

MEMORANDUM

TO: Our Clients and Friends
FROM: Godfrey & Kahn, S.C.
DATE: November 27, 2002
RE: Recent Rule Proposals by the SEC

As mandated by the Sarbanes-Oxley Act of 2002 (the "Sarbanes Act") and as part of its ongoing initiative to enhance the quality of financial disclosures by public companies, the Securities and Exchange Commission (the "SEC") recently published two releases proposing new rules relating to:

- *disclosures regarding the use of non-GAAP financial measures, as required by Section 401(b) of the Sarbanes Act;*
- *current disclosures of earnings and operations announcements following the end of a fiscal period, as required by Section 409 of the Sarbanes Act;*
- *disclosure of off-balance sheet arrangements, as required in Section 401(a) of the Sarbanes Act; and*
- *disclosure of contractual obligations and contingent liabilities and commitments.*

This memorandum is intended to provide a summary of the rules proposed by the SEC in the releases. The rules are subject to a 30 day comment period (which ends December 9, 2002 for the release regarding off-balance sheet arrangements and contractual obligations and December 13, 2002 for the release regarding non-GAAP financial measures and current disclosures of earnings and operations announcements), after which the SEC will issue final rules. We expect the final rules to be substantially similar to the proposed rules.

I. Use of Non-GAAP Financial Measures

In response to Section 401(b) of the Sarbanes Act, the SEC has proposed that companies enhance their disclosure when they publicly disclose or release material information that includes a “non-GAAP financial measure” (defined below). The requirements would vary depending upon whether the non-GAAP financial measures were disclosed in a general publication (such as a press release), orally (in an analyst call, for example), or in an SEC filing. The new disclosures, which would be codified as new Regulation G, are intended to improve the transparency and quality of disclosure of non-GAAP financial measures.

Non-GAAP Financial Measures. The SEC proposes to define a “non-GAAP financial measure” as a numerical measure of a company’s historical or future financial performance, financial position or cash flow that:

- excludes amounts, or is subject to adjustments that have the effect of excluding amounts, that would be included in the comparable GAAP measure in an income statement, balance sheet or statement of cash flows of the issuer; or
- includes amounts, or is subject to adjustments that have the effect of including amounts, that would be excluded from the comparable GAAP measure.

Non-GAAP financial measures include measures that depict a measure of performance that is different from that presented in the financial statements, such as income or loss before taxes, net income or loss as calculated in accordance with GAAP, or a measure of liquidity that is different from cash flow or cash flow from operations computed in accordance with GAAP. For example, EBITDA and measures of operating income before non-recurring items would be non-GAAP financial measures.

Non-GAAP financial measures do not include (a) operating and other statistical measures such as unit sales or numbers of employees or (b) ratios or measures that are calculated using only financial measures calculated in accordance with GAAP, such as sales per square foot or same store sales. Financial measures that are different from the comparable GAAP measure but have the effect of providing the same numerical measures as the comparable GAAP measure are not considered non-GAAP financial measures. Examples of such financial measures include amounts of expected indebtedness, amounts of repayments that have been planned but not yet made, estimated revenues or expenses of a new product line estimated as GAAP figures, and measures of profit or loss and total assets for each business segment required to be disclosed in accordance with GAAP.

General Publication. Under the proposal, whenever a company publicly discloses or releases material information that includes a non-GAAP financial measure, the company would also be required to provide the following as part of the disclosure or release:

- a presentation of the most comparable GAAP financial measure (i.e., earnings or cash flows as reported in GAAP financial statements);

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

Oral Disclosure. If a non-GAAP financial measure is publicly disclosed orally (such as telephonically, by webcast or broadcast), the proposed rules would permit the accompanying information discussed above to be posted on the company's website. During the presentation, the company would be required to disclose the location and availability of the accompanying information.

SEC Filing. The proposed disclosure requirements are more stringent for non-GAAP financial measures included in a filing with the SEC. Under the proposal, companies using non-GAAP financial measures in filings with the SEC must include:

- a presentation of the most directly comparable GAAP financial measure which must be of equal or greater prominence than the non-GAAP financial measures;
- a quantitative reconciliation of the differences between the non-GAAP financial measures presented and the directly comparable GAAP financial measure or measures. The quantitative reconciliation must be provided whether the financial measure is historical or prospective and regardless of the amount of effort involved;
- a statement disclosing the purposes for which the company's management uses the non-GAAP financial measures presented; and
- a statement describing the reasons the company's management believes that the non-GAAP financial measures provide useful information to investors. A statement that the non-GAAP financial measures are used by or useful to analysts, however, cannot be the sole support for presenting the non-GAAP financial measures.

The requirement to include the two statements listed above could be satisfied by including these statements in the company's most recent annual report or more recent quarterly report filed with the SEC and updating those statements, as necessary, no later than the time of the filing containing the non-GAAP financial measure.

In addition to the disclosure requirements, the proposals would prohibit the following in SEC filings:

- presenting a non-GAAP financial measure in a manner that would give it greater authority or prominence than the comparable GAAP financial measure;
- excluding from non-GAAP liquidity measures charges or liabilities that required, or will require, cash settlement, or would have required cash settlement absent an ability to settle in another manner;
- adjusting a non-GAAP financial measure to eliminate or smooth items identified as non-recurring, infrequent or unusual, when the nature of the charge or gain is such that it is reasonably likely to recur;
- presenting non-GAAP financial measures on the face of the company's financial statements prepared in accordance with GAAP or in the accompanying notes;
- presenting non-GAAP financial measures on the face of any pro forma financial information required to be disclosed in connection with a business combination;
- using titles or descriptions of non-GAAP financial measures that are the same as, or confusingly similar to, titles or descriptions used for GAAP financial measures; and
- presenting a non-GAAP per share measure.

No Effect on Antifraud Liability. The proposals provide that a person's compliance or non-compliance with Regulation G would not affect that person's liability under Section 10(b) or Rule 10b-5. For example, a company could disclose a non-GAAP financial measure in accordance with Regulation G, but could still have liability under Rule 10b-5 if that measure misleads investors by obscuring the company's GAAP results.

II. Current Disclosure of Earnings Releases

In response to Section 409 of the Sarbanes Act, the SEC has proposed adding Item 1.04 to Form 8-K which would require the filing of a current report on Form 8-K within two business days of any public announcement or press release disclosing material non-public information regarding a company's results of operations or financial condition for an annual or quarterly fiscal period that has ended. Subject to the exceptions discussed below, this would require an earnings release to be filed on a Form 8-K within two business days after the press release is issued. Companies would be required to identify briefly the announcement and file the announcement as an exhibit. The proposed disclosure requirements for non-GAAP financial measures discussed above would also apply to a Form 8-K filed under this item.

This proposed item would only apply to publicly disclosed material non-public information concerning an annual or quarterly fiscal period that has ended. This proposal would not apply to public disclosure of earnings estimates for future or ongoing fiscal periods, unless those estimates are included in an announcement of material non-public information regarding a fiscal period that has ended. Under those circumstances, specifically identified forward-looking information could be furnished, rather than filed, on Form 8-K. Furthermore, this proposal

would not apply to companies that make earnings announcements only in their quarterly reports on Form 10-Q or annual reports on Form 10-K.

If the information is disclosed orally, telephonically, by webcast or broadcast, the company would not be required to file a Form 8-K if:

- the disclosure initially occurs within 48 hours of a written release or announcement filed on Form 8-K under the proposed item;
- the presentation is accessible to the public by dial-in conference call, webcast or similar technology;
- the financial and statistical information contained in the presentation is provided on the company's website, together with accompanying information required by the non-GAAP financial measures proposals discussed above; 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 information would be available.

III. Disclosure of Off-Balance Sheet Arrangements, Contractual Obligations and Contingent Liabilities and Commitments

In response to Section 401(a) of the Sarbanes Act and to make financial information more transparent, the SEC has proposed to require companies to provide new disclosures about their off-balance sheet arrangements, contractual obligations and contingent liabilities and commitments in the "Management's Discussion and Analysis of Financial Condition and Results of Operations" ("MD&A") section of their quarterly and annual reports.

Off-Balance Sheet Arrangements. Under the proposal, companies would have to disclose the nature and business purpose of off-balance sheet arrangements. Off-balance sheet arrangements ("Arrangements") are defined in the proposal as any transaction, agreement or other contractual arrangement to which an entity that is not consolidated with the company is a party and under which the company, whether or not the company is a party to the Arrangements, has, or in the future may have:

- any obligation under a direct or indirect guarantee,
- a retained or contingent interest in assets transferred to an unconsolidated entity,
- derivatives, to the extent that the fair market value is not fully reflected as a liability or asset in the financial statements, which would include derivatives that are classified as shareholder equity under GAAP, or
- any obligation or liability, including any contingent obligation or liability, to the extent that it is not fully reflected in financial statements (excluding the footnotes to the financial statements). These obligations or liabilities include obligations that are not classified as liabilities under GAAP, contingent liabilities which are not probable

or reasonably estimable and liabilities as to which the amount recognized in the financial statements is less than the reasonably possible maximum exposure to loss under the obligation.

This definition includes Arrangements between a company and an entity conducting off-balance sheet activities, Arrangements between such entity and third parties, and Arrangements between such entity and the company. The definition excludes contingent liabilities arising out of litigation, arbitration or regulatory actions provided they are not otherwise related to an Arrangement.

An Arrangement must be disclosed in MD&A if it may have a current or future material effect on the company's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources. Disclosure of an Arrangement is not required if the likelihood of either the occurrence of an event implicating an Arrangement, or the materiality of its effect, is remote.

The proposal would require a company to disclose facts and circumstances intended to provide investors with a clear understanding of the Arrangement, including:

- the nature and business purpose of the Arrangement, including why and how the company engages in the Arrangement;
- the significant terms and conditions of the Arrangement as are necessary to understand the Arrangement;
- the nature and amount of total assets and total obligations and liabilities (including contingent obligations and liabilities) of the entity in which the activities under the Arrangement are conducted, including total assets transferred by the company to the entity, amounts receivable or payable by the entity and any debt obligations incurred by the entity;
- the amounts of revenues, expenses and cash flows of the company arising from the Arrangement;
- the nature and amounts of interests retained, securities issued and other indebtedness incurred by the company;
- the nature and amount of other obligations or liabilities (including contingent obligations and liabilities) of the company arising from the Arrangement that are, or may become, material and the triggering events or circumstances that could cause them to arise;
- management's analysis of the material effects of the Arrangement on the company's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources, including an analysis of the degree to which the company relies on the Arrangement for its liquidity and capital resources, market risk or credit risk support or other benefits (effects that are common or similar with respect to a number of Arrangements must be analyzed in the aggregate); and

- the circumstances under which a termination or reduction of an Arrangement may occur (for example, a credit rating downgrade) and the material effects of such a termination or reduction.

Contractual Obligations and Contingent Liabilities. While not required under Section 401(a) of the Sarbanes Act, the SEC proposal would require companies to disclose aggregated information about on- and off-balance sheet contractual obligations and contingent liabilities and commitments in a single location in MD&A. The purpose of this proposal is to improve the transparency of a company's short-term and long-term liquidity and capital resource needs and demands and to enable investors to assess the relative role of off-balance sheet arrangements with respect to a company's liquidity and capital resources.

Contractual obligations would be required to be disclosed in tabular form. Categories of obligations would be flexible to allow a company to include categories suitable to its specific business. Recommended categories include long-term debt, capital lease obligations, operating leases, unconditional purchase obligations, other long-term obligations and total contractual obligations. Each category would show total payments required under the obligation and payments due in (i) less than one year, (ii) one to three years, (iii) three to five years and (iv) more than five years.

A company would also be required to disclose, in tabular or textual format, the expected amount, maximum amount or a range of amounts of contingent liabilities or commitments that are expected to expire in the same time periods as listed above. The contingent liabilities must be aggregated by type in a manner suitable for the company's business. Examples of items covered by the proposals include lines of credit, standby letters of credit, guarantees and standby repurchase obligations.

While the table and other disclosures would not be required to be repeated in their quarterly reports, companies would be required to disclose in their quarterly reports material changes to the amounts of their contractual obligations and contingent liabilities and commitments.

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We will continue to monitor the SEC rule proposals and keep you apprised of any new developments. In the meantime, please do not hesitate to contact us if you have any questions.

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