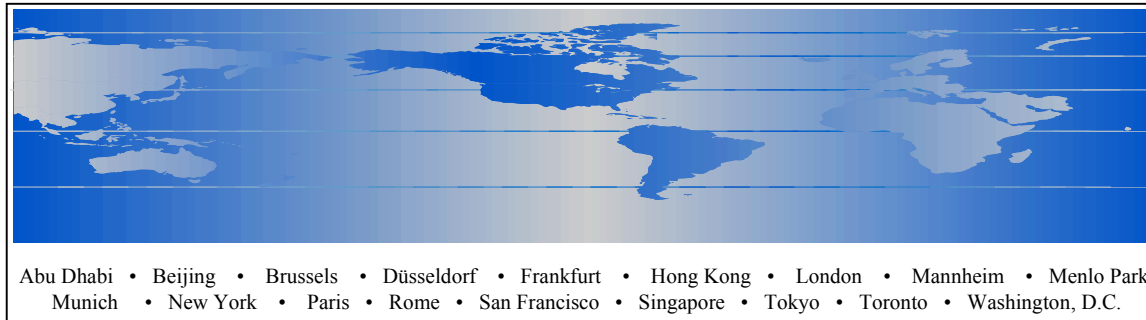


---

SHEARMAN & STERLING



# Recent Developments in the Use of Non-GAAP Financial Measures and in MD&A Disclosure

February 13, 2003

Lisa L. Jacobs  
Anthony R.G. Nolan  
Christopher C. Paci  
James S. Scott, Sr.  
Scott A. Graziano

---

# Use of Non-GAAP Financial Measures

## *The Way We Were*

---

### ***“Global Crossing’s Recurring Adjusted EBITDA up 91%, Cash Revenue up 46%, from Third Quarter of 1999, Pro Forma for M&A Activity***

Global Crossing Ltd. (NYSE: GX), which is building and offering services over the world’s most extensive global IP-based fiber optic network, today reported third quarter 2000 financial results that exceeded the consensus estimates of analysts who follow the company. The Company reported, for its continuing operations, Cash Revenue of \$1,367 million, Recurring Adjusted EBITDA of \$355 million, and a Recurring Net Loss of \$572 million, or \$0.65 per share....”

Global Crossing press release - November 13, 2000

# *The Empire Strikes Back*

---

Trump Hotels & Casino Resorts Inc., January 2002 Enforcement Action

*What they said:*

**Net income increased to \$14.0 million, or \$0.63 per share, before a one-time Trump World's Fair charge, compared to \$5.3 million or \$0.24 per share in 1998. THCR's earnings per share of \$0.63 exceeded First Call estimates of \$0.54.**

*What they didn't say:*

**Stated net income and EPS included a one-time gain of \$17.2 million.**

*What the SEC said:*

**Cease-and-desist**

# Overview

---

- The SEC has adopted new rules as directed by the Sarbanes-Oxley Act to address the use of non-GAAP financial information by public reporting companies.
- The rules are different for information that is contained in a press release or similar public disclosure and for information that is contained in an SEC filing.
- A new disclosure regulation, Regulation G, requires public reporting companies that disclose non-GAAP financial measures to include a presentation of the most comparable GAAP financial measure and a reconciliation of the two measures.
- If the non-GAAP financial measure is included in an SEC filing, the requirements are more extensive and require disclosure about why the non-GAAP measure is important to investors and, if material, the additional purposes for which management uses the non-GAAP measure.

# Overview

---

- The rules also require reporting companies to “furnish” to the SEC on Form 8-K earnings releases disclosing material non-public financial information about completed annual or quarterly fiscal periods.
- The rules generally apply to foreign private issuers.
- Regulation G goes into effect March 28, 2003.
- For SEC filings, the final rules apply to any annual or quarterly report filed with respect to a fiscal period ending after March 28, 2003.

# “Non-GAAP Financial Measure” Defined

---

- The SEC defines “non-GAAP financial measure” 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 measure calculated and presented in accordance with GAAP in the statement of income, balance sheet or statement of cash flows 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 measure so calculated and presented.

# “Non-GAAP Financial Measure” Defined

---

- The SEC clarified that it intends that the definition of “non-GAAP financial measure” capture all presentations of:
  - A measure of performance that is different from that presented in the financial statements, such as income or loss before taxes, or net income or loss as calculated 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.

# “Non-GAAP Financial Measure” Defined

---

- Non-GAAP financial measures would not include:
  - Operating and other statistical measures such as:
    - unit sales
    - numbers of employees
    - numbers of subscribers
    - numbers of advertisers
  - Ratios or statistical measures that are calculated using only:
    - financial measures calculated in accordance with GAAP
    - operating measures or other statistical measures

# Public Disclosure/Release of Non-GAAP Financial Measures

---

- Under new Regulation G, companies that disclose or release non-GAAP financial measures would be required to provide:
  - A presentation of the most directly comparable GAAP financial measure calculated and presented in accordance with GAAP; and
  - A reconciliation (by schedule or other clearly understandable method) of the differences between the non-GAAP financial measure and the most directly comparable GAAP financial measure or measures.
- If a non-GAAP financial measure is released orally, telephonically, in a webcast, broadcast or by similar means, a company would be permitted to provide the required accompanying information by (1) posting it on the company's website and (2) disclosing the location of the required accompanying information during its presentation.

# Public Disclosure/Release of Non-GAAP Financial Measures

---

- With regard to quantitative reconciliation of non-GAAP financial measures that are forward-looking, Regulation G requires a presentation detailing the differences between the forward-looking non-GAAP financial measure and the appropriate forward-looking GAAP financial measure.
- If the GAAP measure is not available on a forward-looking basis, the company must disclose that fact and provide any reconciling information that is available without “unreasonable effort.” Furthermore, the company must identify any information that is unavailable and disclose its probable significance.

# Required Disclosure in SEC Filings

---

- The SEC rules require additional disclosure for companies that include non-GAAP financial measures in SEC filings.
- Companies would be required to include in SEC filings:
  - A presentation, with at least equal prominence, of the most directly comparable GAAP measure;
  - A reconciliation (by schedule or other clearly understandable method) of the two measures;
  - A statement describing the reasons why the company's management believes such non-GAAP financial measures provide useful information to investors; and
  - If material, a statement disclosing any additional purposes for which the company's management uses the non-GAAP financial measure presented.

# Prohibitions

---

- The rules prohibit the following in SEC filings:
  - Excluding from liquidity measures 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;
  - 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;

# Prohibitions

---

- The rules prohibit the following in SEC filings (*continued*):
  - 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.
- If a company includes EBIT or EBITDA, it must reconcile the measure to its most directly comparable GAAP financial measure; the company must also discuss why investors would find EBIT or EBITDA valuable in the context presented.

# Practical Implications

---

- New rules are not new in substance
- Adjusted EBITDA and other non-GAAP financial measures that exclude cash charges or liabilities would no longer be allowed
- Increased difficulty in communicating the “story” to investors
- Is it just a matter of presentation (i.e., presenting GAAP line items with footnote disclosure of non-GAAP financial information, rather than presenting non-GAAP financial information line items with footnotes reconciling to GAAP)?

# Business Combination Transactions

---

- The new rules provide an exception for non-GAAP financial measures included in disclosure relating to (1) a proposed business combination transaction, (2) the entity resulting from the business combination transaction, or (3) an entity that is a party to the business combination transaction.
- For the exception to apply, the disclosure must be contained in a communication that is subject to the SEC's communications rules applicable to business combination transactions.

# Requirement to “Furnish” Earnings Releases on Form 8-K

---

- The SEC rules require companies to furnish to the SEC a Form 8-K within five business days of any public announcement or release disclosing material non-public information regarding a company’s results of operations or financial condition for an annual or quarterly fiscal period that has ended.
- Regulation G would apply to a Form 8-K furnished under the rule if the announcement or release contains a non-GAAP financial measure.
- In addition, if the release or communication contains non-GAAP financial measures, the rule requires the company also to disclose:
  - The reasons why the company’s management believes such non-GAAP financial measures provide useful information to investors; and
  - If material, a statement disclosing any additional purposes for which the company’s management uses the non-GAAP financial measure presented.

# Requirement to “Furnish” Earnings Releases on Form 8-K

---

- The rule does not affirmatively require a company to issue an earnings release or similar announcement.
- The rule does not apply to earnings estimates for future or ongoing fiscal periods, unless they are included in the public announcement of earnings for an annual or quarterly fiscal period that has ended.
- If non-public information is disclosed orally, telephonically, by webcast, broadcast or similar means, a company would not be required to furnish a Form 8-K if:
  - The related written release or announcement has been furnished to the SEC on Form 8-K before the presentation;
  - The presentation is accessible to the public by dial-in conference call, web cast or similar technology;

# Requirement to “Furnish” Earnings Releases on Form 8-K

---

- The financial and statistical information contained in the presentation is provided on the company’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 company’s web site where the information would be available.

---

# MD&A Disclosure of Off-Balance Sheet Arrangements and Contractual Obligations

## New SEC Rule

---

- On January 22, 2003, the SEC adopted new rules as directed by the Sarbanes-Oxley Act to address MD&A disclosure of off-balance arrangements and contractual obligations.
- Compliance Dates (although earlier voluntary compliance is allowed):
  - off-balance sheet disclosure requirements: commencing with filings required to include financial statements for fiscal years ending on or after June 15, 2003; and
  - contractual obligations disclosure requirements: commencing with filings required to include financial statements for fiscal years ending on or after December 15, 2003.

# Overview

---

- The rule requires that public reporting companies provide disclosure of off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on the company that is material to investors.
- Contingent liabilities arising out of litigation, arbitration or regulatory actions are not covered by new rule.
- The rule applies to foreign private issuers.

# Meaning of “Off-Balance Sheet Arrangement”

---

**“Off-balance sheet arrangement”** is defined as any transaction, agreement or other contractual arrangement to which an entity unconsolidated with the registrant is a party, under which the registrant has:

1. Any obligation under a guarantee contract that has any of the characteristics identified in, and that is not excluded from, FASB Interpretation No. 45:
  - This would include guarantees or indemnities triggered by changes in assets, liabilities or equity securities of the guaranteed party, performance guarantees and keepwell agreements, but exclude guarantees by insurance companies, vendor rebates, contingent rents, product warranties, derivatives, subsidiary-parent guarantees of debt to third parties.
2. A retained or contingent interest in assets transferred to an unconsolidated entity that serves as credit, liquidity or market risk support to that entity for those assets:
  - This would include, for example, a subordinated retained interest in a pool of receivables that would serve as a cushion to the senior interests in the event a portion of the receivables becomes uncollectible.

## Meaning of “Off-Balance Sheet Arrangement” (cont.)

---

3. An obligation that would be classified as a derivative instruments under FASB SFAS 133 but for the fact that it is indexed to the registrant’s own stock and classified as stockholders’ equity in the registrant’s financials:
  - This is meant to give greater transparency to investors where the derivative instrument is classified as stockholders’ equity and changes in its fair value may not be periodically recognized.
4. Any obligation arising out of a variable interest (as referenced in FASB Interpretation No. 46) in an unconsolidated entity that is held by, and material to, the registrant where such entity provides financing, liquidity, market risk or credit risk support to, or engages in leasing, hedging or R&D services with, the registrant
  - “variable interest” is defined in FASB Interpretation No. 46 as “contractual, ownership, or other pecuniary interests in an entity that change with changes in the entity’s net asset value.”

# Meaning of “Off-Balance Sheet Arrangement” (cont.)

## Securitization Overview

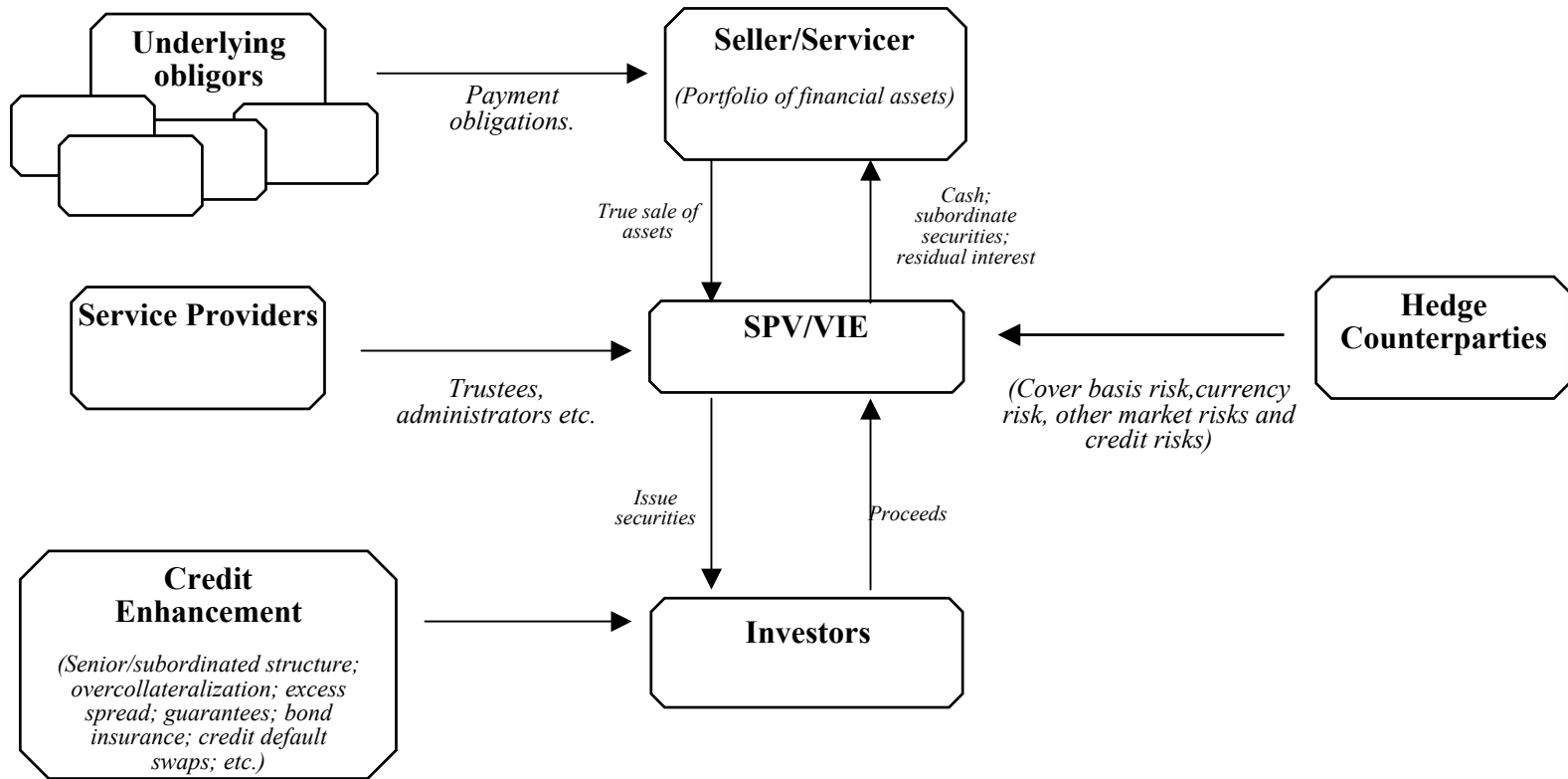
A traditional securitization involves a “true sale” of financial assets to an unconsolidated SPV that issues highly rated fixed income securities.

Assets are “de-linked” from the sponsor’s credit risk and each class of securities is rated based on (i) expected statistical loss and recovery experience of the pool, (ii) credit enhancement to cover losses and (iii) liquidity enhancements to cover interest rate basis risk or currency risk.

NB: The following discussion does not address synthetic securitizations, in which the owner of financial assets purchases credit protection on reference assets (that it may or may not own) through credit default swaps, total rate of return swaps or credit-linked notes. Although there are significant similarities between traditional securitization and synthetic securitization, there are significant differences as well, particularly with respect to the credit protection purchaser (i.e. the originator).

# Meaning of “Off-Balance Sheet Arrangement” (cont.)

## Typical Securitization Structure



# Meaning of “Off-Balance Sheet Arrangement” (cont.)

---

## Identifying “off-balance sheet arrangements” involving transferors

### A. Due Diligence Tips

- True sale and substantive nonconsolidation opinions rendered in connection with securitization transactions may provide clues as to “off balance sheet arrangements” involving the transferor.
- Under the Basle accord banks must reserve capital against retained and purchased recourse that exposes a bank to a greater than pro rata exposure to the credit risk of securitized assets. Thus the regulatory capital posture of a bank also may provide clues to “off balance sheet arrangements” involving a bank as transferor.

# Meaning of “Off-Balance Sheet Arrangement” (cont.)

## Identifying “off-balance sheet arrangements” involving transferors

### B. Rounding up the usual suspects (categories 1 and 2 only):

#### 1. Features indicative of a guaranty by the transferor may include:

- Reps and warranties that obligate the transferor to absorb credit losses;
- Obligations to make cash infusions or pay SPV expenses;
- Dealer incentive programs or customer insurance programs offered by the transferor may make it liable to the SPV for collection shortfalls.
  - E.g. “gap waiver” insurance.
  - E.g 0% APR financing.

## Meaning of “Off-Balance Sheet Arrangement” (cont.)

---

2. Common features in securitizations that may be indicative of a retained or contingent interest in transferred assets:
- Deferred purchase price arrangements or discounted purchase price;
  - Retained loan servicing rights coupled with an advancing obligation;
  - Retained subordinated securities or overcollateralization;
  - Subordinated right to receive excess interest, fees and finance charges on the assets;
  - Buy-back obligations for breaches of certain representations and warranties;
  - Servicer’s right to bid for defaulted assets that are sold by the SPV – this has been severely curtailed under FAS 140.

# How to Apply the Disclosure Threshold

---

- First, management must identify and critically analyze off-balance sheet arrangements.
- Second, management must assess the likelihood of the occurrence of a known trend, demand, commitment, event or uncertainty that could affect an off-balance sheet arrangement.
- If management concludes that the known trend, demand, commitment, event or uncertainty is not reasonably likely to occur, then no disclosure is required in MD&A.
- If management cannot make that determination, disclosure is required on the assumption that such trend, demand, commitment, event or uncertainty will come to fruition, unless management determines that this would not have a material effect on the company's financial condition, results of operations, liquidity, capital expenditures or capital resources.

# Required Disclosure

- Under the rules, required disclosure relating to off-balance sheet arrangements would include:
  1. The nature and business purpose of the company's off-balance sheet arrangements:
    - e.g.: allows leasing instead of purchasing, use to obtain cash through sales of receivables, used to finance inventory or R&D, used to lower borrowing costs
  2. The importance of the arrangements in respect of the company's liquidity, capital resources, market risk or credit risk support or other benefits:
    - e.g.: how often does the company securitize assets, how material are securitizations to liquidity, increase or decrease in securitization
  3. The amount of revenues, expenses and cash flows from the arrangements; the nature and amounts of interests retained, securities issued and other indebtedness incurred in connection with the arrangements; and the nature and amount of any other obligations or liabilities arising out of the arrangements.

## Required Disclosure (cont.)

---

4. Any known event, demand, commitment, trend or uncertainty that will result in, or is reasonably likely to result in, the termination or material reduction in availability of material off-balance sheet arrangements that provide the company with material benefits and the company's current or proposed course of action in such event:
  - e.g: credit rating downgrades, contractual provisions
5. Such other information that the company believes is necessary for an understanding of the company's off-balance sheet arrangements and their material effects.

# Presentation of Disclosure

---

- Disclosure of off-balance sheet arrangements must be in a separately-captioned section of MD&A.
- Disclosure should cover the most recent fiscal year but should also discuss any changes from the previous year where necessary for an understanding of the disclosure.
- Disclosure should aggregate off-balance sheet arrangements in categories or groups in an efficient and understandable manner.
- Cross-referencing to financial statement footnotes to avoid repetition is allowed if done in a clear and informative manner.

# Disclosure of Contractual Obligations

- The new rule require reporting companies to include in MD&A tabular disclosure in their 10-K about specified contractual obligations.
- The table can be placed in any location in MD&A that the company deems appropriate.

Contractual Obligations	Payments due by period				
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
[Long-Term Debt]					
[Capital Lease Obligations]					
[Operating Leases]					
[Purchase Obligations]					
[Other Long-Term Liabilities Reflected in Registrant's Balance Sheet under GAAP]					
Total					

# Disclosure of Contractual Obligations

---

- Definitions:
  - long-term debt: FASB SFAS 47
  - capital lease obligations: FASB SFAS 13
  - operating leases: FASB SFAS 13
  - purchase obligations: agreement to purchase goods or services that is enforceable and legally binding on the registrant and that specifies all significant terms, including: fixed or minimum quantities; fixed, minimum or variable price; and approximate timing
- A company may disaggregate the categories by using categories more suitable for its business but the table must include all obligations falling within the specified categories.
- The table should be accompanied by footnotes necessary to describe material provisions or otherwise necessary for an understanding of the timing and amount of the contractual obligations.
- While a table is not required in quarterly reports, a discussion of material changes to contractual obligations during the interim period should be included in quarterly reports.

# Practical Implications

---

- Interplay of new rule and SEC proposal to expand Form 8-K.
  - SEC's Form 8-K proposal would require current disclosure of creation of material direct or contingent financial obligations and events triggering such material financial obligations.
- Requires additional due diligence with management and the company's auditors.