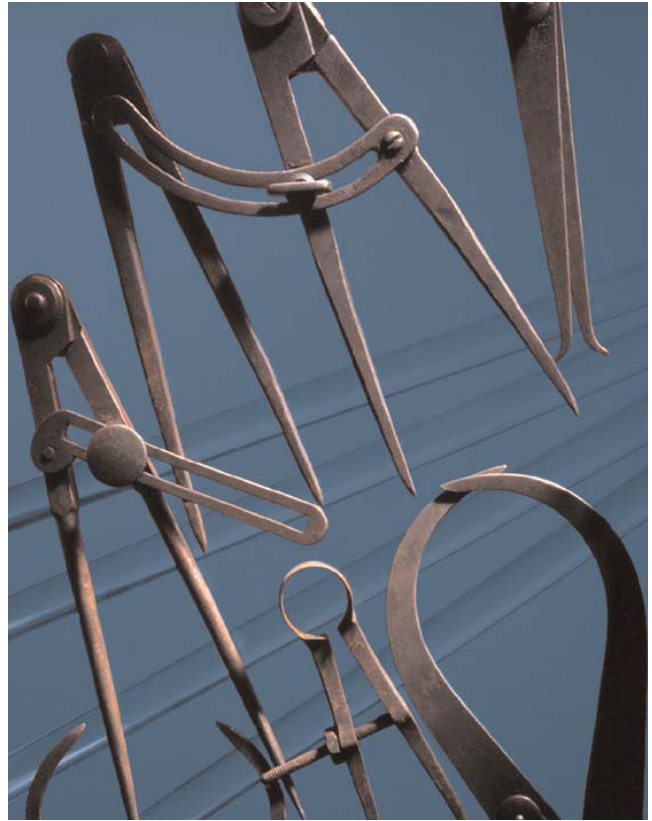


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SEC Staff Guidance on Non-GAAP Financial Measures

The SEC staff’s clarification of the rules on non-GAAP financial measures could lead some registrants to conclude the requirements restrict their presentations more than they originally expected. Others may find it easier to comply with the new rules. The staff’s responses to frequently asked questions, though helpful, will not end interpretations of what constitutes an acceptable non-GAAP financial measure.¹

The question-and-answer document addresses requirements adopted in January that cover both publicly disclosed non-GAAP financial information under new Regulation G and filed non-GAAP financial measures governed by amendments to Regulations S-K and S-B and Form 20-F (collectively, the “S-K amendments”).² The rules prohibit some measures and contain requirements for reconciliations to the most directly comparable GAAP measures and for disclosures on why management believes the non-GAAP financial measure is useful to investors.

(1) SEC Staff, *Frequently Asked Questions Regarding the Use of Non-GAAP Financial Measures*, June 13, 2003, available at www.sec.gov/divisions/corpfin/faqs/nongaapfaq.htm.

(2) SEC Release No. 33-8176, FR-65, *Conditions for Use of Non-GAAP Financial Measures*, January 22, 2003, available at www.sec.gov/rules/final/33-8176.htm.

LIQUIDITY MEASURES

The staff document addressed these questions on the acceptability of non-GAAP liquidity measures under the new rules: how EBIT and EBITDA (both expressly permitted liquidity measures) should be defined and when it is appropriate to employ a non-GAAP liquidity measure, otherwise unacceptable under the new rules, in order to discuss matters material to liquidity as required by MD&A. (Limitations on using EBIT and EBITDA as performance measures are discussed under “Cautions...” below.)

Definition of EBIT and EBITDA. The new rules permit disclosures of earnings before interest and taxes (EBIT) and earnings before interest, taxes, depreciation, and amortization (EBITDA) even though those rules prohibit non-GAAP liquidity measures that exclude charges or liabilities settled or to be settled in cash or that would have been settled in cash if not otherwise settled. “Earnings,” according to the staff document, is intended to mean net income as presented in the GAAP statement of operations. Liquidity measures that differ from what was intended by the adopting release’s description of EBIT and EBITDA are prohibited even if they are designated EBIT or EBITDA. For example, the amortization in EBITDA could not include an impairment of an intangible asset that is subject to amortization.

MD&A Liquidity Discussion. The staff document acknowledges that there are circumstances in which it may be appropriate to disclose a measure otherwise unacceptable under the January rules in an MD&A discussion of items material to liquidity (e.g., EBITDA adjusted for other items). For example, if a material debt agreement contains as part of its material terms a covenant material to investors’ understanding of the company’s financial condition or liquidity, the company may be required to disclose the measure as calculated by the covenant in its MD&A. However, the SEC staff stated that the disclosure may be misleading without a discussion of the materiality of the covenant and the agreement, 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.

PERFORMANCE MEASURES

The rules prohibit the presentation of non-GAAP performance measures that eliminate the effect of items identified as nonrecurring, infrequent, or unusual if the charge or gain is reasonably likely to recur within two years or there was a similar charge or gain within the prior two years. This condition raises the question of how to determine whether an item can be omitted from a measure on the grounds that it is nonrecurring.

There is no explicit prohibition against adjusting a non-GAAP financial measure to eliminate *recurring* items. But companies must be able to demonstrate the usefulness of any measure that excludes recurring items, especially if the non-GAAP financial measure is used to evaluate performance. The nature of an item, not whether it is *labeled* nonrecurring, should determine whether it can be eliminated. If an item (e.g., restructuring charges) may continue and there is no unusual reason for the special nature of the charge, it would be difficult for a company to meet the burden of disclosing the measure’s usefulness.

Companies should never use a non-GAAP financial measure to smooth earnings. The staff document specifies disclosures without which non-GAAP financial measures that eliminate recurring items may be misleading. The disclosures include the way management used the non-GAAP financial measure to conduct or evaluate its business, the material limitations associated with the use of the non-GAAP financial measure compared to the use of the most directly comparable GAAP financial measure and how management compensates for the limitations, and why management believes the non-GAAP financial measure provides useful information to investors. The disclosures apply to non-GAAP financial measures in filings as well as to non-GAAP financial measures included in earnings releases furnished under Item 12 of Form 8-K.

SEGMENT INFORMATION

A non-GAAP financial measure excludes or includes amounts included or excluded, respectively, in a GAAP measure. Thus a measure that is not different from what is required to be presented by GAAP is not a non-GAAP financial measure. It follows that segment information required or expressly permitted by the FASB's Statement 131 is not a non-GAAP financial measure.³ The SEC staff addressed how narrowly to read this position.

Adjustments to Statement 131 information to eliminate or add items create new non-GAAP financial measures subject to the new rules for presentation. Presenting revenues by geographic location or by product line does not create a non-GAAP financial measure as long as the total of the amounts presented equals the amount reported under GAAP in the company's financial statements. However, if a company presents revenues adjusted to eliminate, for example, the effects of changes in foreign currency exchange rates, the amounts would differ from the revenues presented under GAAP and thereby create a non-GAAP financial measure. The measure would be subject to the requirements of Regulation G and the S-K amendments.

Consolidated measures of segment profit and loss (summations of segment results prior to any reconciling items) are not considered required by Statement 131 and are therefore subject to the new rules if presented outside of the Statement 131 note to the financial statements, as when they are discussed in MD&A. A Statement 131 segment profit or loss measure that is discussed in MD&A and presented before the financial statements in the filing document should be accompanied either by the Statement 131 reconciliation information or by a cross reference to the Statement 131 note to the financial statements.

CAUTIONS, REMINDERS, AND CLARIFICATIONS

The staff question-and-answer document points out potential pitfalls for those employing non-GAAP performance measures and explains specific matters that have been raised by registrants' questions.

Performance Measures. The SEC staff document reminds companies of the burden of demonstrating the usefulness of EBIT or EBITDA as a performance measure (because the measures exclude recurring items). The staff also notes that, if EBIT or EBITDA is used as a performance measure, it should be reconciled to net income.

"Free Cash Flow." This measure is most frequently calculated as cash flows from operating activities from the statement of cash flows minus capital expenditures. The SEC staff acknowledges that the measure would not ordinarily be prohibited by the rules, but warns that "companies should be cautious when using such a measure," because the term does not have a uniform definition.

"Funds from Operations." This term, as used in the adopting release as an acceptable non-GAAP financial measure, referred to the January 1, 2000 definition by the National Association of Real Estate Investment Trusts. A modified measure of "funds from operations" or a per share amount based on a modified measure "would be subject to all of the provisions of Item 10(e) of Regulation S-K."

Per Share Measures. Per share liquidity measures are *not* permitted under the new rules. Per share performance measures must be accompanied by Regulation G reconciliations and disclosure of why they are meaningful to investors.

Item 12 of Form 8-K. The January rules that added Item 12 require domestic registrants to furnish to the SEC all releases or announcements disclosing material non-public financial information about completed annual or quarterly periods. Failure to supply these in a timely manner would not affect the company's eligibility to use Form S-3. The staff document provides guidance for several situations in which the timing, content, and location of the required information is at issue, including a company's need to provide information promptly on its website in the event of an unexpected disclosure of material information.

(3) FASB Statement of Financial Accounting Standards No. 131, *Disclosures about Segments of an Enterprise and Related Information*, June 1997.

Business Combination Transactions. Neither Regulation G nor the S-K amendments apply to non-GAAP financial measures in communications subject to the SEC’s rules for business combination transactions. However, the exemption does not apply to non-GAAP measures in a registration or proxy statement related to a business combination (e.g., a registration statement on Form S-4 to register shares to be issued in a business combination) unless the measures were also provided specifically to comply with Item 1015 of Regulation M-A, such as projections given to shareholders to support the fairness of the consideration issued in the transaction.

“VOLUNTARY FILERS”

Some companies continue to file periodic reports with the SEC even though their reporting obligation under Section 15(d) of the Securities Exchange Act of 1934 has been suspended automatically by the statute (because the number of holders of the securities has declined below the 300 threshold that created the Section 15(d) obligation). These “voluntary filers” are not technically subject to Regulation G, but they could face significant anti-fraud risks under the federal securities laws if they do not comply with Regulation G in making non-GAAP public disclosures. Voluntary filings are subject to the provisions of the S-K amendments.

TRANSITION ISSUES

Regulation G applies to public disclosures made on or after March 28, 2003, including SEC filings. The S-K amendments apply to filings, including annual and quarterly reports, that include non-GAAP financial measures for a fiscal period ending after March 28, 2003. The staff document addresses post-March 28 amendments to reports that contain non-GAAP financial measures and similar reports incorporated by reference into registration statements filed after March 28, 2003.

Non-GAAP financial measures included or incorporated by reference into registration statements filed after March 28, 2003 must comply with Regulation G’s reconciliation requirements. However, the reconciliation may be omitted if the non-GAAP financial measure is included in a report filed before March 28, 2003 that is automatically incorporated by reference into a registration statement on Form S-8.

Despite the fact that the S-K amendments do not technically apply to reports filed for a period ending before March 28, 2003, the SEC staff believes the reporting guidelines to be the same as those that should have been applied in filings made before the new rules were issued. The staff holds that the provisions in the S-K amendments on using non-GAAP financial measures “generally codified” staff practice. Therefore, non-GAAP measures for periods ending before March 28, 2003 that are incorporated by reference into registration statements would have conformed to the requirements now codified.

FOREIGN PRIVATE ISSUERS

Non-GAAP financial measures disclosed by foreign private issuers are generally subject to the provisions of Regulation G and the S-K amendments. Foreign private issuers whose securities are listed on a foreign exchange and that disclose non-GAAP financial measures outside of the United States based on foreign GAAP are exempt from Regulation G.

The staff document’s guidance on non-GAAP financial measures incorporated by reference into registration statements filed after March 28, 2003, is similar to the guidance on transition matters for domestic companies.

Filings by Canadian issuers that fall under the Multi-Jurisdictional Disclosure System are not subject to the S-K amendments. The staff clarifies that non-GAAP financial measures included in a Canadian filer’s Form 40-F are not subject to the requirements of Regulation G or the S-K amendments.



The staff also reiterates the SEC’s narrow interpretation of the term “expressly permitted” by home-country GAAP. If a non-GAAP financial measure is required or expressly permitted by the home-country’s accounting standards, it is not prohibited by the S-K amendments. The staff document allows that the expressly-permitted provision is not intended to prohibit the use of natural subtotals within the financial statements that may result in a caption otherwise considered a non-GAAP financial measure.



The SEC staff’s question-and-answer document suggests both that practice on non-GAAP financial measures has been evolving and that it will continue to evolve. The questions frequently asked of the SEC staff are evidence of past uncertainties, but the published set of answers contain enough cautions and clarifications calling for judgment to suggest that additional questions will arise.

The descriptive and summarizing statements above are not intended to substitute for the official text of the SEC staff’s questions and answers. All relevant facts and circumstances should be brought to bear when complying with the related SEC rules and when responding to the staff’s guidance. Companies should consult with their accounting and legal advisors.

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