

Securities Law Developments **NEWSLETTER**

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SEC ISSUES “CAUTIONARY ADVICE” REGARDING PRO FORMA FINANCIAL INFORMATION AND CRITICAL ACCOUNTING POLICIES

In anticipation of public companies' forthcoming publication of earnings releases and preparation and filing of required annual reports, the Securities and Exchange Commission (“SEC” or “the Commission”) has issued two cautionary statements — one regarding “pro forma” information, and the other addressing critical accounting policies.

On December 4, 2001, the SEC issued a statement regarding public companies' use of pro forma financial information in their earnings releases.¹ While not banning such information, the SEC's statement contains significant “cautionary advice” that companies need to bear in mind when calculating and releasing pro forma figures. The Commission's action comes at a time when Congress, certain trade associations, and the financial press have been giving increased at-

attention to the use of pro forma figures in companies' releases.

About a week later, on December 12, 2001, the SEC issued a second statement addressing the selection and disclosure by public companies of critical accounting policies and practices. In this release, the Commission urged companies this year to include in their Management's Discussion and Analysis (“MD&A”) full, plain-English explanations of their critical accounting policies, judgments and uncertainties affecting the application of those policies, and the likelihood that materially different amounts would be reported under different conditions or using different assumptions. The Commission also noted that it would consider new rules in 2002 designed to elicit more precise accounting policy disclosures.²

¹ *Cautionary Advice Regarding the Use of “Pro Forma” Financial Information in Earnings Releases*, Securities Act Release No. 8039, Exchange Act Release No. 45124, Financial Reporting Release No. 59 (available at <http://www.sec.gov/rules/other/33-8039.htm>) (“*Pro Forma Release*”).

² *Cautionary Advice Regarding Disclosure About Critical Accounting Policies*, Securities Act Release No. 8040, Exchange Act Release No. 45149, Financial Reporting Release No. 60 (available at <http://www.sec.gov/rules/other/33-8040.htm>) (“*Critical Accounting Policies Release*”).

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I. PRO FORMA FINANCIAL INFORMATION

A. SEC Statement on Using Pro Forma Information

Pro forma information often is used by companies that wish to present to the public their earnings and the results of their operations on the basis of methodologies other than Generally Accepted Accounting Principles (“GAAP”). The SEC explained in its statement, however, that “[b]ecause . . . ‘pro forma’ financial information by its very nature departs from traditional accounting conventions, its use can make it hard for investors to compare an issuer’s financial information with other reporting periods and with other companies.”³

In issuing its release, the SEC noted that, “with appropriate disclosures about their limitations[,] accurate interpretations of results and summaries of GAAP financial statements taken as a whole can be quite useful to investors.”⁴ Thus, the Commission by no means prohibited the continued use of pro forma information under certain conditions. As the statement elaborated:

“[p]ro forma” financial information can serve useful purposes. Public companies may quite appropriately wish to focus investors’ attention on critical components of quarterly or annual financial results in order to provide a meaningful comparison to results for the same period of prior years or to emphasize the results of core operations. To a large extent, this has been the intended function of disclosures in a company’s Management’s Discussion and Analysis section of its reports. There is no prohibition preventing public companies from publishing interpretations of their results, or publishing summaries of GAAP financial statements.⁵

Nonetheless, the SEC emphasized that it was “concerned that ‘pro forma’ financial information, under certain circumstances, can mislead investors if it obscures GAAP results.”⁶ Thus, the Commission enumerated five “propositions” that companies and investors should bear in mind when calculating, issuing, or interpreting pro forma results. The five propositions are summarized or quoted in full below:

(1) “The antifraud provisions of the federal securities laws apply to a company issuing ‘pro forma’ financial information. Because ‘pro forma’ information is information derived by selective editing of financial information compiled in accordance with GAAP, companies should be particularly mindful of their obligation not to mislead investors when using this information.”

(2) Companies should be particularly careful when presenting financial results addressed to limited features of their overall financial results (e.g., earnings before interest, taxes, depreciation, and amortization), or when setting forth calculations of financial results on a basis other than GAAP. According to the Commission, such statements mislead investors if the company does not clearly disclose the basis of its presentation. Thus, to inform investors fully, companies need to describe accurately the controlling principles of their calculations. For example, “when a company purports to announce earnings before ‘unusual or nonrecurring transactions,’ it should describe the particular transactions and the kind of transactions that are omitted and apply the methodology described when presenting purportedly comparable information about other periods.”

(3) Companies must ensure that they do not omit material information from pro forma presentations. For example, “investors are likely to be deceived if a

³ *Pro Forma Release.*

⁴ *Id.*

⁵ *Id.*

⁶ *Id.*

company uses a ‘pro forma’ presentation to recast a loss as if it were a profit, or to obscure a material result of GAAP financial statements, without clear and comprehensible explanations of the nature and size of the omissions.”

(4) The SEC explicitly commended the recent guidelines regarding earnings press releases jointly developed by Financial Executives International (“FEI”) and the National Investors Relations Institute (“NIRI”), which are discussed in the next section. In so doing, the Commission encouraged companies “to consider and follow [these] recommendations before determining whether to issue ‘pro forma’ results, and before deciding how to structure a proposed ‘pro forma’ statement.” The Commission also noted that:

[a] presentation of financial results that is addressed to a limited feature of financial results or that sets forth calculations of financial results on a basis other than GAAP 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 those deviations.

(5) Finally, in light of the disclosures it said that it expects to see accompanying pro forma presentations, the Commission encouraged investors to compare companies’ summaries or pro forma financial presentations with the results reported on GAAP-based financials.⁷

B. Referenced FEI / NIRI Guidelines

Before the SEC’s release and in response to increasing concerns about non-GAAP earnings measures in press releases, FEI and the NIRI published broad guidelines or “best practices” for earnings press releases.⁸

As mentioned above, the SEC praised the FEI/NIRI guidelines in its Pro Forma Release. Some of the considerations outlined in the guidelines are as follows:

- It is important to provide pro forma results in the context of their GAAP framework. The order in which reported or pro forma results are presented is not as important as their context.
- Pro forma results always should be accompanied by clearly described reconciliations to GAAP results; these reconciliations often are provided in tabular form.
- It is management’s responsibility to prepare earnings press releases with a reasonably balanced perspective of operating performance. Such releases ordinarily should include analyses of operating results and a discussion of both positive and negative factors significantly affecting revenue, profitability, and other key financial indicators that measure the health of the enterprise (e.g., debt to equity ratios, etc.).
- Reconciliation between GAAP and pro forma results should be treated in a similar fashion for comparable periods. In other words, elements of the reconciliation should not be presented in one period without including similar elements in pro forma results for comparable periods.

C. Increased Recent Attention Regarding Pro Forma Calculations

The practice of providing pro forma earnings results that exclude one-time charges and other unusual charges has been ongoing for about six years. Before

⁷ *Id.* (including all quotations from the Pro Forma Release contained in numbered paragraphs 1-5, above). Investors also were referred to the Commission’s “investor alert” on pro forma financial statements (*available at* <http://www.sec.gov/investor/pubs/proforma12-4.htm>). This investor alert, which is intended to educate investors about pro forma results, contains a number of questions that investors should ask themselves when analyzing pro forma figures.

⁸ Financial Executives International and the National Investor Relations Institute, *FEI/NIRI Earnings Press Release Guidelines* (*available at* <http://www.fei.org/news/FEI-NIRI-EPRGuidelines-4-26-2001.cfm>).

the SEC's issuance of its Pro Forma Release, critics had expressed concern that there was scant guidance on pro forma accounting, and that the frequent release of pro forma numbers in advance of filing GAAP financial statements makes the released numbers difficult to evaluate.

The SEC acted at a time of increasing attention by an array of different players regarding pro forma calculations. For example, in July 2001, the U.S. House of Representatives Energy and Commerce Subcommittee on Commerce, Trade and Consumer Protection held hearings on these issues.⁹ Moreover, the *Wall Street Journal* recently outlined how companies "pollute" their earnings reports with adjustments to derive operating earnings, thereby obscuring company valuation by traditional measures.¹⁰ SEC Commissioner Isaac C. Hunt, Jr. also has described the practice as "a tool that some companies use to disseminate an idealized version of their performance."¹¹

Although SEC officials announced earlier this year that they were investigating several companies that may have issued news releases that were misleading in light of their usage of pro forma figures, so far the SEC has not initiated any fraud actions in these cases. Moreover, in its Pro Forma Release, the Commission did not indicate whether any such cases will be forthcoming.¹²

II. CRITICAL ACCOUNTING POLICIES

About a week after the Pro Forma Release, the SEC issued a second release on "critical accounting policies." In its statement, the Commission announced that it intends to consider new rules in 2002 to elicit more precise disclosures about the accounting policies that management considers most critical.

The Commission also used the Critical Accounting Policies Release to remind management, auditors, audit committees, and their advisors in advance of these new rules that "the selection and application of [a] company's accounting policies must be appropriately reasoned." Thus, the Commission explained, it is encouraging "public companies to include in their MD&A this year full explanations, in plain English, of their 'critical accounting policies,' the judgments and uncertainties affecting the application of those policies, and the likelihood that materially different amounts would be reported under different conditions or using different assumptions."¹³ "Communication between investors and public companies could be improved," the release noted, "if management explain[s] in MD&A the interplay of specific uncertainties with accounting measurements in the financial statements."¹⁴

⁹ See Richard Hill, *Jenkins Says "Pro Forma" Accounting Should Be Timed With GAAP*, 33 Sec. Reg. & L. Rep. (BNA) No. 31, at 1160 (Aug. 6, 2001).

¹⁰ Jonathan Weil, *What's the P/E Ratio? Well, It Depends on What Is Meant by Earnings*, Wall St. J., Aug. 21, 2001, at A1.

¹¹ Isaac C. Hunt, Jr., *Emerging Issues Under the Federal Securities Laws*, Address before the D.C. Bar Corporation, Finance and Securities Section, at 2 (May 15, 2001) (available at <http://www.sec.gov/news/speech/spch497.htm>).

¹² See Jonathan Weil, *SEC Threatens to Sue Companies for Misleading "Pro Forma" Results*, Wall St. J., Dec. 5, 2001, at A2.

¹³ *Critical Accounting Policies Release*. The Commission explained that the accounting policies which it considers to be "critical" are those that are the "most important to the portrayal of the company's financial condition and results," and those that "require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain." *Id.*

¹⁴ *Id.*

According to the Commission, investors increasingly demand full transparency of accounting policies and their effects. Current accounting standards require disclosure of information regarding the accounting methods employed in preparing financial statements, and the risks inherent in any significant estimates. Moreover, the Commission's MD&A rules require disclosure of known trends, events, or uncertainties that could have a material impact on reported financial information.¹⁵ However, the Commission noted, even a technically accurate application of GAAP can fail to communicate important information if it is not accompanied by clear disclosure to facilitate an investor's understanding of a company's financial condition and the possibility of changes in its financial and operating status.

The Commission observed that disclosure responsive to the current requirements set forth in the accounting standards and MD&A could be enhanced.¹⁶ Specifically, "environmental and operational trends, events and uncertainties typically are identified in MD&A, but the implications of those uncertainties for the methods, assumptions and estimates used for recurring and pervasive accounting measurements are not always addressed."¹⁷

In light of these perceived shortcomings in disclosure about accounting policies, the Commission explained that it was appropriate "to alert companies to the need for greater investor awareness of the sensitivity of financial statements to the methods, assumptions,

and estimates underlying their preparation."¹⁸ The release continues: "Investors may lose confidence in a company's management and financial statements if sudden changes in its financial condition and results occur, but were not preceded by disclosures about the susceptibility of reported amounts to change, including rapid change."¹⁹

The Commission ended its Critical Accounting Policies Release by stating that, in order to prevent a decline in investor confidence, public companies should employ disclosure regimes with the characteristics summarized or quoted in full below:

(1) *Critical Accounting Policies.* "Each company's management and auditor should bring particular focus to the evaluation of the critical accounting policies used in the financial statements. . . . Management should be able to defend the quality and reasonableness of the most critical policies, and auditors should satisfy themselves thoroughly regarding their selection, application and disclosure."

(2) *MD&A Disclosure.* "Management should ensure that disclosure in MD&A is balanced and fully responsive. . . . [C]ompanies are encouraged to explain in MD&A the effects of the critical accounting policies applied, the judgments made in their application, and the likelihood of materially different reported results if different assumptions or conditions were to prevail."

¹⁵ See Item 303 of Regulations S-K, 17 C.F.R. § 229.303; Item 303 of Regulation S-B, 17 C.F.R. § 228.303; *Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures*, Securities Act Release No. 6835, Exchange Act Release No. 26851, Investment Company Act Release No. 16961; Financial Reporting Release No. 36 (May 18, 1989).

¹⁶ *Critical Accounting Policies Release.*

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.*

(3) *Audit Committees.* “Prior to finalizing and filing annual reports, audit committees should review the selection, application and disclosure of critical accounting policies.” The release also reminds independent auditors that they must “communicate certain matters related to the conduct of an audit to those who have responsibility for oversight of the financial reporting process, specifically the audit committee.”²⁰

(4) *SEC Consultations.* Companies, management, audit committees, and auditors who are uncertain about the application of specific GAAP principles are encouraged to consult with the Commission’s accounting staff.²¹

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If you would like a copy of the SEC’s Pro Forma Release, its Critical Accounting Policies Release, or the FEI/NIRI guidelines discussed above, or if you have any questions, please do not hesitate to contact:

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²⁰ *Id.* at n.3; *see also* Codification of Statements on Auditing Standards, AU § 380, Communication with Audit Committees or Others with Equivalent Authority and Responsibility.

²¹ *Critical Accounting Policies Release* (including all quotations from the Critical Accounting Policies Release contained in numbered paragraphs 1-4, above).

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