# UBS Warburg

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# Reg G -- A Squeeze on Pro Forma?

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■ **New Rules for Non-GAAP Financial Measures Enacted**

On March 28, new SEC rules governing the presentation of "pro forma" or non-GAAP financial measures in earnings releases and similar public announcements take effect. These rules, known as Regulation G and amendments to existing Regulations S-B and S-K, implement Section 401(b) of the Sarbanes-Oxley Act.

■ **Reg G Will Significantly Impact Current Reporting Practice**

The new rules require companies to reconcile any presented non-GAAP financial measure to its most comparable GAAP measure in any type of public communication. For SEC filings, companies must clearly identify the excluded charges, provide reasons for the use of non-GAAP measures, and cannot exclude charges that have occurred in the past two years or could occur in the next two years.

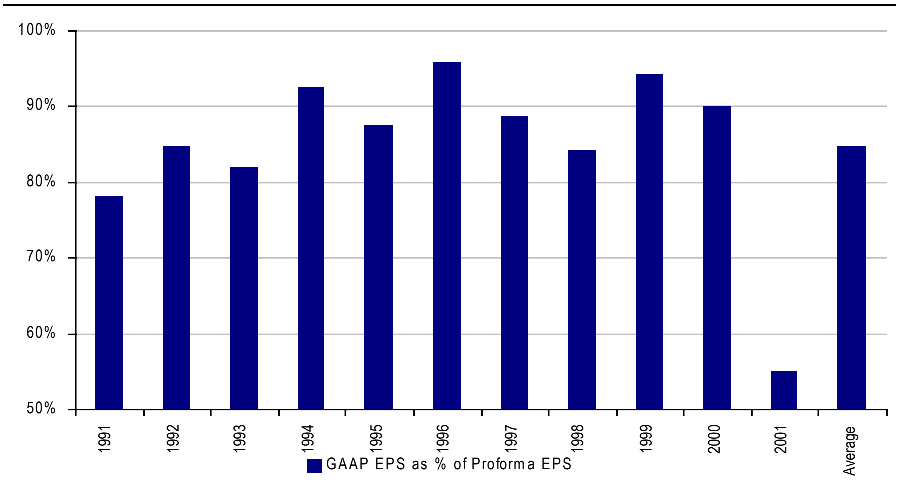
■ **Reg G Raises Prominence of GAAP Earnings to Investors**

These new requirements are intended to make it more difficult to inflate "pro forma" earnings and raise investor attention and consideration of GAAP earnings. In all communications, GAAP earnings must now be given at least equal prominence as pro forma.

■ **New Disclosure Requirements May Pressure Pro Forma Earnings**

By comparing GAAP with pro forma EPS for the S&P 500 since 1991, we estimate the risk to pro forma earnings could approach 10%. This, along with the new rule on SPEs, potential accounting changes in stock options, and pension assumptions, raises earnings concerns.

**Chart 1: S&P 500 Reported Earnings as a Percentage of Pro Forma Earnings**




Source: Standard & Poor's Statistical Service

## Contents



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# Executive Summary

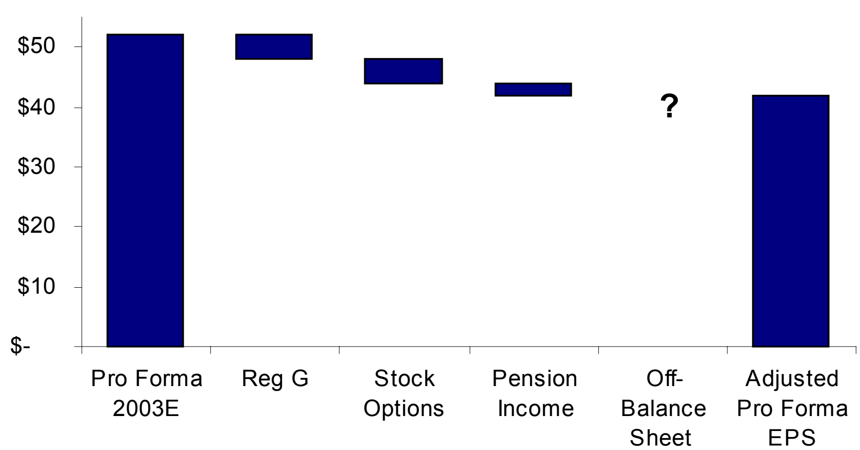
In the coming quarters and perhaps a year or two, we believe Regulation G will unmask a lower level of normalized earnings than currently perceived by most investors. This is because we expect companies to use special charges far less frequently and, when they do, to exclude fewer costs as being nonrecurring. This may be a significant drag on pro forma earnings growth in coming periods.

We estimate that Regulation G could place as much as $5.00 or 10% of pro forma EPS at risk. This estimate is based on the 1991-2001 average difference between GAAP and pro forma (First Call) earnings of 16% adjusted for an expected continuation of more reasonable cost exclusions such as losses on asset sales. We note that the pro forma earnings risk may be greater for technology, media and telecom.

Regulation G and recurring one-time charges is only one of several key concerns that underlies our thesis that the quality of earnings is among the lowest levels in at least the past decade. Our three other most significant concerns stem from pension investment income, employee stock option expense, and off-balance sheet transactions soon to be disclosed per new SEC rules. All things considered, our best advice to investors is to shave as much as $10 from pro forma S&P 500 earnings forecasts for valuation purposes.

This adjustment to current consensus pro forma S&P 500 EPS of $52 for 2003 would raise the PE on the index to 20 times from 16 times.

**Chart 2: Earnings Quality Adjustments to S&P 500 Pro Forma EPS, 2003**




Source: UBS Warburg estimates

# Implications of Reg G

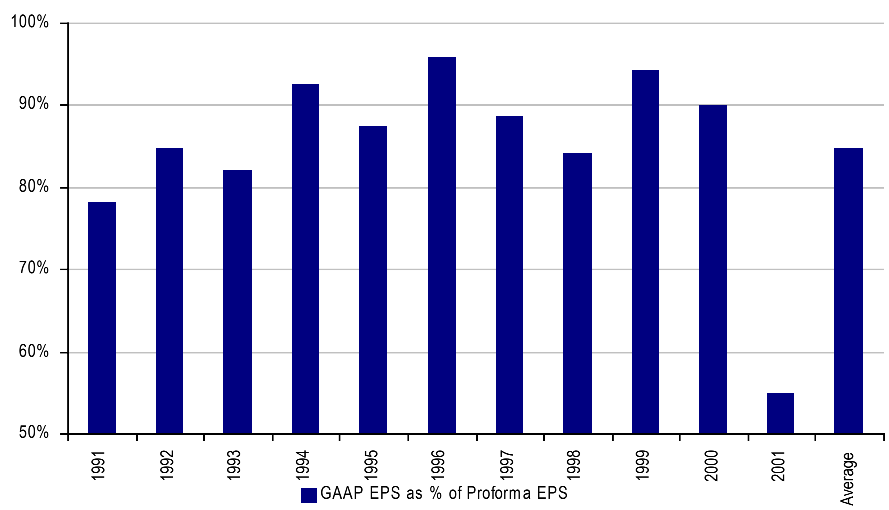
One of investors' and regulators' primary concerns regarding the quality of earnings is the widespread use of non-GAAP company financials. The practice of companies providing investors with non-GAAP financial measures, such as pro forma earnings, that ultimately present companies in a better light than would be reflected under GAAP has been on the rise in recent years. Companies have been able to present pro forma earnings to investors largely because financial reporting rules do not apply to earnings press releases.

By passing Section 401(b) of the Sarbanes-Oxley Act, Congress provided the SEC with a legislative mandate to regulate the disclosure of non-GAAP financial information. The new rules enacted by the SEC will make it more difficult for companies to inflate pro forma earnings and may narrow the growing divergence between GAAP earnings and pro forma earnings.

In the coming quarters and perhaps in a year or two, we believe the new rules will unmask a lower level of normalized earnings than currently perceived by most investors. This is because we expect companies to use special charges far less frequently and when they do, to exclude fewer costs as being nonrecurring. This may be a significant drag on pro forma earnings growth in coming periods.

From 1991-2001, GAAP (excluding FAS 142 goodwill impairment) was 84% of S&P 500 pro forma EPS on average. In 2001, GAAP EPS (excluding FAS 142) was as low as 55% of pro forma EPS. And actual reported GAAP EPS (including FAS 142) of $21 was 47% of First Call pro forma EPS of $45.

**Chart 3: S&P 500 Reported Earnings as a Percentage of Pro Forma Earnings**




Note: Based on historical S&P 500 constituents each year.

Source: Standard & Poor's Statistical Service

## How Will the New Rules Influence Investors?

- These new rules should enable investors to better understand and reconcile the difference between GAAP earnings and non-GAAP earnings measures. This enhances the ability to estimate a company's normalized earnings, which we think is the most appropriate measure for valuation purposes.

- The required increased prominence of GAAP earnings, particularly whenever pro forma is presented, will make it more difficult to ignore.

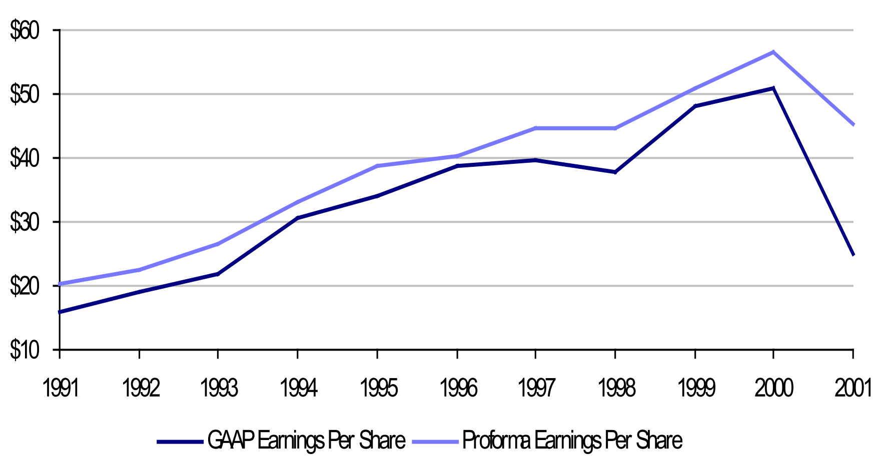
## How Will the New Rules Influence Reporting Practices?

- Requiring management to clearly identify one-time charges in quantitative schedules, with explanations for why adjustments to GAAP were made in SEC filings (including annual reports), should enhance management restraint and discipline in using such one-time exclusions. Otherwise, it helps reveal when cost exclusions are plain attempts to inflate earnings.

- Prohibiting the exclusion of costs from pro forma earnings when those types of costs have occurred in the past two years or are reasonably likely to recur in the next two years should additionally curb and deter the practice of excluding charges as well as effectively end serial "nonrecurring" charges.

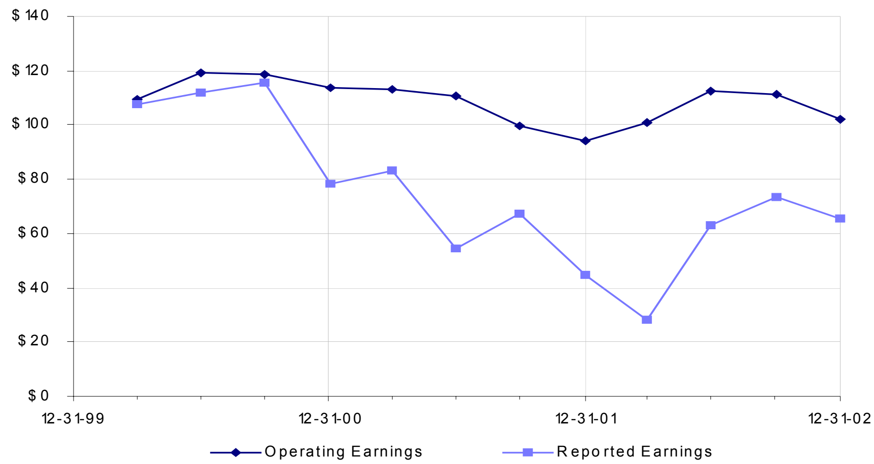
While there has always been a difference between GAAP and pro forma corporate earnings, the divergence materially widened in 2001 and 2002 as reported to date. Although part of the expanded difference between the two measures could be attributed to poor economic conditions of late, we did not see as dramatic a widening of the gap in 1991 the previous recession year. In our view, this supports the contention that the use of one-time charges has reached an unprecedented level. We think this makes the use of historical valuation benchmarks based on pro forma earnings misleading if not adjusted.

**Chart 4: S&P 500 Pro Forma Versus Reported EPS Annually, 1991-2001**




Source: Standard & Poor's Statistical Service

**Chart 5: S&P 500 Pro Forma Versus Reported EPS Quarterly, 2000-02, in billions**

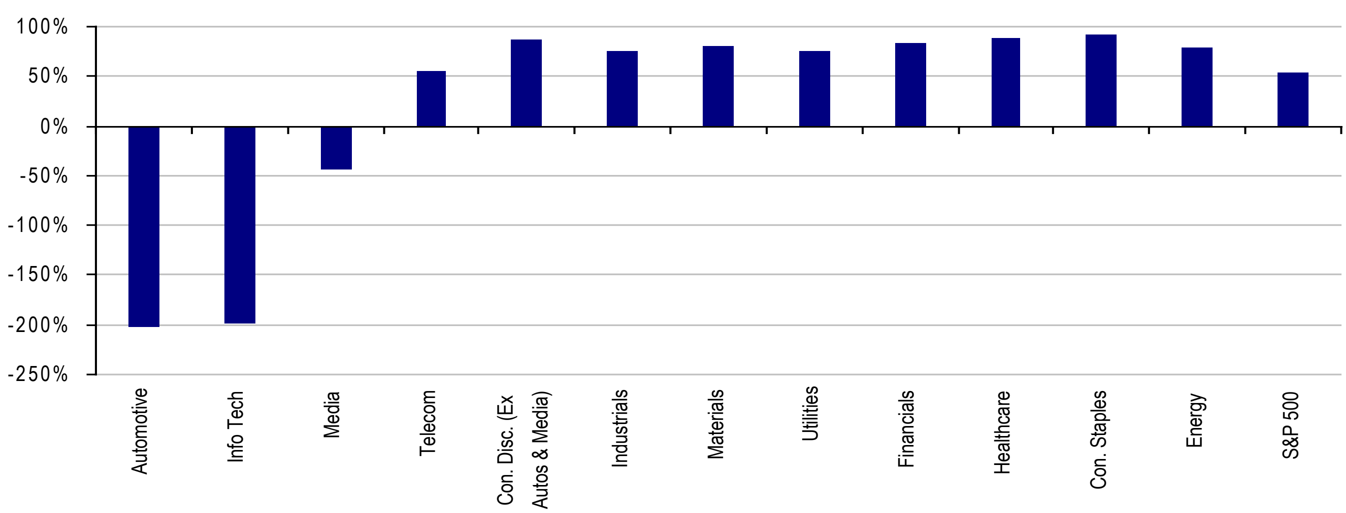



Note: Based on current S&P 500 constituents excluding AOL and JDSU FAS 142 charges.
Source: Compustat and First Call.

The substantial difference between GAAP and pro forma earnings in 2001 has continued through 2002 as reported to date. Even in the most recent quarter, fourth calendar quarter of 2002, GAAP was merely 55% of pro forma earnings.

The difference in earnings measures for fully reported 2001 is pronounced in the automotive, technology, telecom, and media sectors. We think these are the sectors most at risk of experiencing a drag on pro forma earnings growth or impeded from recovering to late-1990s earnings levels from Regulation G.

**Chart 6: Reported Earnings as a Percentage of Pro Forma by S&P 500 Sector, 2001**




Source: Compustat and First Call

We performed an analysis on the companies in the S&P 500 to determine which had the largest discrepancy between GAAP and non-GAAP earnings for the most recent three fiscal years, 1999-2001. The complete S&P 500 list is available upon request.

## Table 1: Largest Discrepancy in Cumulative Three-Year GAAP Versus Pro Forma Earnings

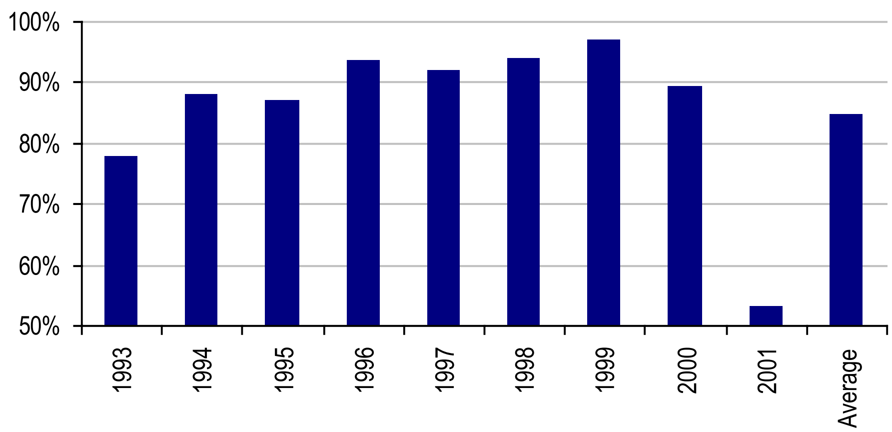
| S&P 500 Companies | Cum. Pro Forma Earnings | Cum. GAAP Earnings | Difference | Pro Forma to GAAP Differential Relative to GAAP Earnings | UBSW Rating |
|---|---|---|---|---|---|
| WINN-DIXIE STORES INC | 397.5 | -0.5 | -398.0 | -73094% | Neutral 2 |
| WASTE MANAGEMENT INC | 2629.4 | 6.8 | -2622.5 | -38379% | Neutral 1 (under review) |
| SYMBOL TECHNOLOGIES | 304.1 | -7.3 | -311.4 | -4266% | Not Rated |
| BRUNSWICK CORP | 541.6 | 24.1 | -517.5 | -2147% | Not Rated |
| GREAT LAKES CHEMICAL CORP | 274.9 | -22.9 | -297.8 | -1300% | Reduce 2 (under review) |
| COCA-COLA ENTERPRISES | 392.8 | -35.7 | -428.4 | -1201% | Buy 1 |
| NOVELL INC | 251.8 | -30.3 | -282.1 | -931% | Not Rated |
| RAYTHEON CO | 1793.4 | -217.0 | -2010.5 | -926% | Buy 2 |
| YAHOO INC | 402.2 | 41.8 | -360.4 | -862% | Not Rated |
| WILLIAMS COS INC | 2161.1 | 270.9 | -1890.2 | -698% | Neutral 2 |
| WYETH | 7713.3 | -1306.1 | -9019.3 | -691% | Buy 1 |
| EDISON INTERNATIONAL | 1673.4 | -284.9 | -1958.3 | -687% | Not Rated |
| BMC SOFTWARE INC | 715.8 | 102.1 | -613.8 | -601% | Not Rated |
| INTERPUBLIC GROUP OF COS | 1185.4 | 175.4 | -1010.0 | -576% | Not Rated |
| FEDERATED DEPT STORES | 2259.9 | 335.2 | -1924.7 | -574% | Neutral 1 (under review) |
| STARWOOD HOTELS&RESORTS WRLD | 898.9 | -200.4 | -1099.3 | -549% | Buy 2 |
| QUALCOMM INC | 1970.9 | 329.7 | -1641.2 | -498% | Neutral 2 |
| CMS ENERGY CORP | 834.8 | -223.2 | -1057.9 | -474% | Not Rated |
| MATTEL INC | 826.1 | -221.8 | -1047.9 | -472% | Not Rated |
| MANOR CARE INC | 353.3 | 63.5 | -289.8 | -456% | Buy 2 |
| EL PASO CORP | 2748.6 | 500.7 | -2248.0 | -449% | Buy 2 |
| GOODYEAR TIRE & RUBBER CO | 408.2 | 78.1 | -330.0 | -422% | Reduce 2 |
| MCDERMOTT INTL INC | 123.9 | -41.5 | -165.5 | -398% | Not Rated |
| NEWMONT MINING CORP | 72.0 | -24.6 | -96.6 | -393% | Buy 2 |
| BALL CORP | 315.0 | 67.3 | -247.7 | -368% | Not Rated |
| CUMMINS INC | 297.7 | 65.2 | -232.6 | -357% | Neutral 2 |
| COMPUTER ASSOCIATES INTL INC | 2498.6 | -999.5 | -3498.0 | -350% | Not Rated |
| GATEWAY INC | 803.8 | -364.4 | -1168.2 | -321% | Not Rated |
| PACTIV CORP | 400.5 | 95.2 | -305.3 | -321% | Not Rated |
| THERMO ELECTRON CORP | 442.5 | -216.0 | -658.5 | -305% | Not Rated |
| INTL PAPER CO | 1737.3 | -876.9 | -2614.2 | -298% | Buy 2 |
| AOL TIME WARNER INC | 5417.3 | -2900.7 | -8317.9 | -287% | Not Rated |
| AMERICAN GREETINGS -CL A | 271.4 | -146.2 | -417.6 | -286% | Not Rated |
| HUMANA INC | 316.2 | -174.8 | -490.9 | -281% | Neutral 2 (under review) |
| RATIONAL SOFTWARE CORP | 300.1 | 82.0 | -218.1 | -266% | Neutral 2 |
| FORTUNE BRANDS INC | 1066.7 | -643.3 | -1710.0 | -266% | Not Rated |
| LOCKHEED MARTIN CORP | 1934.9 | -1183.4 | -3118.3 | -263% | Buy 1 |
| ALLIED WASTE INDS INC | 438.5 | -275.6 | -714.1 | -259% | Buy 2 |
| HASBRO INC | 367.8 | 103.8 | -264.0 | -254% | Not Rated |
| SIMON PROPERTY GROUP INC | 1701.8 | 501.0 | -1200.8 | -240% | Buy 1 |
| ANADARKO PETROLEUM CORP | 2162.0 | 646.9 | -1515.1 | -234% | Neutral 2 |
| MOTOROLA INC | 2390.1 | -1812.5 | -4202.6 | -232% | Neutral 2 (under review) |
| LOUISIANA-PACIFIC CORP | 103.9 | 31.9 | -72.0 | -226% | Buy 2 |
| ADC TELECOMMUNICATIONS INC | 412.8 | -333.0 | -745.8 | -224% | Neutral 2 (under review) |
| PG&E CORP | 2845.3 | -2337.5 | -5182.8 | -222% | Not Rated |
| COMPUWARE CORP | 712.6 | 224.0 | -488.6 | -218% | Not Rated |
| EASTMAN CHEMICAL CO | 529.3 | 172.3 | -357.1 | -207% | Neutral 2 (under review) |
| PENNEY (J C) CO | 342.6 | -365.0 | -707.7 | -194% | Neutral 2 (under review) |
| KINDER MORGAN INC | 396.3 | 135.6 | -260.7 | -192% | Neutral 1 |
| QWEST COMMUNICATION INTL INC | 2058.8 | -2756.8 | -4815.6 | -175% | Neutral 2 (under review) |

Source: Compustat and First Call

Many companies with recent accounting-related investigations/investor concerns, such as AOL Time Warner, El Paso, Interpublic Group, Qualcomm, Qwest, and Waste Management, surfaced on the top-50 list.

Owing to the expulsion of some large one-time charge takers from the S&P 500, such as Worldcom, Enron, Global Crossing, and Nortel, we checked the history of the GAAP and pro forma earnings divergence based on the current constituents of the index. The fact that the average long-term period discrepancy was just as large for the current constituents as historical constituents left us with little comfort in the notion that this problem is behind us.

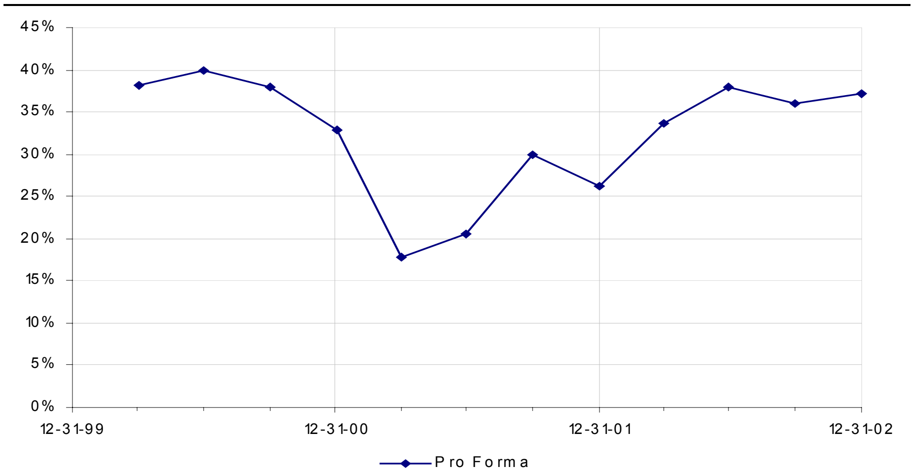
**Chart 7: S&P 500 GAAP Earnings as a Percentage of Pro Forma, 1993-2001**




Note: Based on current S&P 500 constituents.
Source: Compustat and First Call

The divergence between GAAP and pro forma earnings is one of both depth and breadth. During the 12 quarters between 2000 and 2002, less than one-third of the S&P 500 companies reported pro forma earnings that were equal to GAAP earnings. The record quarterly match during these three years was 40%, a level that recent quarters remain beneath.

**Chart 8: Percentage of S&P 500 Companies With Matching GAAP and Pro Forma EPS**




Source: Compustat and First Call

Only eight of the current S&P 500 constituent companies have reported pro forma earnings per share equal to GAAP earnings per share in the last 12 quarters. Whereas about 85 current S&P 500 constituent companies never reported pro forma earnings per share equal to their GAAP earnings per share in each of the last 12 quarters.

**Table 2: S&P 500 Companies With First Call Earnings Equal to GAAP, 2000-02**

| Company Name | UBSW Rating | Quarters Reported | Pro Forma = GAAP | % Pro Forma = GAAP |
|---|---|---|---|---|
| CAPITAL ONE FINL CORP | Buy 2 | 12 | 12 | 100.0% |
| CENTEX CORP | NR | 12 | 12 | 100.0% |
| COUNTRYWIDE FINANCIAL CORP | Buy 1 | 8 | 8 | 100.0% |
| FAMILY DOLLAR STORES | NR | 12 | 12 | 100.0% |
| HARLEY-DAVIDSON INC | Buy 2 | 12 | 12 | 100.0% |
| HOME DEPOT INC | NR | 12 | 12 | 100.0% |
| KOHLS CORP | Buy 1 | 12 | 12 | 100.0% |
| LINEAR TECHNOLOGY CORP | NR | 12 | 12 | 100.0% |
| ROCKWELL COLLINS INC | Neutral 1 | 5 | 5 | 100.0% |
| SYNOVUS FINANCIAL CP | Buy 2 | 12 | 12 | 100.0% |

Source: Compustat, First Call, and UBS Warburg research

*Please contact us for the full S&P 500 analysis.*

## Table 3: S&P 500 Companies With Quarterly First Call Earnings Not Equal to GAAP, 2000-02

| Company | Rating | Number of Quarters | % Pro Forma = GAAP | Company | Rating | Number of Quarters | % Pro Forma = GAAP |
|---|---|---|---|---|---|---|---|
| ACE LIMITED | Buy 2 | 12 | 0.0% | JDS UNIPHASE CORP | Reduce 2 | 11 | 0.0% |
| ADC TELECOMMUNICATIONS | Neutral 2 (under review) | 12 | 0.0% | JEFFERSON-PILOT CORP | Not Rated | 12 | 0.0% |
| AES CORP. (THE) | Reduce 2 | 11 | 0.0% | KIMBERLY-CLARK CORP | Buy 1 | 12 | 0.0% |
| AETNA INC | Neutral 1 | 11 | 0.0% | KROGER CO | Neutral 1 | 12 | 0.0% |
| ALBERTSONS INC | Reduce 1 | 12 | 0.0% | LOCKHEED MARTIN CORP | Buy 1 | 12 | 0.0% |
| ALLIED WASTE INDS INC | Buy 2 | 11 | 0.0% | LSI LOGIC CORP | Neutral 2 (under review) | 12 | 0.0% |
| ALLSTATE CORP | Buy 1 | 12 | 0.0% | LUCENT TECHNOLOGIES | Neutral 2 | 12 | 0.0% |
| ALLTEL CORP | Not Rated | 12 | 0.0% | METLIFE INC | Buy 1 | 11 | 0.0% |
| AMERICAN ELECTRIC POWER | Neutral 2 | 10 | 0.0% | MONSANTO CO | Neutral 2 | 8 | 0.0% |
| AMERICAN INTERNATIONAL | Buy 1 | 11 | 0.0% | MOTOROLA INC | Neutral 2 (under review) | 12 | 0.0% |
| ANTHEM INC | Buy 1 | 8 | 0.0% | NCR CORP | Not Rated | 12 | 0.0% |
| AOL TIME WARNER INC | Not Rated | 10 | 0.0% | PERKINELMER INC | Not Rated | 12 | 0.0% |
| APPLE COMPUTER INC | Not Rated | 12 | 0.0% | PFIZER INC | Buy 1 | 12 | 0.0% |
| AVAYA INC | Not Rated | 12 | 0.0% | PG&E CORP | Not Rated | 11 | 0.0% |
| BMC SOFTWARE INC | Not Rated | 12 | 0.0% | PHARMACIA CORP | Buy 1 | 11 | 0.0% |
| BROADCOM CORP -CL A | Reduce 2 (under review) | 12 | 0.0% | POWER-ONE INC | Not Rated | 12 | 0.0% |
| CARDINAL HEALTH INC | Neutral 2 | 12 | 0.0% | PRINCIPAL FINANCIAL GRP | Neutral 1 | 4 | 0.0% |
| CHEVRONTEXACO CORP | Neutral 2 | 12 | 0.0% | PROCTER & GAMBLE CO | Buy 1 | 12 | 0.0% |
| CHUBB CORP | Neutral 2 | 12 | 0.0% | PROGRESSIVE CORP-OHIO | Neutral 2 | 12 | 0.0% |
| CINCINNATI FINANCIAL CORP | Not Rated | 12 | 0.0% | PRUDENTIAL FINANCIAL | Neutral 2 | 3 | 0.0% |
| CISCO SYSTEMS INC | Neutral 1 | 12 | 0.0% | QUALCOMM INC | Neutral 2 | 12 | 0.0% |
| COMCAST CORP | Not Rated | 9 | 0.0% | RATIONAL SOFTWARE | Neutral 2 | 12 | 0.0% |
| COMPUTER ASSOCIATES INTL | Not Rated | 12 | 0.0% | RAYTHEON CO | Buy 2 | 12 | 0.0% |
| CONOCOPHILLIPS | Buy 2 | 12 | 0.0% | ROHM & HAAS CO | Neutral 2 | 12 | 0.0% |
| CORNING INC | Neutral 2 | 12 | 0.0% | SABRE HLDGS CORP -CL A | Not Rated | 12 | 0.0% |
| DANA CORP | Neutral 2 | 11 | 0.0% | SAFECO CORP | Neutral 2 | 12 | 0.0% |
| DELTA AIR LINES INC | Buy 2 | 12 | 0.0% | SIMON PROPERTY GROUP | Buy 1 | 12 | 0.0% |
| DEVON ENERGY CORP | Buy 2 | 12 | 0.0% | SLM CORP | Buy 1 | 12 | 0.0% |
| DOW CHEMICAL | Buy 1 | 12 | 0.0% | SNAP-ON INC | Not Rated | 12 | 0.0% |
| DOW JONES & CO INC | Neutral 2 | 12 | 0.0% | SOLECTRON CORP | Neutral 2 | 9 | 0.0% |
| DU PONT (E I) DE NEMOURS | Neutral 1 (under review) | 12 | 0.0% | ST PAUL COS | Buy 2 | 12 | 0.0% |
| EATON CORP | Not Rated | 12 | 0.0% | TEXAS INSTRUMENTS INC | Neutral 2 (under review) | 12 | 0.0% |
| EQUITY OFFICE PROPERTIES | Neutral 1 | 12 | 0.0% | THERMO ELECTRON CORP | Not Rated | 12 | 0.0% |
| EQUITY RESIDENTIAL | Neutral 1 | 12 | 0.0% | TORCHMARK CORP | Not Rated | 12 | 0.0% |
| FORD MOTOR CO | Reduce 2 | 12 | 0.0% | TUPPERWARE CORP | Not Rated | 12 | 0.0% |
| GOODRICH CORP | Not Rated | 12 | 0.0% | UNOCAL CORP | Neutral 2 | 12 | 0.0% |
| HANCOCK JOHN FINL SVCS INC | Neutral 2 | 12 | 0.0% | VERITAS SOFTWARE CO | Not Rated | 12 | 0.0% |
| HCA INC | Buy 2 | 12 | 0.0% | VERIZON | Neutral 1 | 12 | 0.0% |
| HEINZ (H J) CO | Not Rated | 12 | 0.0% | WATSON | Neutral 2 | 12 | 0.0% |
| HERCULES INC | Not Rated | 11 | 0.0% | WELLPOINT HLTH NETWRK | Buy 1 | 12 | 0.0% |
| HEWLETT-PACKARD CO | Not Rated | 12 | 0.0% | WILLIAMS COS INC | Neutral 2 | 12 | 0.0% |
| INTL PAPER CO | Buy 2 | 12 | 0.0% | XL CAPITAL LTD | Buy 2 | 12 | 0.0% |
| INTUIT INC | Neutral 1 (under review) | 12 | 0.0% | YUM BRANDS INC | Not Rated | 12 | 0.0% |

Source: Compustat and First Call

## How Will Reg G Impact Foreign Issuers?

Regulation G applies to registrants that are foreign private issuers, subject to a limited exception. Specifically, Regulation G does not apply to public disclosure of a non-GAAP financial measure if:

- The securities of the foreign private issuer are listed or quoted on a securities exchange or inter-dealer quotation system outside the United States;
- The non-GAAP financial measure is not derived from or based on a measure calculated and presented in accordance with U.S GAAP; and
- The disclosure is made by or on behalf of the foreign private issuer outside the United States, or is included in a written communication that is released outside the United States.

Regulation G also does not apply to any written communication these companies may release in the United States, so long as the communication is released in the United States contemporaneously with or after its release outside the United States and is not otherwise targeted at persons located in the United States.

These conditions primarily focus on whether the financial measure relates to U.S. GAAP. As such, we believe foreign-based companies that are listed on a U.S. exchange are subject to the requirements of Reg G. It is only foreign private issuers listed outside the United States that are generally exempt from Regulation G requirements.

## Valuation Implications

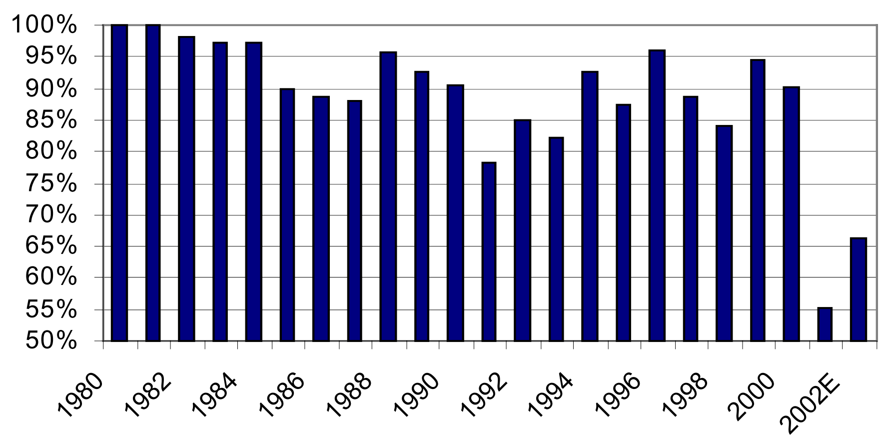
We estimate the pressure on pro forma earnings from regulation G could be as much as 10% for the S&P 500 or about $5.00 in EPS over time. This estimate is based on the 11-year average GAAP to pro forma differential of 16% adjusted for an expected continuation of more reasonable one-time cost exclusions such as gains/losses on asset sales or impairments. This pro forma earnings pressure will make the S&P 500 and most companies in the index more expensive based on the most visible and popular valuation metric—price/pro forma EPS.

We are not comfortable with arguments that discount the possibility of share price corrections if pro forma earnings decline to levels more in line with GAAP based on the belief that the difference between GAAP and pro forma earnings from poor-quality cost exclusions is already reflected in valuations; perhaps it's partial at best.

This is because while some investors do consider GAAP earnings, it is too often shrugged off as being irrelevant compared with pro forma, despite an often admitted weakness of the one-time cost argument for certain items, because of the notion that pro forma is simply the way the market works.

We think investors should be particularly cautious when comparing historical valuation multiples with current multiples based on pro forma earnings. Because as Chart 9 illustrates, the difference between GAAP and pro forma was smaller historically and there is little to no pro forma earnings data easily available before about 1980. This means that almost all cited long-term average PE multiples are based on GAAP earnings. We believe it's like comparing apples with oranges.

**Chart 9: S&P 500 Reported Earnings as a Percentage of Pro Forma, 1980-2002E**




Source: Standard & Poor's Statistical Service

For instance, while the 20-year historical average PE multiple based on pro forma earnings for the S&P 500 is approximately 17.5 times, this average should not be applied to current pro forma earnings without adjusting for the historical difference between pro forma and GAAP versus that deviation today. From 1980 to 1991, GAAP earnings were 94.5% of pro forma earnings, whereas from 1992 to 2001, GAAP earnings were 84.5% of pro forma earnings.

This analysis is critical when analyzing an individual company's historical valuation relative to current valuation or when comparing an individual company's current valuation to that of the market.

More importantly, as the appropriate PE is not necessarily the historical PE, we think investors attempting to determine the appropriate intrinsic PE (based on a cost of equity estimate and a long-term earnings growth estimate) should use a current normalized earnings estimate adjusted for quality of earnings such as recurring one-time charges.

## Just One of Many Quality-of-Earnings Concerns

Perhaps our most important message regarding Reg G and the spread between pro forma and GAAP earnings is that it is only one of several key concerns that underlies our thesis that the quality of earnings is among the lowest levels in at least the past decade. We voice our concern on this issue again with a stronger warning to investors because of the definitive actions we see coming in the next year or two by regulators, FASB, and better self-imposed corporate discipline.

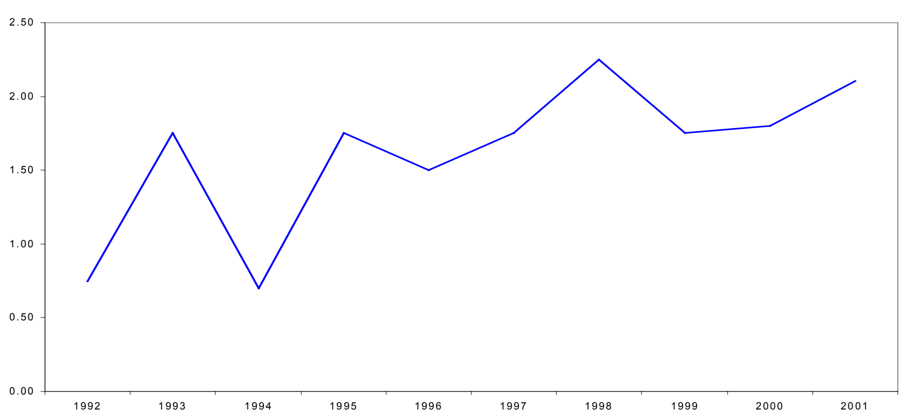
In addition to one-time charges, our three other most significant quality-of-earnings concerns relate to excessive pension investment income within GAAP earnings, employee stock option expense not captured by GAAP earnings, and off-balance sheet transactions that often hide assets and lower a company's financing costs through higher (but unrevealed) levels of risk.

### Pension Investment Income

In 2001, S&P 500 EPS (of $45 pro forma, $21 GAAP) included approximately $2.50 of pension investment income, which comes from management assuming returns on plan assets higher than the interest rate used to discount the future liability.

In 2001, S&P 500 companies assumed a rate of return of 9.5% on average for pension assets compared with an average discount rate of 7.25%. Considering the typical asset allocation of a pension fund is typically 60% equities and 40% fixed income and other, the 9.5% ROA assumption implies an 11-12% long-term return expectation for equities. We think these assumed returns are too high and we believe companies are now being pressured to lower such expectations. Moreover, even if returns above the pension liability interest rate are achieved, we do not believe it adds any value to a company owing to the higher risk required to achieve such returns. In all cases, we encourage investors to exclude pension investment income from a company's earnings as being of very poor quality and deserving of a PE of zero.

**Chart 10: Spread Between Expected ROA on Pension Assets and Interest Rate**




Source: Compustat

We estimate that pension investment income will contribute approximately $2.00 in S&P 500 EPS in 2003, assuming ROA assumptions are not significantly cut.

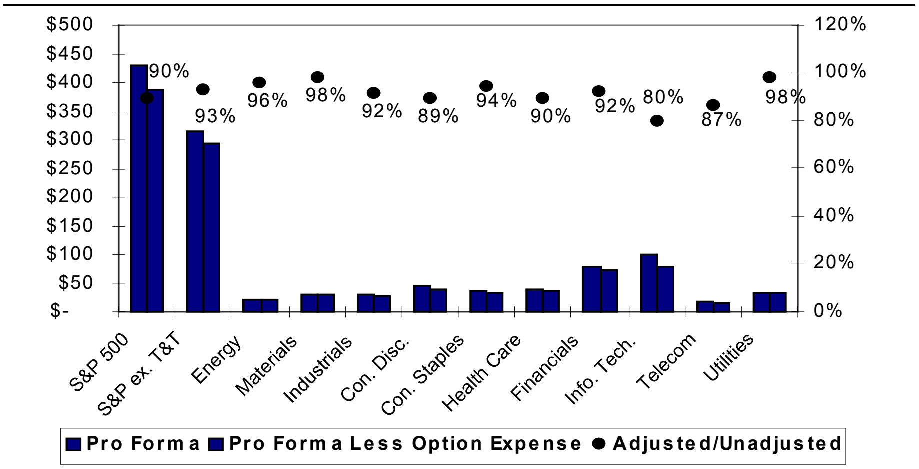
## Employee Stock Option Expense

In 2001, S&P 500 EPS failed to capture the fair value cost of employee stock options, as only Boeing and Winn Dixie (both with negligible option expense) chose to expense options, as permitted by current GAAP. However, according to footnotes required by FAS 123, if the fair value of options granted were expensed, it would have reduced S&P 500 EPS by about $5.00.

Although the expensing of options is still voluntary at this time, we expect more companies to opt for fair value expensing owing to mounting investor concern and pressures and we believe that there is a 70% chance the FASB will require fair value expensing of employee stock options effective as early as 2004.

We note that the 2001 fair value option expense, according to FAS 123 footnotes, was at record levels and we acknowledge the likelihood of fewer options being granted to employees by companies should fair value expensing be made voluntary. Therefore, for the purpose of making a quality-of-earnings adjustment to S&P 500 earnings for employee stock options, we think it is fair to deduct a value less than $5.00 to capture the ongoing more normalized cost.

**Chart 11: S&P 500 Pro Forma Earnings Adjusted for FAS 123 Stock Option Expense**



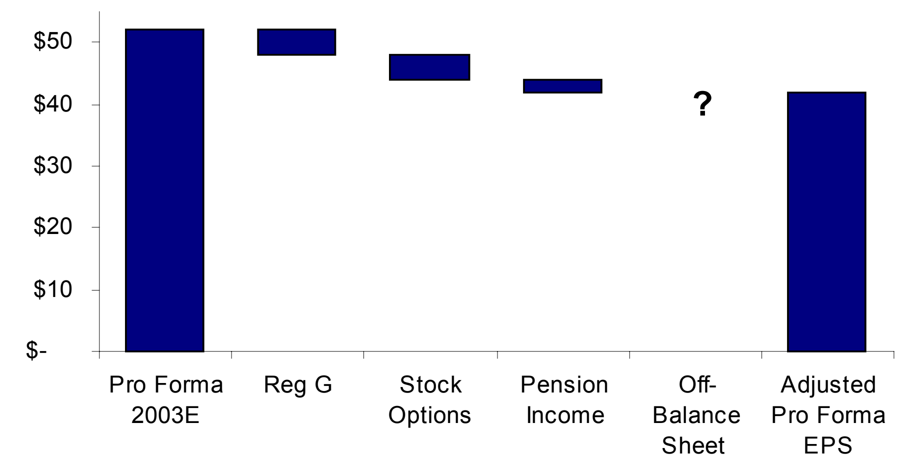

Source: UBS Warburg research

## Off-Balance Sheet Transactions

New FASB special purpose entity (SPE) consolidation tests and rules will be in effect later this year along with greater SEC disclosure requirements. For some S&P 500 companies, the impact of these rules could be materially adverse; at this time we have little ability to quantify the risk to earnings at any macro level.

These issues considered our best advice to investors is to shave off as much as $10 from pro forma S&P 500 earnings forecasts for valuation purposes.

**Chart 12: Earnings Quality Adjustments to S&P 500 Pro Forma EPS, 2003**




Source: UBS Warburg estimates

# Is the SEC on a Mission?

This corporate to investor communication culture of cost exclusions combined with often unbalanced investor community attention given to pro forma over GAAP is not new news. What's new is that the SEC, through Reg G and other Sarbanes-Oxley empowerment, appears determined to do something about it.

The Sarbanes-Oxley Act, signed into law by President Bush on July 30, 2002, is widely viewed as the most sweeping accounting and corporate reform act since the Great Depression. The act is aimed at restoring investor confidence in the public markets by preventing future corporate, accounting, and analyst malfeasance through new oversight and deterrence measures. The act also significantly increases SEC funding for enforcement.

Reg G is simply one of many new rules implemented and to be implemented per Sarbanes-Oxley. Table 4 outlines other new key SEC and FASB rule effective dates. One of the most important of which is the SEC's new rules on off-balance sheet transaction disclosures, which follows on the heels of FASB's new FIN 46 effective date that instates new consolidation tests and rules.

**Table 4: Sarbanes-Oxley Act—Key Effective Dates**

| | |
|---|---|
| July 30, 2002 | Act signed into law mandating new SEC rules. |
| August 29, 2002 | Certifications by CEO and CFO financials. |
| October 28, 2002 | Appoint Accounting Oversight Board. |
| January 26, 2003 | SEC to adopt rules on: auditor independence, off-balance sheet transaction disclosure, presenting non-GAAP financials, required financial expert on audit committee. |
| March 28, 2003 | Effective – SEC Reg G, SEC Reg S-B & S-K Amendments for presentation of non-GAAP financials. |
| June 15, 2003 | Effective – FASB FIN 46 and SEC MD&A disclosure. (SEC required tabular disclosure for off-balance sheet transactions December 15, 2003.) |
| July 30, 2003 | SEC to adopt analyst conflict of interest rules. |
| July 30, 2003 | Accounting firms prohibited from performing certain nonaudit functions for public companies. |

Source: UBS Warburg research

It is our understanding that the SEC is determined to produce tangible improvements in the quality of financial reporting. We believe some of the items agency auditors will be flagging in coming periods include: unbalanced emphasis of pro forma results relative to GAAP in all public communications; nebulous identification of one-time costs such as "realignment" or "streamlining" initiatives; and high pension ROA assumptions and the quality of the explanation and quantification of one-time charges in SEC filings.

Investors should realize that these new rules governing non-GAAP financial measures are not necessarily the final restrictions. The Sarbanes-Oxley Act calls for numerous congressional studies over the coming couple of years to determine the effectiveness of these new rules. In fact, the Sarbanes-Oxley Act went as far as to introduce the possibility of the SEC placing an outright ban on the use of any non-GAAP earnings per share measures.

We are pleased that this was not put into effect by the SEC owing to many letters from companies and institutional investors citing the importance and value of pro forma information. However, we remind investors that Congress is wrestling with balancing the needs of institutional investors with those of individual investors should new major corporate accounting scandals emerge causing more investor losses—anything is possible.

Of course, only time will tell just how rigorous SEC enforcement of these and other new rules will be and ultimately the agency's ability to effectively improve the quality of financial information communicated to investors. But considering this environment of substantial investor losses, frustration, and new congressional SEC empowerment—including the new accounting oversight board and increased SEC enforcement funding—as well as a new investor advocate SEC chairman, William Donaldson, we believe these rules will be strictly enforced and examples will be made of companies willing to push the envelope on financial reporting.

Lastly, we continue to believe that there is a high probability FASB will take decisive action on the employee stock option issue owing to its need to restore credibility and not to lose eminence to agencies like the IASB.

# The New Rules

## Summary

As per the Sarbanes-Oxley Act of 2002, the SEC has enacted the following new rules that regulate the use of non-GAAP financial information:

- **Regulation G** requires reconciliation of any presented non-GAAP financials to GAAP financials in *all* public communications.

- **Amendments to Item 10 of Regulations S-K & S-B** regulate the use of non-GAAP measures in *filings* with the SEC. The amendments require Reg G reconciliation. In addition, companies are required to provide the reasons for the use of non-GAAP measures and are prohibited from making certain disclosures.

## Regulation G—Regulating Non-GAAP Disclosure

Regulation G would apply whenever a reporting company publicly discloses or releases any material information that includes a non-GAAP financial measure, whether that disclosure is communicated in writing, orally, telephonically, in a Web cast or broadcast, or by similar means.

Specifically, companies must present the following in public announcements:

- The most directly comparable GAAP financial measure; and

- A reconciliation (by schedule or other clearly understandable method) of the difference between the non-GAAP measure and the most comparable GAAP measure. The reconciliation must be quantitative for historical measures.

In the newly enacted rules, the SEC uses "non-GAAP" to refer to "pro forma" (or sometimes "operating EPS") financial measures, in order to avoid confusion with other SEC rules. Historically, pro forma information is used in the context of business combinations to provide premerger financial measures as if the combined companies had always been one.

Regulation G defines a "non-GAAP financial measure" as a numerical measure of a company's historical or future financial performance, position, or cash flows that:

(1) "Excludes amounts (or is subject to adjustments that have the effect of excluding amounts) that would otherwise be included in the most directly comparable measure calculated and presented in accordance with GAAP;" 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 measure."

Regulation G casts a wide net, but it does not encompass all financial information that may be derived from non-GAAP methodologies. For example, Regulation G does *not* apply to measures that do not have a comparable GAAP measure. See Table 5 for examples of exempted measures.

**Table 5: Examples of Non-GAAP Financial Measures and Exempt Measures**

| Included In Non GAAP Definition | Excluded From Non GAAP Definition |
|---|---|
| Operating EPS | Financial measures calculated according to GAAP. |
| Pro forma EPS | Ratios using numbers calculated according to GAAP. |
| Earnings excluding restructuring charges | Operating or other statistical measures (e.g., unit sales and number of subscribers). |
| EBIT excluding any other special charges | Amount of expected indebtedness. |
| | Amount of planned but not yet made debt repayments. |
| | Estimated revenue or expenses of a new product line, so long as such amounts were estimated in the same manner as would be computed under GAAP. |
| | Financial measures used for regulatory purposes. |
| | Non-GAAP financial measures included in disclosure relating to a proposed business combination. |
| | Non-GAAP financial measures in communications issued by foreign private issuers outside of the United States so long as the communication is not solely targeted at persons located in the United States. |

Source: SEC and UBS Warburg LLC

## Amendments to Regulation S-K and S-B

### Enhanced Disclosure for Filings

The SEC has amended Item 10 of Regulation S-K and S-B to address the disclosure of non-GAAP financial measures in filings with the SEC. These amendments apply to the same categories of non-GAAP financial measures as are covered by Regulation G, but require more detailed disclosures. In particular, management must explain the reasons why the non-GAAP measure provides useful information.

Specifically, companies that use non-GAAP financial measures in SEC filings must provide the following three items:

(1) *Prominent GAAP financials*—the most directly comparable GAAP financial measures must be presented with equal or greater prominence;

(2) *Reconciliation* of the difference between the disclosed non-GAAP financial measure with the most directly comparable GAAP measure; and

(3) *Management explanation*—why management believes the particular non-GAAP financial measure provides useful information.

In addition to the affirmative disclosures just described, the amendments prohibit certain disclosure behavior. One of the prohibited activities is excluding charges that have occurred in the past two years or are reasonably likely to recur within two years. As discussed before, we believe this will significantly curb serial one-time charges or the practice of excluding recurring "one-time" charges from non-GAAP earnings measures.

Table 6 provides examples of prohibited and exempted activities under the amendments.

**Table 6: Regulations S-K and S-B—Examples of Prohibited and Exempt Disclosure Activity**

| Prohibited Activities | Exempt Activities |
|---|---|
| Excluding cash-settled charges or liabilities from non-GAAP liquidity measures other than EBIT or EBITDA. | Excluding cash-settled charges or liabilities from EBIT or EBITDA as liquidity measures. |
| Excluding an item identified as nonrecurring, infrequent, or unusual when it is reasonably likely to recur within two years or there was a similar charge or gain within the prior two years. | Including "non-GAAP per share measures" in documents filed with the SEC. |
| Presenting non-GAAP financial measures on the face of GAAP financial statements. | Including non-GAAP financial measure in disclosure relating to a proposed business combination if the disclosure is contained in a communication subject to the communications rules applicable to business combinations. |
| 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. | |
| 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. | |

Source: SEC Final Rule on Conditions for Use of Non-GAAP Financial Measures

# Views on the New Rules

Our concern is that the enhanced requirements and restrictions of the new rules may simply cause companies to curb voluntary disclosure of non-GAAP earnings measures. This would leave investors little choice but to use GAAP earnings. While this would be good for weaning the investment community off its dependence on company-determined pro forma earnings, it reduces the information available for making independent pro forma earnings estimates.

Providing only GAAP measures makes it difficult to discern normalized earnings if the GAAP numbers include a material amount of truly nonrecurring items not adequately described or quantified in footnotes or management's discussion and analysis.

As stated before in our research, we have little concern regarding the existence of pro forma earnings. We only take concern with pro forma earnings when they are more determined by the reporting company than the investor community with little disclosure provided by the company on the adjustments.

Citigroup recently announced that it has decided to report only GAAP numbers going forward. In the past few weeks, we have also seen AT&T, Coca-Cola, McDonald's, Pepsico, and Sun Microsystems decide to stop providing formal quarterly earnings projections.

For liquidity measures (such as CFO or FCF), the new rules prohibit exclusion of cash costs such as severance, facility closings, and other similar type restructuring charges. However, the SEC provides explicit exceptions for EBIT and EBITDA measures. This concerns us because EBIT and EBITDA are key liquidity measures and are key inputs to popular valuation metrics. The reconciliation requirements of non-GAAP to GAAP comparable do, however, help to alleviate some of this concern.

Item 10 of rules S-B and S-K also exempt any forward-looking non-GAAP financial measures from being reconciled to their most directly comparable GAAP financial measure if the forward-looking GAAP measure can only be obtained with unreasonable effort. This could result in fewer companies actually providing reconciliation for forward-looking financial measures, which are the fundamental building blocks for equity valuation.

In addition to the issues noted previously, there are still a few questions that we feel the new rules never addressed such as: 1) What exactly should be considered the "most directly comparable GAAP financial measure" for a non-GAAP number when reconciling it to GAAP? 2) Will the reconciliation be reviewed or audited by the company's auditors in order to provide greater comfort to the investing public? 3) Does the two years back and forward cost exclusion prohibition for SEC filings include gains/losses on asset sales or asset impairments?

## ■ Statement of Risk

This research report is not intended and should not be construed as legal advice. The full final ruling of the SEC can be obtained at http://www.sec.gov/rules/final/33-8176.htm.

### Global ratings: Definitions and allocations

| UBS rating | Definition | UBS rating | Definition | Rating category[1] | Coverage[2] | IB services[3] |
|---|---|---|---|---|---|---|
| **Buy 1** | Excess return potential > 15%, smaller range around price target | **Buy 2** | Excess return potential > 15%, larger range around price target | **Buy** | 45% | 35% |
| **Neutral 1** | Excess return potential between -15% and 15%, smaller range around price target | **Neutral 2** | Excess return potential between -15% and 15%, larger range around price target | **Hold/Neutral** | 47% | 31% |
| **Reduce 1** | Excess return potential < -15%, smaller range around price target | **Reduce 2** | Excess return potential < -15%, larger range around price target | **Sell** | 8% | 25% |

Excess return: Target price / current price - 1 + gross dividend yield - 12-month interest rate. The 12-month interest rate used is that of the company's country of incorporation, in the same currency as the predicted return.
1: UBS Buy 1/Buy 2 = Buy; UBS Neutral 1/Neutral 2 = Hold/Neutral; UBS Reduce 1/Reduce 2 = Sell.
2: Percentage of companies under coverage globally within this rating category.
3: Percentage of companies within this rating category for which investment banking (IB) services were provided within the past 12 months.
4: Closed-end funds ratings and definitions are: Buy: Higher stability of principal and higher stability of dividends; Neutral: Potential loss of principal, stability of dividend; Reduce: High potential for loss of principal and dividend risk.

Source: UBS AG, its subsidiaries and affiliates; as of 11 January 2003.

### Companies mentioned

| Company Name | Reuters | Rating | Price[*] |
|---|---|---|---|
| **Advanced Micro Dev.** | AMD.N | Neutral 2 | US$5.17 |
| **Agilent Tech.** | A.N | Not rated | US$11.73 |
| **Allegheny Tech.** | ATI.N | Not rated | US$3.96 |
| **American Greetings** | AM.N | Not rated | US$12.85 |
| **AOL Time Warner**[6] | AOL.N | Not rated | US$10.36 |
| **AT&T Corp.**[3a,10] | T.N | Neutral 2 | US$17.88 |
| **Avaya Inc.** | AV.N | Not rated | US$2.30 |
| **Ball Corp.** | BLL.N | Not rated | US$52.47 |
| **Big Lots Inc.** | BLI.N | Not rated | US$11.10 |
| **BMC Software Inc.** | BMC.N | Not rated | US$17.99 |
| **Boise** | BCC.N | Buy 2 | US$24.58 |
| **CIENA Corp.**[1] | CIEN.O | Neutral 2 | US$5.85 |
| **Cisco Systems Inc.**[1,6,10] | CSCO.O | Neutral 1 | US$13.15 |
| **Citigroup**[3a,3b,6,10] | C.N | Buy 2 | US$32.89 |
| **Clear Channel**[3a,3b,10] | CCU.N | Buy 1 | US$37.23 |
| **CMS Energy** | CMS.N | Not rated | US$4.70 |
| **Coca-Cola Co.**[10] | KO.N | Buy 1 | US$40.06 |
| **Coca-Cola Ent.**[3a,10] | CCE.N | Buy 1 | US$20.95 |
| **Compuware Corp.**[1] | CPWR.O | Not rated | US$3.45 |
| **Corning Inc.**[7] | GLW.N | Neutral 2 | US$5.40 |
| **Dana Corp.**[3b,10,12] | DCN.N | Neutral 2 | US$10.55 |
| **Deere & Co.**[3a,3b,10,12] | DE.N | Neutral 2 | US$40.50 |

| Company Name | Reuters | Rating | Price* |
|---|---|---|---|
| **Delphi Corporation**[10] | DPH.N | Neutral 2 | US$8.67 |
| **Dow Chemical**[3a,6,10] | DOW.N | Buy 1 | US$28.43 |
| **Eastman Chemical Co.** | EMN.N | Neutral 2 (under review) | US$33.20 |
| **EMC Corporation**[10] | EMC.N | Not rated | US$7.95 |
| **Fed. Dept. Stores** | FD.N | Neutral 1 (under review) | US$23.98 |
| **Georgia-Pacific**[3a,10,12] | GP.N | Buy 2 | US$15.43 |
| **Great Lakes Chemical**[10] | GLK.N | Reduce 2 (under review) | US$21.62 |
| **International Paper**[3a,10] | IP.N | Buy 2 | US$35.33 |
| **Interpublic Group**[3a] | IPG.N | Not rated | US$10.25 |
| **Intuit Inc.**[1] | INTU.O | Neutral 1 (under review) | US$42.23 |
| **JDS Uniphase Corp.**[1,7] | JDSU.O | Reduce 2 | US$2.84 |
| **Lockheed Martin**[10] | LMT.N | Buy 1 | US$50.14 |
| **Loews Corp.** | LTR.N | Not rated | US$42.50 |
| **McDermott Intl.** | MDR.N | Not rated | US$3.74 |
| **McDonalds Corp.** | MCD.N | Not rated | US$13.70 |
| **Newmont Mining Corp.**[3a,10] | NEM.N | Buy 2 | US$27.64 |
| **Novell Inc.**[1] | NOVL.O | Not rated | US$3.05 |
| **Power-One Inc.**[1] | PWER.O | Not rated | US$4.46 |
| **Qualcomm Inc.**[1] | QCOM.O | Neutral 2 | US$37.62 |
| **Quintiles Corp.**[1,7] | QTRN.O | Neutral 2 | US$12.19 |
| **Qwest Communications**[10,12] | Q.N | Neutral 2 | US$4.24 |
| **Rational Software**[1,7] | RATL.O | Neutral 2 | US$10.39 |
| **Raytheon Co.**[3b,10] | RTN.N | Buy 2 | US$29.73 |
| **Sun Microsystems**[1] | SUNW.O | Not rated | US$3.20 |
| **Symbol Technologies** | SBL.N | Not rated | US$8.57 |
| **Tellabs Inc.**[1] | TLAB.O | Neutral 2 | US$7.56 |
| **Texas Instruments** | TXN.N | Neutral 2 (under review) | US$15.08 |
| **Unisys Corp.** | UIS.N | Not rated | US$8.73 |
| **Veritas Software Co.**[1] | VRTS.O | Not rated | US$17.47 |
| **Visteon Corp.**[3a,12] | VC.N | Reduce 2 | US$6.80 |
| **Williams Cos Inc.**[3a,3b,10] | WMB.N | Neutral 2 | US$2.90 |
| **Xilinx, Inc.**[1] | XLNX.O | Neutral 2 (under review) | US$18.92 |

* As of February 10, 2003. Source: UBS AG, its subsidiaries and affiliates.

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