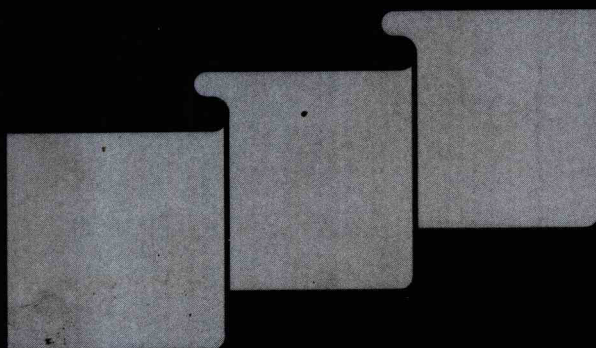


CENTER FOR INTERNATIONAL  
LEGAL STUDIES

TRENDS AND  
DEVELOPMENTS IN  
CORPORATE  
GOVERNANCE



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# **Trends and Developments in Corporate Governance**

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**The Comparative Law Yearbook of International Business**

**Special Issue, 2003**

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**Dennis Campbell**

*Director, Center for International Legal Studies  
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**Volume Editor**

**Susan Woodley**

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## Editor's Note

The 2003 Special Issue of the Comparative Law Yearbook of International Business deals with issues relating to Corporate Governance. Following a series of scandals involving reporting by public companies in the United States, there has been an increase in the number of measures dealing with, among other things, the liability of directors and managers when submitting company financial returns. The first and most well-known piece of legislation to be introduced was, of course, the United States Sarbanes-Oxley Act of 2002.

The Sarbanes-Oxley Act covers matters including the establishment of audit committees, disclosure committees, and codes of ethics, with an emphasis upon the disclosure of information and transparency. It describes, for example, the principle of "vicinity of insolvency" and the relevant information to be disclosed to shareholders and creditors. The issue of directors' duties and responsibilities is addressed, together with the consequences of insider trading and conflicts of interests. The Act also contains provisions on whistleblowers and introduces new criminal sanctions for company wrongdoings, as well as enhancing those penalties already in place.

As a result of the Sarbanes-Oxley Act, many countries have followed suit and adopted their own measures to combat corporate failings, corruption, and the misuse of power. Among those covered in this publication are South Africa, China, a number of eastern and western European states, and various Asian jurisdictions. Other specific topics discussed are, *inter alia*, generally accepted accounting principles, insolvency, the banking, securities and insurance industries, foreign issuers, and close private companies.

Corporate governance is an extremely topical subject which is of great importance and relevance to anyone involved in company affairs. Many corporate practitioners will, therefore, find this publication highly useful when advising clients on their various rights and responsibilities under new legislation.

**Susan Woodley, Editor**  
**Center for International Legal Studies**  
**Salzburg, Austria**

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# **Non-Generally Accepted Accounting Principles and Reporting of Earnings Releases**

**Steven J. Abrams  
Pepper Hamilton LLP  
Philadelphia, Pennsylvania, United States**

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## **Introduction**

The Securities and Exchange Commission (SEC) adopted a new Regulation G, effective as of 28 March 2003, to address public companies' disclosure or release of certain financial information that is calculated and presented using methods that are not in accordance with generally accepted accounting principles (GAAP). When a public company (other than a registered investment company) or a person acting on a company's behalf, publicly discloses or releases a non-GAAP financial measure, Regulation G requires the inclusion of a presentation of the most directly comparable GAAP financial measure and a reconciliation of the differences between the non-GAAP financial measure and the most directly comparable GAAP financial measure. Only public disclosures trigger compliance with Regulation G. Whether a disclosure is "public" depends on the facts and circumstances surrounding the disclosure.

For the purposes of Regulation G, a non-GAAP financial measure is defined as a numerical measure of a company's past or future financial performance, financial position or cash flows that:

- (1) Excludes amounts, or is subject to adjustments that have the effect of excluding amounts, that are included in the most directly comparable measure calculated and presented in accordance with GAAP in the statement of income, balance sheet or statement of cash flows (or equivalent statements) of a company; or
- (2) Includes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded from the most directly comparable GAAP financial measure.



The following are considered to be non-GAAP financial measures:

- (1) A measure of performance that differs from measures presented in the financial statements, such as net income or loss, as calculated in accordance with GAAP, for example:
  - (a) a measure of operating income that excludes one or more expense or revenue items that are identified as "non-recurring"; or
  - (b) EBITDA; and
- (2) A measure of liquidity that is different from cash flow or cash flow from operations computed in accordance with GAAP.

The following are not considered to be non-GAAP financial measures:

- (1) Operating and other financial measures, such as unit sales or numbers of employees or subscribers;
- (2) Ratios or statistical measures calculated using exclusively one or both of:
  - (a) financial measures calculated in accordance with GAAP (such as operating margin that is calculated by dividing revenues into operating income, where both revenues and operating income are calculated in accordance with GAAP); or
  - (b) operating measures or other measures that are not non-GAAP financial measures;
- (3) Financial information that does not have the effect of providing numerical measures that are different from the comparable GAAP measure, such as:
  - (a) disclosure of amounts of expected indebtedness, including contracted and anticipated amounts;
  - (b) disclosure of amounts of repayments that have been planned or decided but not yet made;
  - (c) disclosure of estimated revenues or expenses of a new product line, so long as such amounts were estimated in accordance with GAAP; and
  - (d) measures of profit or loss and total assets for each segment required to be disclosed in accordance with GAAP; and
- (4) Financial measures required to be disclosed by GAAP, SEC rules or a system of regulation of a government, governmental authority or self-regulatory organization that applies to the company.

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## **Requirements of Regulation G**

### **Comparison and Reconciliation of Accounting Principles**

Under Regulation G, whenever a company, or a person acting on its behalf, publicly discloses material information that includes a non-GAAP financial measure, a company must include:

- (1) A presentation of the most directly comparable financial measure calculated and presented in accordance with GAAP; and
- (2) A reconciliation (by schedule or other clearly understandable method) of the differences between the non-GAAP financial measure disclosed or released and the most directly comparable GAAP financial measure.

The SEC has stated that, in the case of ratios or measures where a non-GAAP financial measure is the numerator and/or denominator in the calculation, a company must reconcile each non-GAAP financial measure used in the calculation. Also, a company must show the ratio or measure as calculated using the most directly comparable GAAP financial measure. The reconciliation must be quantitative for historical non-GAAP measures and, to the extent possible without unreasonable effort, for forward-looking information.

If a non-GAAP financial measure is made public orally, telephonically, by webcast, broadcast or similar means, then the required accompanying information can be provided on a company's website, as long as it is on the website when the non-GAAP financial measure is made public and the website address is included in the public presentation. The SEC suggests that if a company chooses to post the required information on its website, it should leave the information posted for at least twelve months.

### **General Materiality Disclosure Requirement**

Under Regulation G, a company, or person acting on its behalf, must not make public a non-GAAP financial measure that, taken together with the information accompanying that measure, contains an untrue statement of a material fact or omits to state a material fact necessary to make the presentation not misleading. This catch-all materiality disclosure requirement is important for a company to keep in mind when it structures its Regulation G disclosure. For example, if a company changes its method of calculating or presenting a non-GAAP

financial measure from one period to another, it may need to disclose a complete description of that change to comply with this disclosure requirement.

### **Risks Associated with Non-Compliance**

Non-compliance with the requirements of Regulation G can result in serious penalties. In addition to risking an SEC enforcement action for violating Regulation G, any disclosure under Regulation G that is materially deficient may violate Section 10(b) or Rule 10b-5 of the Securities Exchange Act.

### **Securities and Exchange Commission Filings**

In addition to Regulation G (which regulates all public disclosures of non-GAAP financial measures, including, but not limited to, SEC filings), the SEC amended Item 10 of Regulation S-K (as well as Regulation S-B) to address the use of non-GAAP financial measures in SEC filings. The Regulation S-K requirements apply to the same categories of non-GAAP financial measures as those covered by Regulation G, but the Regulation S-K disclosure requirements are more extensive than those in Regulation G.

SEC filings include annual reports on Form 10-K, quarterly reports on Form 10-Q and certain current reports on Form 8-K. Under SEC rules, a number of documents furnished to the SEC are not considered "filed" with the SEC, so are subject only to the disclosure requirements of Regulation G, not to the more extensive disclosure requirements of Regulation S-K. Examples of documents that are "furnished" to the SEC, and are not considered to be filed with the SEC, include annual reports to shareholders, Regulation FD Forms 8-K and earnings release/announcement Forms 8-K.

### **Disclosure Requirements**

Whenever non-GAAP financial measures are included in an SEC filing, the following disclosures are required:

- (1) A presentation, with equal or greater prominence, of the most directly comparable GAAP financial measure;

- (2) A reconciliation (by schedule or other clearly understandable method) of the differences between the non-GAAP financial measures and the most directly comparable GAAP financial measures;
- (3) A statement of why a company's management believes that the non-GAAP financial measure provides useful information to investors regarding a company's financial condition and results of operations; and
- (4) To the extent material, a statement disclosing the additional purposes, if any, for which the company's management uses the non-GAAP financial measure.

### **Prohibited Disclosures**

The SEC amended Regulation S-K to prohibit the use of certain kinds of non-GAAP financial measures in SEC filings, either generally or in specified contexts. The prohibitions cover the following:

- (1) Excluding charges or liabilities that require, or will require, cash settlement, or would have required cash settlement absent an ability to settle in another manner, from non-GAAP liquidity measures other than the EBIT and EBITDA measures;
- (2) Adjusting a non-GAAP performance measure to eliminate or smooth items identified as non-recurring, infrequent or unusual when:
  - (a) the nature of the charge or gain is such that it is reasonably likely to recur within two years; or
  - (b) there was a similar change or gain within the prior two years;
- (3) Presenting non-GAAP financial measures on the face of a company's financial statements prepared in accordance with GAAP or in the accompanying notes;
- (4) Presenting non-GAAP financial measures on the face of any pro forma financial information required to be disclosed by Article 11 of Regulation S-X; and
- (5) 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.

It should be remembered that these prohibited disclosures relate solely to the use of non-GAAP financial measures in SEC filings. Item 9 (Regulation FD Disclosures) and Item 12 (Results of

Operations and Financial Condition) of Form 8-K are not considered to be SEC filings for this purpose.

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## **Disclosure of Results of Operations and Financial Condition**

### **General Rule**

The SEC amended Form 8-K to add new Item 12, which brings earnings information into the reporting system by requiring companies to furnish to (not file with) the SEC a Form 8-K within five business days of any public announcement or release that discloses material non-public information regarding a company's results of operations or financial condition for an annual or quarterly fiscal period that has ended. A company must briefly identify the release or announcement and include its text as an exhibit to the Form 8-K.

An Item 12 of Form 8-K must be furnished to the SEC regardless of whether the announcement includes the disclosure of a non-GAAP financial measure. However, if it does, the disclosure requirements of Regulation G will apply. The new Regulation S-K disclosure requirements (which are triggered solely in connection with SEC filings) do not apply because an Item 12 of Form 8-K is furnished to, not filed with, the SEC.

In addition to the Regulation G required disclosures, some of the more extensive new Regulation S-K disclosure requirements are required in an Item 12 of Form 8-K, such as the statements about why the company's management believes that the non-GAAP financial measure provides useful information to investors, as well as the additional purposes, if any, for which management uses the non-GAAP financial measure. It should be noted that information furnished to the SEC is not incorporated by reference into a registration statement, proxy statement or other report unless a company specifically incorporates that information into those documents by reference. Therefore, if a company intends to incorporate an Item 12 of Form 8-K by reference into a registration statement, proxy statement or other report, the Item 12 of Form 8-K must comply with all of the other more stringent Regulation S-K disclosure requirements, such as the presentation of the GAAP comparable financial measure with equal or greater prominence than the non-GAAP financial measure and compliance with the prohibited disclosures in SEC filings.

## **Methods of Disclosure**

If material non-public financial information is disclosed orally, telephonically or by webcast, broadcast or similar means in a presentation that complements, and initially occurs within forty-eight hours after, a related written release or announcement that triggers the requirements of Item 12 of Form 8-K, a company is not required to furnish a Form 8-K for that subsequent presentation if:

- (1) The related written release or announcement has been furnished to the SEC on Form 8-K under Item 12 before the presentation;
- (2) The presentation is broadly accessible to the public by dial-in conference call, webcast, broadcast or similar means;
- (3) The financial information in the presentation is provided on the company's website, together with any information related to non-GAAP financial matters that would be required under Regulation G (the SEC has indicated informally that it expects the required information to be posted to the website no later than the time of the presentation, although the rules do not address this issue); and
- (4) The presentation was announced by a widely disseminated press release that included instructions for when and how to access the presentation and the location of the information on the company's website.

## **Form 8-K Practice Pointers**

In connection with an earnings press release followed by a conference call or webcast, the following three alternatives would comply with the new Item 12 of Form 8-K requirements.

### **All Financial Information in Press Release**

In the earnings press release, the company would include all of the material non-public financial information that would be used in the conference call or webcast. This would avoid the need to post material non-public financial information contained in the presentation on the company's website. The downside would be that the earnings press release would be cluttered with financial information.

### Limited Financial Information with Website Posting

In the earnings press release, the company would not include the material non-public financial information that would be used in the conference call or webcast. After issuing the earnings press release, but before the conference call or webcast, the company would:

- (1) Furnish the earnings press release to the SEC on an Item 12 of Form 8-K;
- (2) Announce the conference call or webcast by a widely disseminated press release (including instructions as to when and how to access the presentation and the location of the information on the company's website); and
- (3) Post on the company's website the material non-public financial information contained in the conference call or webcast, together with any information related to non-GAAP financial matters that would be required under Regulation G.

This alternative would allow the company to use a press release containing customary disclosures. The downside would be the timing pressure of having to furnish a Form 8-K before the conference call or webcast, and the requirement to promptly post the material non-public financial information contained in the conference call or webcast (as well as the Regulation G disclosure requirements) on the company's website.

### Limited Financial Information with No Website Posting

In the earnings press release, the company would not include the material non-public financial information that would be used in the conference call or webcast. The company would not furnish to the SEC an Item 12 of Form 8-K before the conference call or webcast and would not post the material non-public financial information contained in the presentation on the company's website. Instead, the company would furnish to the SEC an Item 12 of Form 8-K within five business days of issuing the earnings press release. The Item 12 of Form 8-K would contain the earnings press release, as well as the text of the conference call or webcast presentation, disclosing any additional material non-public financial information.

This would allow the company to use a press release containing customary disclosures, and would negate the requirement to quickly file an Item 12 of Form 8-K before the conference call or webcast, as

well as the requirement to post all of the material non-public financial information from the conference call or webcast presentation (as well as the Regulation G disclosure requirements) on the company's website.

The downside to this alternative, however, would be the added disclosure in the Item 12 of Form 8-K of the additional material non-public financial information contained in the conference call or webcast, in contrast to merely having to provide such information on the company's website, as in the second alternative. The SEC has not provided guidance on whether the disclosure requirement of the Item 12 of Form 8-K is limited to the written materials used in the conference call or webcast (for example, slides, Regulation G GAAP comparisons/reconciliations and possibly written scripts) or whether the entire transcript of the conference call or webcast, including any question and answer session, must be furnished with the Form 8-K.

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## **Compliance Guidelines for Use of Financial Information**

The following chart may help in complying with the new SEC rules:

		<b>Item 10</b>	<b>Item 12</b>
<b>Question:</b>	<b>Regulation G</b>	<b>Regulation S-K</b>	<b>Form 8-K</b>
<b>1. Is it a public or private announcement or release?</b>			
Private	No	No <sup>1</sup>	No
Public — go to Question 2			

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<sup>1</sup> Note that all publicly available SEC filings are deemed to be public announcements or releases.



Question:	Item 10		Item 12
	Regulation G	Regulation S-K	Form 8-K
<b>2. Does the public announcement or release contain material information?</b>			
Information is not material	No	See footnote 2 <sup>2</sup>	No
Information is material — go to Question 3			
<b>3. Was the material information non-public before the announcement or release?</b>			
Previously made public; information will not appear in an SEC filing	Yes	No	No
Previously made public; information will appear in an SEC filing	Yes	Yes	No

2 If the information is contained in a Securities and Exchange Commission filing, Item 10 of Regulation S-K will apply. If, however, the information is not contained in a Securities and Exchange Commission filing, Item 10 of Regulation S-K will not apply.