

PAUL, WEISS, RIFKIND, WHARTON & GARRISON

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SEC CAUTIONS ON USE OF “PRO FORMA” FINANCIAL INFORMATION IN EARNINGS RELEASES

In an unusual public statement, the SEC has formally cautioned public companies that present, in earnings releases, their earnings or other line items from their results of operations on a basis other than GAAP. The SEC, after noting that these “pro forma” figures can provide useful information, warned that under certain circumstances this type of presentation can mislead investors if it obscures GAAP results. Because pro forma information departs from uniform accounting conventions, its use, said the SEC, can make it harder for investors to compare financial information presented on a pro forma basis to prior periods or to comparable companies.

In recent years, the Staff of the SEC has telegraphed its views on disclosure and accounting issues through written compilations of current issues, speeches to industry groups and presentations at legal and accounting seminars. The warning on pro formas comes at a time of increased scrutiny by the Staff of the periodic disclosure regime and hints that current requirements will be supplemented by a new concept of current disclosure, and increased use of earnings releases as a means of communicating material information to the marketplace following promulgation of Regulation FD.

The SEC statement reminds issuers that they should be particularly mindful of the anti-fraud provisions of the securities laws when presenting pro forma information, as such information is derived by “selectively editing” financial information compiled in accordance with GAAP.

The statement notes that a presentation of financial results that focuses on a limited feature of an issuer’s overall results (such as EBITDA) or that sets forth calculations of results on a non-GAAP basis, will be misleading if the issuer fails to clearly disclose the basis of the presentation. Unless the underlying principles are presented, investors risk not understanding the information, let alone being able to compare the information to prior periods.

The statement also notes that pro forma information, though literally correct, may nonetheless be misleading if it omits material information. For example, use of a pro forma to

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recast a loss as if it were a profit, or to obscure a material GAAP result, would be misleading in the absence of a clear and comprehensive explanation of the nature and size of the omission.

The statement commends the joint guidelines on earnings releases issued by Financial Executives International and the National Investor Relations Institute and encourages issuers to follow these guidelines. Among other things, the guidelines note that although pro forma results may be more analytically useful, GAAP results provide a critical framework for the pro forma results. It is therefore important to provide the pro forma results in the context of their GAAP framework. The guidelines suggest that pro forma results should always be accompanied by clearly described reconciliations to GAAP results (which can be in tabular form). The SEC statement assures issuers, which have elected to follow the FEI/NIRI best practices in determining whether to include pro forma results, that such results will not be deemed misleading merely due to deviation from GAAP if they are accompanied by a plain English discussion of how the results deviate from GAAP and by how much.

For some time, the SEC Staff has provided issuers with comments on pro forma and other non-GAAP line items included in registration statements. In its statement, the SEC recognizes the value of focusing investor attention on critical components of results to provide a meaningful comparison to prior periods or highlight the results of core operations. The SEC recognizes that, although this is the intended function of the MD&A, alternative interpretations of results outside the MD&A are not prohibited; in fact, they can be quite useful. The message is to not provide alternative presentations that are misleading.

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Any questions concerning the foregoing should be addressed to members of the Paul Weiss Securities Group (including any of those listed below). This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. In addition, memoranda on related topics may be accessed under Securities Group publications on our web site (www.paulweiss.com).

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