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HRO Alert

The Sarbanes-Oxley Act of 2002

FINAL RULES: CONDITIONS FOR USE OF NON-GAAP (PRO FORMA) FINANCIAL INFORMATION

On January 22, 2003, the SEC released final rules relating to the disclosure of:

- Non-GAAP financial measures (such as EBITDA); and
- Earnings information for completed annual and quarterly periods.

These rules, issued under the Sarbanes-Oxley Act of 2002 (the "SO Act"), finalize and, in some cases, revise the SEC's proposed rules in these areas, which were released on November 5, 2002.

This HRO Alert summarizes the main provisions of the final rules. These rules, which apply to U.S. public companies and foreign private issuers, apply to covered disclosures made or filed on or after **March 28, 2003**.

USE OF NON-GAAP FINANCIAL INFORMATION

The SO Act reflects Congress's concern about the potential of what the SO Act calls "pro forma financial information" (and the SEC calls "non-GAAP financial measures") to mislead investors—a concern the SEC has also expressed publicly and in comments to specific company filings. As required by the SO Act, the final rules regulate public companies' use of non-GAAP financial measures, both in filings with the SEC and in other public communications.

Existing SEC regulations generally use the term "pro forma financial information" to apply to a company's hypothetical results after taking into account certain reportable transactions, but the SO Act and most public companies use the term to apply to actual non-GAAP results, such as EBITDA. To avoid confusion, the final rules adopt a new term, "non-GAAP financial measure." A "non-GAAP financial measure" is defined as a numerical measure of a company's financial performance that:

- excludes amounts that would be included in the comparable GAAP measure presented in the company's financial statements; or
- includes amounts that would be excluded from the comparable GAAP measure.

Operating and statistical measures (such as sales per square foot, same store sales or numbers of customers) are not considered to be non-GAAP financial measures under this definition. Non-GAAP financial measures also exclude measures required to be disclosed by GAAP, SEC rules or other governmental or regulatory requirements.

RULES COVERING ALL PUBLIC STATEMENTS

Whenever a reporting company publicly discloses material information that includes a non-GAAP financial measure, the rules require the information to be accompanied by:

- a presentation of the most comparable GAAP measure; and
- a quantitative reconciliation of the differences between the non-GAAP financial measure presented and the most comparable GAAP measure.¹

For forward-looking measures, the quantitative reconciliation is required only to the extent available without unreasonable effort, but a company relying on this exclusion must disclose that the reconciliation is unavailable, provide any reconciling information that is reasonably available and explain the probable significance of the unavailable information.

The final rules do not apply to disclosures related to a proposed business combination, an entity that is a party to the business combination or the surviving entity, if the disclosure is included in a communication that is subject to SEC rules governing communications applicable to business transactions.

If the company publicly releases a non-GAAP financial measure orally, by telephone, or during a webcast, the rules permit the company to provide the required accompanying information by posting it on the company's website. The company is required to disclose the availability and location of the accompanying information during its presentation. The company also will be required to file a Form 8-K containing this information, as discussed below, if the disclosure includes material non-public financial information about a completed year or quarter. The SEC suggested that, at a minimum, the information should remain on the company's website for twelve months.

The SEC emphasized that it could bring actions in appropriate cases under the rules, under existing antifraud rules (such as Rule 10b-5) or under both sets of rules. In other words, the SEC believes that a company's use of non-GAAP financial measures, even in compliance with the rules, could still give rise to an action under Rule 10b-5.

Rules Covering Filings with the SEC

For filings with the SEC, the rules require that a company including non-GAAP financial measures in an SEC filing also provide:

- a presentation, with equal or greater prominence, of the most comparable GAAP measure;
- a quantitative reconciliation of the differences between the non-GAAP financial measure presented and the most comparable GAAP measure;
- a statement of the substantive reasons why the company's management believes the non-GAAP financial measure is useful to investors; and
- to the extent material, a statement of the additional purposes, if any, for which the company's management uses the non-GAAP financial measure, to the extent not otherwise disclosed.

¹ Although they generally would be subject to the proposed rule, foreign private issuers would be entitled to an exception from the disclosure requirement under limited circumstances where:

- the issuer's securities are publicly traded outside the United States;
- the most comparable GAAP measure is not otherwise required to be presented; and
- the disclosure is made or released by the issuer outside the United States.

This exception would apply even to communications released in the United States if the information is (1) released in the United States contemporaneously with or after the foreign release, (2) not exclusively targeted to U.S. investors, or (3) included in a Form 6-K filed with the SEC.

Unlike the proposed rules, the final rules provide an unreasonable effort exception for forward-looking measures. The discussions of management's purposes and reasons for using non-GAAP financial measures may be included in a company's annual report on Form 10-K (or Form 20-F) and updated as necessary in later filings. Filings by Canadian issuers on Form 40-F are not subject to the non-GAAP disclosure rules. The SEC indicated that the required disclosures should be specific to the non-GAAP financial measure used, the company, the company's industry and management's use of the measure.

The final rules also prohibit the use of certain non-GAAP information in SEC filings, such as non-GAAP performance measures adjusted to smooth non-recurring items (where a similar adjustment has occurred in the past two years or is expected to recur within the next two years), and titles for non-GAAP financial measures that are confusingly similar to titles of GAAP measures. In response to commenters' concerns, the SEC did not adopt the proposed prohibition on the use of non-GAAP per-share measures, and expressly excluded EBIT and EBITDA from the prohibited categories (subject to the other requirements of the rule).

FORM 8-K FILING OF EARNINGS INFORMATION

The final rules also require a public company to file a Form 8-K within five business days of publicly announcing material non-public financial information about a completed year or quarter. The filing requirement does not apply to disclosures about ongoing or future periods, or to disclosures made in an annual report on Form 10-K or a quarterly report on Form 10-Q. This 8-K requirement is in addition to the SEC's other outstanding proposed changes to Form 8-K. (See the HRO Alert on Proposed Form 8-K Changes dated June 21, 2002.)

Originally, the SEC proposed a deadline of two business days for 8-Ks required by this rule. The final rule provides a "temporary" deadline of five business days because the SEC's other 8-K proposals, which would impose a filing deadline of two business days in most cases, have not yet been finalized. The deadline is likely to be shortened to two business days once the SEC finalizes its other 8-K proposals.

The final rules do not require a company to issue earnings releases. The release of earnings information at the company's election would trigger an 8-K filing requirement, and any release of updated or revised information would trigger an additional filing obligation. These required filings would not satisfy the company's existing obligation to file or furnish information under Regulation FD, unless the Regulation FD requirements were also met. This means that the company might have to file two concurrent 8-Ks to satisfy its obligations under both filing requirements. In response to commenters' concerns, the final rules provide that information included in an 8-K required by the rules is "furnished" for SEC purposes, rather than "filed" as originally proposed.

The final rules exempt public disclosures of earnings information in a presentation that is made orally, telephonically, or by webcast or similar means, if:

- The disclosure initially occurs within 48 hours of a written release or announcement filed on Form 8-K;
- The presentation is accessible to the public by conference call, webcast or similar technology, which was announced by a widely disseminated press release that included access instructions; and
- The financial and statistical information contained in the presentation is provided on the company's website, in a location that was publicly announced in advance.

This exception does not eliminate the 8-K filing obligation. Instead, it simply allows the company to disclose information that will later be contained in an 8-K. The SEC suggested that, at a minimum, the information should remain on the company's website for twelve months.

HOW HRO CAN HELP

These final rules are likely to have a significant impact on your company's disclosure practices. If you would like to discuss these rules and how they may affect your company, we encourage you to contact any of the persons listed in the margin of the first page of this HRO Alert.

This HRO Alert is a periodic publication of Holme Roberts & Owen LLP and should not be construed as legal advice or legal opinion on any specific facts or circumstances. Nor is it intended to address specific disclosure or compliance issues that may arise in particular circumstances or all of the provisions included in the newly adopted rules. The contents are intended for general informational purposes only, and you are urged to consult counsel concerning your own situation and any specific legal questions you may have. For further information regarding these rules, please contact any of the persons listed in the margin of the first page of this HRO Alert.

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