ROBERT G. HUTCHINS – LEGAL ESSAYS

Public Companies - Evolving Trends in Financial Disclosure

Part I "Pro Forma" Financial Information in Earnings Releases

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Preliminary Note

In December 2001, the SEC embarked on an aggressive campaign to improve the quality of financial reporting by public companies. Acting under both the Securities Act of 1933 and the Securities Exchange Act of 1934, it issued the following series of Financial Releases and declared its intent to adopt new rules respecting corporate disclosure:

⇒ December 4, 2001 - "Cautionary Advice Regarding the Use of 'Pro Forma' Financial Information in Earnings Releases."

⇒ December 12, 2001 - "Cautionary Advice Regarding Disclosure About Critical Accounting Policies."

⇒ January 22, 2002 - "Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations."

⇒ February 13, 2002 – "SEC to Propose New Corporate Disclosure Rules."

Given their obvious importance, I determined to comment on these releases and to try to anticipate the new Rules that will follow them. This Essay begins with the cautionary advice respecting pro forma financial information.

Current Regulation of Pro Forma Information

For general legal purposes, the Latin phrase "pro forma" refers, without elaboration, to anything "made or done as a formality" and, in the context of financial statements, to anything "provided in advance to describe items, predict results, or secure approval."[1]

In the world of corporate finance, "pro forma" refers, with somewhat more precision, to financial information that omits significant gains, charges or footnote

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[1] Black's Law Dictionary, 7th Edition, 2000.

disclosure that would be contained in financial statements prepared in accordance with Generally Accepted Accounting Principles ("GAAP"). The omissions produce short hand results that have long been used as analytical tools by merging or acquiring companies, issuers and investors. Examples include computations of earnings that eliminate interest and taxes ("EBIT"), interest and depreciation ("EBID") or interest, taxes, depreciation and amortization ("EBITDA"). Though they depart from GAAP, these computations can facilitate a rough comparison between companies with similar operations but different capital structures. They isolate operating cash flow, separating it from variable tax and interest rates and from non-cash expenditures like depreciation and amortization. When accompanied by meaningful explanations, they can provide a valuable yardstick for comparing companies and investments and for understanding complex financial statements.

On the other hand, a pro forma earnings calculation can be seriously misleading as a stand-alone measurement precisely because of its omissions. For example, a company does not have the free use of operating cash flow that must be devoted to debt payments, working capital or the acquisition of capital assets, but those expenditures are not reflected in EBIT or any of its variations. A company's use of its cash can also be restricted significantly by loan covenants that are omitted from pro forma summaries but would be disclosed in financial footnotes under GAAP. Under all the circumstances, pro forma information is too useful to be discarded, but can be too dangerous standing alone to be reliable for investment purposes.

The SEC has adopted Rules *requiring* that pro forma financial information be furnished by public companies to illustrate the impact of certain *transactions.* For example, Regulation S-K requires that pro forma information be furnished in partnership registration statements filed in connection with "roll up transactions" in which the partnership is reorganized, individually or with others, and holders will receive new securities. The pro forma information must illustrate the effect of the roll up based upon two alternative assumptions; first that all affected partnerships are participating; second that only the partnerships which together produced the lowest combined operating cash flow for the previous fiscal year are participating.[2]

Regulation S-X requires that pro forma financial information be furnished for other completed or probable transactions that would be "material" to investors, including significant business combinations or dispositions and real estate acquisitions. The pro forma information must illustrate the "continuing impact" of these transactions by showing, hypothetically, how they might have altered the

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[2] Regulation S-K governs the non-financial statement portions of registration statements filed under the Securities Act. Rules 901 and 914 of Regulation S-K govern pro forma, non-financial statement disclosure of the effect of roll ups on the security holders of participating partnerships.

historical financial statements of the reporting company if closed at an earlier date. Comparative GAAP disclosure must be furnished separately from the pro forma numbers and specific reporting periods must be covered.[3]

There are other instances in which public companies need not provide full financial statement disclosure, but they also are circumscribed. For example, "summarized" financial information can be provided in lieu of full financial statements in connection with certain discontinued operations. Regulation S-X requires, however, that the summary include as a minimum such things as current and non-currant assets and liabilities, net sales or gross revenues, gross profit and income from operations before extraordinary events. As another example, "Consolidated Condensed Financial Information" for a corporate group can be provided in lieu of separate financial statements for each member in connection with an offering by one member of debt securities that are guaranteed by the group's corporate parent. There are elaborate refinements and qualifications.[4]

As of February 2002, however, there is no Regulation or Rule that contains a general definition of "pro forma" for securities law purposes or that imposes specific structural standards for pro forma information furnished *voluntarily* in an *earnings release*. A company preparing a pro forma reconstruction of normal course earnings or cash flow must therefore rely upon other guidelines that appear to be analogous. Examples would include the Regulations on transaction-based information already mentioned, NYSE and NASDAQ Rules regulating earnings press releases by companies with listed securities and SEC proceedings or court decisions enforcing the general requirement that companies provide full and accurate disclosure to investors.

Despite the regulatory gap, there is a growing tendency on the part of public companies to issue pro forma earnings releases. The benefits touted for investors are that pro forma information can simplify financial statements, eliminate distortions caused by non-recurring events, focus attention on core businesses and show

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[3] Regulation S-X governs the form and content of financial statements filed as part of a registration statement. Rules 11-01 and 11-02 of that Regulation require pro forma information in specified transactions other than roll ups and Rule 1-01(o) limits "material" financial information to matters "about which an average prudent investor ought reasonably to be informed."

[4] When applying Generally Accepted Auditing Standards ("GAAS") to financial statements conforming to GAAP, auditors use subjective judgments respecting the materiality of numbers and the adjustments they will make to journal entries to ensure the fair presentation of financial results. In addition, auditors rely upon the subjective judgment of a company's managers respecting the value of assets for which there is no ready market and of its counsel respecting the likelihood that potential claims are material and will be asserted or adversely decided. Nevertheless, despite these subjective elements GAAP and GAAS ensure a high degree of consistency and precision in financial reporting from year-to-year and from company-to-company and are deemed essential to the integrity of US capital markets.

meaningful comparative results for current and prior fiscal periods. On the other hand, any pro forma reconstruction of GAAP based financial data has an obvious capacity to mislead and because of the high volume of reconstructed data now reaching the public, that risk has drawn the attention of the SEC.

The SEC Cautionary Release

On December 4, 2001, the SEC issued a Financial Release under both the Securities Act and the Exchange Act entitled "Cautionary Advice Regarding the Use of 'Pro Forma' Financial Information in Earnings Releases."[5] In it, the SEC acknowledged that pro forma information could be helpful to investors and that there was no general prohibition against its use. The SEC stated it was concerned, however, because selected operating results presented as "pro forma" could mislead investors if the underlying assumptions, and the degree to which they changed results determined by GAAP, were not explained. Accordingly, the SEC used its Release to "alert" reporting companies to the following "propositions:"

⇒ The antifraud provisions of the federal securities laws apply as thoroughly to pro forma information as to any other information.

⇒ A presentation addressed only to a portion of overall financial results raises special concerns when the basis of the presentation is not clearly explained.

⇒ Companies must analyze the information *omitted* from pro forma results carefully since the missing information could be material. The example given was a pro forma presentation that "recast a loss as if it were a profit…."

⇒ Companies should consult the "Best Practices Guidelines" for the use of pro forma numbers in earnings releases published jointly by Financial Executives International and the National Investors Relations Institute.[6]

⇒ The SEC would continue to encourage investors to compare "pro forma" financial results with the results shown in GAAP-based financial reports by the same company.

Now I doubt that, prior to the Release, anyone familiar with the securities laws thought pro forma information was somehow immune from the antifraud

[5] Release Nos. 33-8039, 34-45124, FR-59, December 4, 2001.

[6] The Guidelines are available on the FEI and NIRI websites at www.fei.org. and www.niri.org. respectively. I summarize them below.

provisions, or that such information safely could be inserted in an earnings release without regard to the possibility that it might be misleading if not explained. On the other hand, I am not confident that it would be feasible for the SEC to regulate pro forma disclosure of normal operating results, as opposed to roll ups or other discrete transactions, beyond requiring that the assumptions underlying the pro forma calculation be explained and that pro forma results always be accompanied by comparative results conforming to GAAP. It is one thing to recast historical GAAP-based financial statements on a pro forma basis to show how a specific transaction closed at arm's length at a later date would have altered them. That process is relatively devoid of selective editing. The SEC has been able to devise a structure for it that is reasonably specific.

It is another thing, however, to recast current earnings by selectively omitting from their computation information that under GAAP would be included. Pro forma earnings are restated from GAAP-based earnings according to subjective criteria devised by the reporting company. If companies are permitted to publish pro forma earnings at all, they must be given leeway to establish the criteria. They must be permitted to take account of all special circumstances that could distort their earnings in any given fiscal period. No one can predict accurately what those circumstances may be, when they will occur or with what effect. No Rule regulating a pro forma description of them would cover all possible variations. Yet a blanket prohibition of pro forma earnings releases would deprive investors of valuable and timely insights.

As a practical matter, the best solution may be limited rule making confined to a requirement that pro forma results be compared to GAAP and that companies report significant financial events on a current rather than periodic basis. That modified scheme would, of course, be backed by the general prohibition against misleading disclosure. On the other hand, given the current public outcry over perceived inadequacies in corporate financial reporting, the SEC's cautionary advice may be a harbinger of detailed rule making respecting the formulation and content of earnings releases. A recent enforcement proceeding, the first initiated by the SEC in this context, illustrates the SEC's concern with unexplained pro forma numbers.

The Trump Cease and Desist Order

On January 16, 2002, the SEC published its Cease and Desist Order against Trump Hotels & Casino Resorts, Inc. ("Trump").[7] Trump consented to the jurisdiction of the SEC, and to the Order, without admitting or denying the SEC's findings of culpability. Those findings can be summarized as follows:

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[7] Securities Act Release 45287, Accounting and Accounting Enforcement Release 1499, January 16, 2002.

On October 25, 1999, Trump issued an earnings release for the 3rd quarter of 1999 that reported net income of $14 million or $0.63 per Share, *before* a one-time *charge* of $81.4 million. That compared to net income of $5.3 million or $0.24 per share for the 3rd quarter of 1998 determined in accordance with GAAP. Trump did *not* disclose that its 3rd Q 99 revenue *included* a one-time *gain* of $17.2 million. Trump also did not state that its reported 99 results were pro forma although that fact would necessarily be inferred from its disclosure of the excluded charge. Trump *did* state that its current net income before the charge reflected an improved operating margin, decreased marketing costs and increased revenue from non-gaming operations. Trump then claimed that its overall performance exceeded analysts' estimates.

In fact, if the $17.2 million one-time gain were excluded, Trump's net income for the 3rd Q 99 would only have been $3 million or $ 0.14 per share, down substantially from the year-earlier figure. Trump's operating margin would have increased, but only by 0.4%. Its marketing cost would have decreased, but only by $549,000 or 1%. Its non-gaming revenue would have increased, but only by $1.8 million or 2.25%. In terms of Trump's overall performance, those negligible improvements were more than offset by the *decrease* in its revenue from gaming activities. The SEC used the following table to illustrate the effect of Trump's exclusion of the one-time gain:

(In thousands)	**3rd Q 1998**	**3rd Q 1999 Per Release**	**3rd Q 1999 Excluding One-Time Gain**
Revenues	$397,387	$403,072	$385,872
Net Income	$5,312	$13,958	$3,048
EPS	$0.24	$0.63	$0.14

The SEC found that the earnings release was materially misleading and that Trump's publication of it violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. The reference to the excluded charge, coupled with the omission of any reference to the included gain, created the false impression that there were no further non-recurring items in Trump's 3rd quarter 99 financial results. By then claiming an increase in its operating margin, a decrease in its marketing cost, increased cash sales from non-casino operations and net earnings in excess of analyst's expectations, Trump created the additional false impression that it had improved overall operating performance when, properly understood, its performance had deteriorated.[8]

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[8] Section 10(b) makes it unlawful to "…use or employ, in connection with the purchase or sale of any security…any manipulative or deceptive device or contrivance in contravention of such rules…as (the SEC) may prescribe…." SEC Rule 10b-5 prohibits "(a) …any device, scheme, or artifice to defraud, (b)… any untrue statement (or omission) of a material fact, or

The Underlying Facts

Prior to September 15, 1999, Planet Hollywood International, Inc. operated a restaurant called the All Star Café from space it leased in one of the Trump casinos. The All Star Café was not successful and its percentage rent failed to reach targeted levels. On September 15, Trump, Planet Hollywood and certain of their affiliates reached an agreement under which the All Star Café lease was cancelled without further liability and Trump took title to the facilities improvements and personal property installed or used at the space by its former tenant. Because Trump would continue to operate a theme restaurant in the same space, it treated the appraised fair market value of the acquired assets, $17.2 million, as a one-time gain to be included in revenue for financial reporting purposes. That treatment accorded with GAAP.

Historically, Trump had itemized revenue in its earnings releases by dividing it into three source categories, "Casino" (gaming), "Food and Beverage," and "Other" (the category in which the one-time gain would have fallen). For the 3rd Q 99, however, apparently in response to a "streamlined" format introduced by some of its competitors, Trump reported all revenue on one line. As a result, there was nothing in the earnings release to put analysts and others on notice that Trump's quarterly revenue might be inflated by a non-recurring event.

On the day the earnings release was published, Trump held a conference call with analysts in which its CEO discussed the release without disclosing the fact that the reported year-to year improvement in revenue and net income resulted primarily from the All Star Café transaction. After the conference call ended, however, some analysts asked Trump's CFO for a detailed explanation of quarterly results. In response, the CFO disclosed the All Star transaction and set off an expanded inquiry that escalated rapidly over the next several days.

Trump immediately took three steps to contain the damage from the incident and to prevent a recurrence: First, Trump's CFO telephoned every analyst who participated in the conference call intending to disclose to each of them the significance of the All Star Café lease and its cancellation. Apparently, he reached most but not all of them. Second, Trump accelerated the preparation of its quarterly report on Form 10-Q, filing it on November 4 rather than November 15, the scheduled due date. The Form contained full disclosure of the All Star transaction and its impact on revenue and earnings. Third, Trump adopted a formal policy requiring that its future earnings releases be approved in advance by its Audit

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(c)…any (fraudulent) act, practice, or course of business… in connection with the purchase or sale of any security." It is settled law that periodic reports and earnings releases are filed and issued "in connection" with the purchase and sale of outstanding securities.

Committee. These remedial efforts induced the SEC to confine its enforcement remedy to the agreed Cease and Desist Order.[9]

I have three immediate reactions to all of this.

⇒ First, the publication of pro forma operating results is a by-product of the speed with which current information must now be provided to satisfy analysts and investors and of the escalating pressure placed upon public companies to maximize earnings. Of course pro forma information can mislead, as can any seemingly firm conclusion extrapolated from complex data.

⇒ Second, the root problem for regulators and investors alike is that pro forma information is derived from GAAP-based financial statements that are certified by outside auditors. Pro forma information so derived can be biased and misleading while seeming to be objective and authoritative. That makes pro forma earnings releases attractive to struggling companies with depressed share prices. It also makes it likely that the use (and occasional abuse) of these releases will continue to increase, and that the SEC will respond by adopting new rules to provide remedial disclosure guidelines.

⇒ Third, a recurring irony when pro forma releases go awry is that the intended message often could have been delivered just as forcefully without misleading anyone. Trump, for example, may have been able to create a favorable impression without omitting any disclosure by including in its release a carefully drafted and accurate explanation of the All Star Café transaction and its aftermath. After all, one of the most important attributes of good management is the ability to recognize at the earliest practical date the fact that a business strategy has failed. That recognition permits management to implement curative measures before the damage caused by the failure becomes irreversible. The All Star Café was a costly failure for Planet Hollywood, but it also threatened the image, and ultimately the economic health, of Trump's casino. The termination of the All Star lease can be seen as a responsible and timely corrective action that would have positive economic benefits for Trump going forward and was already an indicator of improved overall performance. [10]

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[9] On October 25th, the day of the earnings release, Trump's stock price rose 7.8% on volume 5 times the previous day's volume. On October 28,th when the All Stare Café transaction was disclosed, the stock price declined by 6% on volume 4 times the previous day's volume. The SEC noted the "short lived" nature of the price inflation.

[10] Trump took a different tack to protect its image. On the day the Cease and Desist Order was announced, Trump issued its own press release noting, pointedly, that its 3rd Q 99 release had been issued by its "then Chief Executive Officer…whose contract was not renewed." It added, presumably to calm investors everywhere, that Donald J Trump, "Chairman of the

The FEI/NIRI Best Practices Guidelines

These Guidelines address earnings press releases as opposed to announcements of changes in earnings estimates or of significant events that could affect earnings but do not involve restatements of GAAP results. The Guidelines require that earnings releases be issued as soon as practical after the end of the relevant quarter. The releases should always include both GAAP and pro forma results plus a clear reconciliation between the two. The text should be "balanced," containing a forthright discussion of both positive and negative factors that affect revenue, profitability and financial position. Examples of these factors include "enterprise phenomena" (non-core gains or losses, accounting changes, productivity, price and cost trends etc.), "natural phenomena" (earthquakes etc.), and "economic phenomena" (interest and exchange rate changes etc.). Pro forma results, if used, should be presented on a consistent basis from period to period. "Forward looking" information should be included subject to applicable "Safe Harbor" provisions.[11]

Recommendations

Pending the adoption of any new SEC Rules on the subject, I believe that companies preparing pro forma earnings releases should take the following steps to protect themselves from liability:

√ Include comparative financial results determined in accordance with GAAP in any press release or other public communication that contains pro forma results. Include GAAP based estimates (and identify them as such) if the earnings release is issued before final GAAP results are known.

√ Provide a narrative explanation of the reasons for using pro forma information and of the assumptions used to compile or derive it. The explanation should identify and rationalize any significant omission of information required by GAAP.

√ If the pro forma disclosure is based on a planned or negotiated event, such as the lease cancellation and transfer of assets recited in the

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Board and now President…had no knowledge… (of the actions leading to the Order)." The Donald then assured one and all that "I have great respect for the Commission and its Chairman, Harvey Pitt. I am very happy that this all worked out." Doubtless, the Chairman, the other Commission members and the entire SEC staff were vastly comforted by that pronouncement. The Trump releases are available at www.trump.com.

[11] Section 27A of the Securities Act, Section 21E of the Exchange Act and SEC Rule 175 provide, in effect, that erroneous "forward looking statements" about future events or prospects are not fraudulent if they are identified as predictions rather than facts, are based on reasonable assumptions and are disclosed in good faith.

Trump Consent Order, consult the SEC Rules for transaction-based pro forma information found in Regulations S-X and S-K.

√ If the pro forma disclosure is based upon a natural catastrophe or other unanticipated event beyond the control of the company, disclose any information that might shed light on a recurrence and on the steps the company has or will take to minimize future catastrophic losses.

√ Do not include revenue from planned transactions that are subject to a significant contingency. Do not exclude product development, pre-opening and similar expenses as "one-time" charges without disclosing fully any significant risk of a recurrence of them. For example, pre-opening store expenses would not represent a "one-time charge" for a retailer actively planning an expansion into new geographic markets. 12

√ Follow the Best Practices Guidelines to the extent applicable. The SEC will probably build upon them if it adopts new rules for earnings releases.

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[12] By way of analogy, SEC Rule 170 prohibits the use of financial statements that "purport to give effect to the receipt and application of any part of the proceeds from the sale of securities for cash … unless (the underwriters) …are or will be committed to take and pay for the securities…."