

# corporate advisor

## SEC Preannounces Earnings Guidance

The SEC has issued new guidance regarding the reporting of *pro forma* financial information in press releases. All public companies should take this guidance into account as they prepare for the upcoming earnings reporting season.

This Corporate Advisor reviews the “*pro forma* issue” and the two new statements issued by the SEC on December 4, 2001 — one directed to companies reporting *pro formas* and the other directed to investors reading them — and recommends best practices for reporting *pro forma* financial information and for earnings releases in general. The SEC’s statements are available at [www.sec.gov](http://www.sec.gov).

### **Pro Formas: An Undefined Problem**

The term “*pro forma* financial information” encompasses a broad and undefined range of methodologies for presenting earnings and results of operations on a basis other than generally accepted accounting principles, or GAAP. The use of *pro forma* financials in press releases has expanded dramatically in recent years, with many companies now presenting information which excludes restructuring costs, non-cash stock compensation charges and acquisition-related costs. In some industries, EBITDA (earnings before interest, taxes, depreciation and amortization) has become the de facto standard for market

valuation and measurement of operating performance. In other settings, companies have excluded payroll taxes on employee stock options, continuing operations of a money losing majority-owned subsidiary, the cost of warrants issued to customers and ongoing costs related to new Internet operations. These exclusions have sometimes had the effect of converting a significant GAAP loss into a *pro forma* profit.

The increasing use of *pro forma* financial information in the context of reporting earnings, and concerns about its potential abuse, have been a frequent topic of SEC speeches and newspaper articles over the past year.

### **Change in Tone**

While the SEC calls its new guidance “cautionary advice” and says that it is designed to “sound a warning” to public companies reporting *pro forma* information, the new guidance is more tolerant of *pro forma* financial information than prior SEC positions.

For example, earlier this year, some companies received comment letters from the SEC which noted the company’s use of *pro forma* information in its press releases, stated that this information was not in accordance with GAAP and should be avoided in reporting financial results in the future, and asked the company to “confirm its intention” with regard to future press releases.

In contrast, the SEC’s new guidance recognizes

The SEC says that its new guidance is designed to “sound a warning” to public companies reporting *pro forma* financial information.

**SEC Promotes Increased Disclosure of Critical Accounting Policies—See Page 5**

The SEC's guidance is a clear reminder that the antifraud provisions of the federal securities laws do apply to *pro forma* financial information.

that *pro forma* information can serve useful purposes, such as focusing investors' attention on critical components of financial results in order to provide meaningful comparisons to prior periods or emphasizing the results of core operations.

Of course, the SEC's new guidance also highlights what it sees as the inherent potential for abuse that exists given the lack of any uniform standards or definitions for presenting *pro forma* financial information. The SEC's guidance sets out a series of propositions for companies to consider before they report *pro forma* results.

### **Best Practices for Reporting *Pro Forma* Information**

The following best practices are based on the propositions contained in the SEC's December 2001 statements, guidelines originally published in April 2001 by Financial Executives International and the National Investor Relations Institute and subsequently endorsed by the SEC in its new statements, and our own experience in working with companies on these issues.

#### *Know why the company is reporting pro formas*

- Any company that reports *pro forma* financial information should be able to articulate the reason why *pro formas* are meaningful and helpful to investors. These reasons should be better than a desire to explain away an earnings shortfall. In any event, the SEC's guidance is a clear warning to companies that the antifraud provisions of the federal securities laws do apply to *pro forma* financial information presented in earnings releases and that *pro formas* must not be used to mislead investors.
- In addition to concern about drawing SEC scrutiny, companies should keep in mind that overly aggressive *pro forma* exclusions run the risk of alienating investors and analysts and damaging management's credibility.

#### *Always report GAAP numbers*

- The earnings release should contain GAAP financial information in addition to the *pro forma* financial information. The SEC acknowledges that *pro forma* financial information generally will not be deemed to be misleading merely due to its deviation from GAAP if the company in the same public statement discloses in plain English how it has deviated from GAAP and the amounts of each of the deviations.
- Earnings releases that include *pro forma* financial information should include a reconciliation to GAAP. This reconciliation should generally be presented in tabular format as part of the financial statements attached to the press release.

#### *Clearly describe the basis for pro formas*

- The SEC believes that investors cannot understand or meaningfully use *pro forma* financial information unless the company accurately describes the controlling principles that underlie the *pro forma* presentation. For example, rather than just saying the *pro forma* information excludes "unusual or nonrecurring transactions," the company should describe the particular transactions involved or the specific kinds of transactions that are omitted.
- While some of the details underlying the excluded items may be relegated to the reconciliation of *pro forma* versus GAAP results included within the financial schedules attached to the earnings release, the text of the earnings release itself should summarize the most important information regarding the basis of *pro forma* presentations.

#### *Don't obscure material deviations from GAAP*

- The SEC cautions companies to pay particular attention to situations where the *pro forma* information omits or obscures material results contained in the GAAP financial statements.

This would be the case, for example, where the *pro forma* presentation recasts a loss as a profit. In situations like this, it is important to consider whether the *pro forma* presentation is necessary, and to explain clearly the nature and magnitude of the excluded items. In addition, management should pay extra attention in these situations to the press release's headline and subheading to avoid conveying a misleading message.

- The order in which *pro forma* and GAAP financial information is presented in the release is not paramount — so long as all material information is conveyed clearly and with appropriate balance. The greater the disparity between GAAP and *pro forma* results, the more care is needed to making sure the *pro formas* are presented in a balanced fashion.
- Even where the difference between *pro forma* and GAAP numbers is not so dramatic as to turn a loss into a profit, the company should present a reasonably balanced perspective of its performance in the earnings release and should not use *pro formas* in a way that is inconsistent with this obligation.

#### *Present pro formas on a consistent basis*

- If a company is going to present *pro forma* financial information, it should generally apply the same adjustments during each earnings period. While it may be appropriate to vary a *pro forma* presentation because of a change in circumstances (such as a significant acquisition), a company should not revise its *pro forma* presentation simply to produce a more positive result. Any changes made over time to the company's definition of *pro forma* should be appropriately disclosed.
- When comparing *pro forma* results in different periods, the *pro forma* adjustments should be consistently applied in both periods so that the comparison is meaningful.
- To facilitate comparability with its peers, a

company should consider following prevailing industry practices as long as those practices are consistent with the SEC's guidance.

### **Other Best Practices for Earnings Releases**

The proper use of *pro forma* financial information is only one of many issues that arise when drafting and reviewing earnings releases. The following best practices, which are based on our experience working with clients on earnings releases, relate to some of the other significant areas meriting consideration.

#### *Give forward-looking statements the extra attention they deserve*

- Before including any forward-looking information, consider whether the benefit to the company of making the statement outweighs the associated legal risks. For example, may the forward-looking statement result in a duty to update? If so, is the company prepared to make updates?
- Consider whether the press release should contain any earnings guidance that the company plans to provide during its conference call or webcast. In most cases, inclusion of this information in the press release is not required by law. However, the company may wish to provide some or all of its guidance in the earnings release either for investor relations reasons or to help ensure that the company's message is fully and correctly disseminated. In addition, depending on the materiality of the guidance, the company may have an obligation under NYSE or Nasdaq rules to include it in a press release.
- The company should have a reasonable basis for all forward-looking statements. This basis should be consistent with, and supported by, internal documentation. Consider creating a file containing the information used as support for forward-looking statements.

The proper use of *pro forma* financial information is only one of many issues that arise when drafting or reviewing earnings releases.

- When discussing forward-looking events, the company should not make promises or guarantees. Projections should be presented as management’s current expectations or targets, not as fact. All forward-looking statements should be accompanied by appropriate qualifiers such as “plans to,” “expects to” or “scheduled to.”
- If the earnings release contains forward-looking information, include appropriate safe harbor language and a disclaimer of a duty to update. For example:

“Statements contained in this press release about [*specifically identify forward-looking statements*], and all other statements that are not purely historical, are forward-looking statements for purposes of the safe harbor provisions under The Private Securities Litigation Reform Act of 1995. Actual results may differ materially from those indicated by these forward-looking statements. Factors that may cause or contribute to such differences include [*specifically identify material factors*] and the other factors discussed in [*insert cross reference to appropriate SEC filing containing risk factors*], which is on file with the SEC. In addition, any forward-looking statements represent our estimates only as of today and should not be relied upon as representing our estimates as of any subsequent date. While we may elect to update forward-looking statements at some point in the future, we specifically disclaim any obligation to do so, even if our estimates change.”

The safe harbor language should not be treated as boilerplate. The material factors specifically identified as part of the safe harbor should be tailored to the forward-looking statements included in the particular release. In addition, the safe harbor language will look less like boilerplate if it is included

in the body of the press release and in the same type size as the main text of the release.

- When reporting historical results, statements should generally be worded in the past tense to avoid accidentally turning historical statements about performance in a recently completed period into guidance about the current or future periods. Avoid characterizations such as “momentum,” that may be interpreted as transforming a historical statement into a prediction.

*Ensure that the earnings release is accurate and not misleading*

- Remember that the company can get into as much trouble for what it doesn’t say as for what it does say. The federal securities laws prohibit both the making of false or misleading statements and the omission of statements necessary to make information presented not misleading.
- Superlatives and absolutes are usually inappropriate in an earnings release. Also, avoid hyperbole and buzzwords such as “dominant,” “unique” and “explosive.”
- The company may be held responsible for what is said in its press releases, regardless of whether a statement is made directly by the company or by a third party. Apply the same standard of review to quotes from other parties as the company does to its own statements.
- The headline and any subheading are also part of the press release, and care must be taken that they not be misleadingly incomplete. For example, a headline that the company is reporting “record” revenues or growth may be misleading in the context of the overall financial results.
- It is generally advisable to have earnings releases reviewed by either in-house or outside counsel.

*(continued on page 6)*

Remember that a company can get into as much trouble for what it doesn’t say as for what it does say.

## SEC Promotes Increased Disclosure of Critical Accounting Policies

On December 12, 2001, the SEC issued new guidance to public companies regarding the disclosure of their most significant accounting policies. The guidance reflects the SEC's concern that investors may be unaware of (1) the importance that accounting policies have on a company's reported financial condition and results and (2) the significant variability in financial condition and results which may occur due to a change in the application of a particular accounting standard.

### The Importance of Accounting Policies

Financial statements typically imply to investors a degree of precision and certainty. However, many necessarily imprecise policies and estimates underlie a company's financial statements. As a result, even an accurate application of generally accepted accounting principles may fail to communicate important information regarding the risks and uncertainties inherent in the company's application of accounting standards. While existing rules require information in financial statements about the accounting principles and methods used and the risks and uncertainties inherent in significant estimates, the SEC's new guidance suggests that these traditional disclosures may no longer be sufficient.

### New Rules Coming; Suggestions in the Meantime

The SEC release states that new rules requiring increased MD&A disclosure regarding the application of accounting policies may be forthcoming. In the release, however, the SEC encourages public companies to begin improving their MD&A discussions of critical accounting policies now.

Based on the SEC's new guidance, we suggest the following steps for public companies in the preparation of their annual and quarterly reports:

- In cooperation with its outside auditors, the *company* should identify its "critical" accounting policies — that is, those policies that are important to the portrayal of the company's financial condition and results and require management's most difficult, subjective or complex judgments. In addition, consideration should be given to those policies that would be most likely to result in material changes to the company's financial condition or results if they were applied differently in future periods.
- As part of the normal audit process, the company's *outside auditors* should understand management's judgments in selecting and applying accounting principles and methods. Company *management* should be able to defend the quality and reasonableness of the critical policies.
- The *company* should discuss critical accounting policies in MD&A. Where appropriate, this discussion would include the judgments made in their application and the likelihood of materially different reported results if different assumptions or conditions were to exist in future periods.
- The company's *audit committee* should review the selection, application and disclosure of critical accounting policies.

—Richard G. Costello

(continued from page 4)

*Remember the perils of web site links in press releases*

- The SEC's view is that if a company includes a hyperlink in a press release, the company assumes responsibility for the hyperlinked information and that information becomes subject to liability under the federal securities laws.
- For a more comprehensive discussion of web site liability issues, please see our August 2000 Corporate Advisor, which is available at [www.haledorr.com](http://www.haledorr.com).

*Adequately disseminate the earnings release*

- The earnings release should be simultaneously sent to the Dow Jones News Wire, Reuters, Bloomberg Business News, and Business Wire or PR Newswire. The company may also post the press release on its web site and send it directly to analysts and stockholders, provided that is not done prior to the public dissemination described above. For a more comprehensive discussion of dissemination issues under Regulation FD, please see our October 2000 Corporate Advisor, which is available at [www.haledorr.com](http://www.haledorr.com).
- Comply with all applicable stock exchange rules concerning press releases. For example, Nasdaq requires that the Nasdaq Market Surveillance Department be notified at least ten minutes prior to any public release of material information, such as an earnings release.
- Publicly disseminate only the final version of the earnings release. This problem comes up most often in coordinating the version that is posted on the company's web site with the version released over the wires. Also, if the company distributes electronic copies in

Microsoft Word format, all metadata must be removed or else someone may be able to see "deleted" text.

- If the company has an effective "shelf" registration statement, consider whether the earnings release should be filed with the SEC on a Form 8-K.

*Obtain all required consents*

- Consider whether any consents are required in connection with the press release. For example, market data from analysts often cannot be reproduced without permission.
- Even if it is not contractually required, the company may want to seek approval from its customers before mentioning them in the press release.

–Patrick J. Rondeau

–David A. Westenberg

–Jonathan Wolfman

**corporate advisor**

For more information, contact one of the following:

**Mark G. Borden**

**617.526.6675**

<[mark.borden@haledorr.com](mailto:mark.borden@haledorr.com)>

**John A. Burgess**

**617.526.6418**

<[john.burgess@haledorr.com](mailto:john.burgess@haledorr.com)>

**David E. Redlick**

**617.526.6434**

<[david.redlick@haledorr.com](mailto:david.redlick@haledorr.com)>

*This publication is not intended as legal advice. Readers should not act upon information contained in this publication without professional legal counseling.*  
© 2001 Hale and Dorr LLP

**[www.InternetAlerts.net](http://www.InternetAlerts.net)**

Enroll here to receive Hale and Dorr's brief and useful email alerts on a wide range of topics of interest to technology companies.



- **Boston**  
617 526 6000
- **London\***  
44 20 7645 2400
- **Munich\***  
49 89 24 213 0
- **New York**  
212 937 7200
- **Oxford\***  
44 1235 823 000
- **Princeton**  
609 750 7600
- **Reston**  
703 654 7000
- **Waltham**  
781 966 2000
- **Washington**  
202 942 8400

\*an independent joint venture law firm