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SEC Adopts New Rules Governing Disclosure of Non-GAAP Financial Measures and Amendments to Form 8-K Relating to Earnings Releases and Other Financial Disclosures

On January 23, 2003, the Securities and Exchange Commission (the “SEC”) published final rules addressing the disclosure or release of financial information prepared or derived other than in accordance with generally accepted accounting principles (“GAAP”). The SEC also adopted amendments to Form 8-K that will impact the release of earnings reports and other financial information.

The new rules implement Section 401(b) of the Sarbanes-Oxley Act of 2002 (the “Act”), which directs the SEC to issue final rules requiring that any public disclosure or release of pro forma financial information by a public company be presented in a manner that:

- does not contain an untrue statement of material fact or omit to state a material fact necessary in order to make the pro forma financial information not misleading; and
- reconciles the pro forma financial information presented with the financial condition and results of operations of the company under GAAP.

Summary of New Rules and Amendments

In Release No. 33-8176; 34-47226; FR-65, the SEC adopts a two-pronged approach to the disclosure of pro forma financial information:

- New Regulation G requires companies that publicly disclose or release material information containing “non-GAAP financial measures” to include (i) a presentation of the most directly comparable GAAP financial measure and (ii) a reconciliation of the differences between the non-GAAP financial measure and the most directly comparable GAAP financial measure.
- Item 10 of Regulation S-K and Item 10 of Regulation S-B have been amended to prescribe disclosure requirements for companies that



include “non-GAAP financial measures” in SEC filings.

Additionally, the SEC has added new Item 12 to Form 8-K. Item 12 requires reporting companies to furnish to the SEC on Form 8-K any public announcement or release of material non-public information regarding a company’s results of operations or financial condition for an annual or quarterly fiscal period that has ended.

Effective Dates of the New Rules

Regulation G will apply to all disclosures made on and after March 28, 2003. Item 12 of Form 8-K will apply to earnings releases or similar announcements made after March 28, 2003, and the amendments to Item 10 of Regulations S-K and S-B and Form 20-F will apply to any annual or quarterly report filed with respect to a fiscal period ending after March 28, 2003.

Although Item 10 of Regulations S-K or S-B will not apply to a Form 10-K filed on or after March 28, 2003 for a fiscal year ending December 31, 2002, Regulation G will apply to such a filing. As a result, reporting companies will be required to provide the Regulation G disclosures discussed below if the Form 10-K contains non-GAAP financial measures and is filed on or after March 28, 2003.

Definition of “Non-GAAP Financial Measures”

Section 401(b) of the Act uses the term “pro forma financial information.” In order to avoid confusion with previously existing SEC rules and regulations relating to pro forma financial statements, the SEC has adopted the term “non-GAAP financial measures” to identify the types of information targeted by Section 401(b) of the Act. The SEC defines a “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 comparable measure calculated and presented in accordance with GAAP in the statement of income, balance sheet or statement of cash flows (or equivalent statements) of the company; or
- includes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded from the comparable measure so calculated and presented.

The SEC intends that this definition capture all measures that have the effect of depicting either (i) 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 (ii) a measure of liquidity that is different from cash flow or cash flow from operations computed in accordance with GAAP.

Additionally, non-GAAP financial measures will not include financial measures required to be disclosed by GAAP, SEC rules or a system of regulation of a government, governmental authority or self regulatory organization that is applicable to the company. For example, a measure of capital or reserves that is required by SEC rules will not constitute a non-GAAP financial measure.

The following table provides descriptions and examples of the types of financial information that will and will not constitute non-GAAP financial measures:

<u>Examples of Non-GAAP Financial Measures:</u>	<u>Non-GAAP Financial Measures Do <i>Not</i> Include :</u>
<ul style="list-style-type: none"> EBITDA (earnings before interest, taxes, depreciation and amortization) 	<ul style="list-style-type: none"> unit sales, numbers of employees, numbers of subscribers, numbers of advertisers or other operating and statistical measures
<ul style="list-style-type: none"> a measure of operating income that excludes one or more expense or revenue items that are identified as “non-recurring” 	<ul style="list-style-type: none"> ratios or measures that are calculated using only financial measures calculated in accordance with GAAP and/or operating measures or other measures that are not non-GAAP financial measures, including: <ul style="list-style-type: none"> sales per square foot; and same store sales
<ul style="list-style-type: none"> a measure of operating margin where either the revenue component or the operating income component, or both, were not calculated in accordance with GAAP 	<ul style="list-style-type: none"> financial information that does not have the effect of providing numerical measures that are different from the comparable GAAP measure, including: <ul style="list-style-type: none"> disclosures of amounts of expected indebtedness, including contracted and anticipated amounts; disclosures of amounts of repayments that have been planned or decided upon but not yet made; disclosures of estimated revenues or expenses of a new product line, so long as such amounts were estimated as GAAP figures; and measures of profit or loss and total assets for each segment required to be disclosed in accordance with GAAP
<ul style="list-style-type: none"> a measure of liquidity that is different from cash flow or cash flow from operations computed in accordance with GAAP 	

Regulation G: Applicable to any Public Disclosure of Material Information Containing a Non-GAAP Financial Measure

Generally

Regulation G applies to any entity that is required to file reports pursuant to Sections 13(a) or 15(d) of the Securities Exchange Act of 1934 (the ‘*Exchange Act*’), other than a registered investment company. When a reporting company publicly discloses or releases any *material* information that includes a non-GAAP financial measure, the company must provide the following information as a part of the disclosure or release:

- a presentation of the most directly comparable 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 financial measure(s) calculated and presented in accordance with GAAP.

The reconciliation must be quantitative for historic measures and, to the extent available without unreasonable efforts, must be quantitative for prospective measures. As for the reconciliation of prospective non-GAAP financial measures, if a comparable GAAP financial measure is not accessible on a forward-looking basis, the company must (i) disclose that fact, (ii) explain why the forward-looking GAAP financial measure is not accessible, (iii) provide any reconciling information that is available without unreasonable effort and (iv) identify any information that is unavailable and disclose its probable significance.

Regulation G, tracking the language of Section 401(b) of the Act, provides that non-GAAP financial measures, taken together with the accompanying information, may not misstate a material fact or omit to state a material fact necessary to make the presentation of the non-GAAP financial measure not misleading, in light of the circumstances under which it is presented.

Oral, Telephonic and Webcast Disclosure of Non-GAAP Financial Measures

Regulation G applies to written as well as oral public disclosures of non-GAAP financial measures. Analyst calls are the most common example of oral disclosures that might include non-GAAP financial measures. If a non-GAAP financial measure is released orally, telephonically, in a webcast or broadcast or by similar means, the company may provide the required accompanying information by posting it on the company's website, so long as the company discloses the location and availability of the required information during the presentation.

Exception for Disclosures Relating to Business Combination Transactions

Regulation G does not apply to a non-GAAP financial measure included in a disclosure relating to (i) a proposed business combination transaction, (ii) the entity resulting from the business combination or (iii) an entity that is a party to the business combination if the disclosure is contained in a communication that is subject to the communications rules applicable to business combination transactions. This exception would include disclosures under (i) Rule 165 under the Securities Act of 1933 (the "*Securities Act*") relating to offers to issue or sell securities made in connection with a business combination transaction, (ii) Rule 14a-12 under the Exchange Act relating to solicitation of proxies before furnishing a proxy statement, (iii) Rule 14d-2 under the Exchange Act relating to the commencement of tender offers, (iv) Rule 425 under the Securities Act relating to the filing of prospectuses and communications in connection with a business combination transaction and (v) Item 1015 of Regulation M-A relating to reports, opinions, appraisals and negotiations by or with outside parties in connection with going private transactions.

Foreign Private Issuers

Regulation G applies to reporting companies that are foreign private issuers, subject to a limited exception. Regulation G does not apply to the public disclosure of a non-GAAP financial measure by, or on behalf of, a company that is a foreign private issuer if (i) the securities of the issuer are listed or quoted on an exchange or inter-dealer quotation system outside the United States, (ii) the non-GAAP financial measure is not derived from or calculated and presented in accordance with United States GAAP and (iii) the disclosure is made by or on behalf of the issuer outside

the United States or is included in a written communication that is released by or on behalf of the issuer only outside the United States.

If the above elements are met, the SEC, in the adopting release, states that the exception will continue to apply even if one or more of the following circumstances exist:

- a written communication is released in the United States, as long as the communication is released in the United States contemporaneously with or after its release outside the United States and is not otherwise targeted at persons in the United States;
- foreign journalists, United States journalists or other third parties have access to the information;
- the information appears on websites maintained by the company, as long as the websites, taken together, are not available exclusively to, or targeted at, persons in the United States; or
- following the disclosure or release of the information outside the United States, the information is included in a submission to the SEC made under cover of a Form 6-K.

Liability

Compliance with Regulation G is not a safe harbor from liability under the antifraud provisions of Section 10(b) of the Exchange Act or Rule 10b-5. Additionally, the facts and circumstances surrounding a Regulation G violation may give rise to a Rule 10b-5 violation if all the elements are present.

Enforcement

Under Section 3(b) of the Act, if an issuer or any person acting on its behalf fails to comply with Regulation G, the SEC may bring an enforcement action against the issuer and/or the person acting on behalf of the issuer. Additionally, as stated above, the SEC could bring an action under both Regulation G and Rule 10b-5 if the facts and circumstances warrant.

Amendments to Item 10 of Regulations S-K and S-B: Applicable to Disclosures of Non-GAAP Financial Measures in SEC Filings

Generally

Amended Item 10 of Regulation S-K and Item 10 of Regulation S-B require companies using non-GAAP financial measures in SEC filings to provide:

- a prominent presentation of the most directly comparable GAAP financial measure;
- a quantitative reconciliation of the differences between the non-GAAP financial measure and the most directly comparable GAAP financial measure;
- the reasons why the company's management believes the non-GAAP financial measure provides useful information; and

- if material, any additional purposes for which the company's management uses the non-GAAP financial measure.

The same limited exception to the quantitative reconciliation requirement is available under Item 10 of Regulations S-K and S-B as is available under Regulation G, *i.e.*, if a corresponding GAAP financial measure is not accessible on a forward-looking basis, the company must (i) disclose that fact, (ii) explain why the forward-looking GAAP financial measure is not accessible, (iii) provide any reconciling information that is available without unreasonable effort and (iv) identify any information that is unavailable and disclose its probable significance.

In addition to the affirmative disclosure requirements described above, Item 10, as amended, prohibits disclosures that (i) give greater prominence or authority to non-GAAP financial measures, (ii) present non-GAAP financial measures on the face or in the notes of GAAP financial statements or on the face of pro forma financial information required under Article 11 of Regulation S-X, (iii) exclude charges or liabilities that require cash settlement from non-GAAP liquidity measures, other than EBIT (earnings before interest and taxes) and EBITDA, (iv) adjust a non-GAAP performance measure to eliminate or smooth non-recurring, infrequent or unusual items when the charge or gain is likely to recur within two years, or if there was a similar charge or gain in the prior two years or (v) use titles or descriptions of non-GAAP financial measures that are the same or confusingly similar to titles or descriptions used for GAAP financial measures.

Non-GAAP financial measures contained in SEC filings trigger more extensive and detailed disclosure requirements than those set forth in Regulation G (although Regulation G also applies to these disclosures). Specifically, the presentation of comparable GAAP financial measures must have equal or greater prominence than the non-GAAP financial measures. Additionally, as described above, any non-GAAP financial measure must be accompanied by statements setting forth the purposes for which the company's management uses the non-GAAP financial measures and the reasons why the company's management believes the non-GAAP financial measures provide useful information.

Exception for Disclosures Relating to Business Combination Transactions

Identical to the Regulation G exception discussed above, the Item 10 disclosure requirements do not apply to non-GAAP financial measures included in disclosures relating to a proposed business combination transaction, the entity resulting from the business combination or an entity that is a party to the business combination if the disclosure is contained in a communication that is subject to the communications rules applicable to business combination transactions.

Foreign Private Issuers

Unlike under Regulation G, there is no limited exception for foreign private issuers; therefore, the amendments to Item 10 of Regulations S-K and S-B apply to filings on Form 20-F. However, an otherwise prohibited non-GAAP financial measure is permitted on Form 20-F if the measure was required or expressly permitted under the generally accepted accounting principles used in the issuer's primary financial statements and was included in the issuer's annual report or financial statements used in its home country jurisdiction or market. This limited exception applies only when the foreign organization affirmatively acts to require or permit the financial measure in question, and not in situations where the financial measure is merely not prohibited.

Item 12 of Form 8-K: Applicable to Disclosures of Results of Operations and Financial Condition for Historical Periods

Generally

Section 409 of the Act added new Section 13(l) to the Exchange Act, which obligates public companies to disclose “on a rapid and current basis such additional information concerning material changes in the financial condition or operations of the issuer . . . as the Commission determines, by rule, is necessary or useful for the protection of investors and in the public interest.”

The SEC has implemented Section 409 of the Act by amending Form 8-K to add a new Item 12, which requires companies to furnish to the SEC, within five business days, *any* earnings release or other public announcement or release disclosing material non-public information regarding a registrant’s results of operations or financial condition for an annual or quarterly fiscal period that has ended. These releases or announcements must be furnished to the SEC on Form 8-K regardless of whether they contain non-GAAP financial measures.

Item 12 does not require companies to issue earnings releases or similar announcements; however, if a company does issue such a release or announcement, the company must briefly identify the release or announcement under Item 12 and furnish it as an exhibit on Form 8-K. If the release contains a non-GAAP financial measure, Regulation G would apply to the Form 8-K, mandating the disclosures described above.

Information may be “Furnished” to the SEC Rather than “Filed” for Liability Purposes

Before the adoption of Item 12, earnings releases or similar announcements were furnished to the SEC under Item 9 of Form 8-K pursuant Regulation FD. Similarly, companies may “furnish” to the SEC earnings releases or similar announcements under new Item 12; information furnished under Item 12 is not considered “filed” with the SEC for liability purposes. The implications of this distinction are threefold: (i) information furnished under Item 12 does not subject issuers to liability under Section 18 of the Exchange Act unless the company specifically states that the information is to be “filed,” (ii) information furnished under Item 12 is not incorporated by reference into registration statements, proxy statements or other filings for liability purposes and (iii) while Regulation G will apply to earnings releases or announcements containing non-GAAP financial measures, “furnishing” the information under Item 12 does not trigger the more extensive and detailed disclosure requirements for information “filed” under Item 10 of Regulations S-K and S-B. Nevertheless, if the release or announcement filed under Item 12 contains a non-GAAP financial measure, Item 12 requires the company to disclose the reasons why management believes the non-GAAP financial measure provides useful information and, if material, the additional purposes, if any, for which management uses the non-GAAP financial measure.

Although the disclosure requirements under Item 12 are in addition to existing Regulation FD requirements, information furnished on Form 8-K pursuant to Item 12 may also satisfy the company’s Regulation FD requirements if the information is also furnished under Item 9 within the time period required under Regulation FD.

Item 12 applies only to information regarding a registrant’s results of operations or financial condition for an annual or quarterly fiscal period that has ended; it does not apply to earnings estimates for future or ongoing fiscal periods, unless those estimates accompany information about past fiscal periods.

Limited Exception to Item 12 Disclosure Requirement

If the non-public information is disclosed orally or by conference call, broadcast or webcast, the company still must furnish the information on Form 8-K unless:

- the related written release or announcement has been furnished to the SEC on Form 8-K pursuant to Item 12 within 48 hours prior to the presentation;
- the presentation is widely accessible to the public (by conference call, webcast, etc.) and the information is available on the company's website (including any required Regulation G information); *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 website where the financial information is contained.

Repetition of previously disclosed information (even if in a different form, such as in an annual report to stockholders) does not trigger additional disclosure requirements under Item 12. Additionally, the disclosure requirements under Item 12 do not apply to companies that make these announcements only in their periodic reports on Form 10-Q or 10-K.

Suggestions and Guidelines

The new disclosure rules may substantially curtail the practice of disclosing non-GAAP financial measures. When a non-GAAP financial measure is released, companies must pay particular attention to the materiality of the information omitted from the presentation of non-GAAP financial information. A disclosure of financial results containing non-GAAP financial measures that is literally true standing alone may still be misleading if it omits material information.

The new disclosure requirements will most commonly be triggered in companies' quarterly and year-end press releases and analysts calls where earnings information is released and discussed. To the extent companies wish to avoid the disclosure of non-GAAP financial measures, we have identified below areas in which disclosures frequently arise and have summarized suggestions and guidelines for preventing the inadvertent disclosure of non-GAAP financial measures.

- Review the Overall Use and Utility of Disclosing Non-GAAP Financial Measures: In light of the new rules, companies should reflect upon why they use non-GAAP financial measures and question whether such disclosures prove to be useful and prudent on a going-forward basis. Even if a company complies with the new disclosure rules, the use of non-GAAP financial measures could nevertheless result in Rule 10b-5 liability.
- Review Company Websites: Companies must review their websites to determine whether any previously issued press release or other financial information contains non-GAAP financial measures and, if so, either remove the non-GAAP financial measures or provide the necessary comparable GAAP financial measure and reconciliation in order to comply with Regulation G. In addition, companies should consider removing from their websites any links to other websites that contain non-GAAP financial information regarding the company (*e.g.*, analysts' websites) because such links could be deemed to be a public disclosure of a non-GAAP financial measure by the reporting company.

- Review all Public Information Prior to Release: Companies should establish a system, formal or informal, to require a review of all public statements (whether oral (e.g., in analyst calls), through the posting of information on the company's website, or through press releases) to ensure compliance with Regulation G.
- Caution Officers About Public Statements: Officers or other individuals who speak publicly regarding the company's financial condition or results of operations should be counseled to avoid inadvertent disclosures of non-GAAP financial measures. These individuals should be cautioned that even informal oral statements in what is considered a "public" forum will be subject to Regulation G. The SEC has not provided guidance in determining what activities or mediums constitute a "public" disclosure or release.
- Furnish Earnings Releases to the SEC on Form 8-K: Companies should consider furnishing on Form 8-K any earnings release or similar announcement before the ensuing analyst call in order to take advantage of the limited exception to the Item 12 filing requirement for oral, telephonic, webcast or similar non-written disclosures of financial information. Companies must also remember to continuously monitor these releases for Regulation G compliance. Companies should also consider filing earnings releases or other similar announcements under both Item 12 and Item 9 of Form 8-K in order to satisfy the company's Regulation FD obligations.
- Identify Non-GAAP Financial Measures in SEC Filings: In preparing SEC filings on a going-forward basis, companies should identify any financial information that might constitute non-GAAP financial measures. For example, if a company discloses its calculations relating to financial covenants contained in loan agreements and other debt instruments, the company should identify whether any of these disclosures involve non-GAAP financial measures such as EBITDA and, if so, add the necessary disclosures under Item 10 of Regulations S-K or S-B. Conversely, non-GAAP financial measures that are required by SEC rules or by some other regulatory body are exempt from the new disclosure rules, *e.g.*, certain oil and gas measures and statistics required by the SEC. Companies must be prepared to provide clear, understandable, substantive, well-reasoned and detailed statements regarding the purposes for the use of non-GAAP financial measures and the reasons the company's management believes such non-GAAP financial measures provide useful information.

Impact of the New Rules

The new disclosure rules will likely have a significant impact on traditional practices such as earnings releases and analyst calls. The SEC has not provided guidance on what constitutes a "public disclosure or release" of non-GAAP financial measures; therefore, the breadth of the new rules remains to be seen. Companies should implement the guidelines discussed above and should proceed with caution to identify non-GAAP financial measures in order to avoid triggering the new rules.

Further Information

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This Client Alert summarizes certain key points of the new and amended rules. You are encouraged to review the full text of the rules at <http://www.sec.gov/rules/final/33-8176.htm>. If you have any questions regarding these rule changes or need advice regarding a specific situation, please contact your Haynes and Boone attorney.