

Regulation G Update

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Overview

- Revised Compliance and Disclosure Interpretations (CDIs) for Non-GAAP Financial Measures (Reg. G and Reg. S-K Item 10(e))
- First Reg. G Enforcement Action: SEC v. SafeNet

Reg. G Review

- Adopted January 22, 2003, effective March 28, 2003, pursuant to Section 401(b) of the Sarbanes-Oxley Act of 2002
- Reg. G and Reg. S-K Item 10(e) impose limits and conditions on the use of non-GAAP financial measures.

What is a Non-GAAP Financial Measure?

Numerical measure of a registrant's historical or future financial performance, financial position or cash flows that:

- Excludes amounts included in the most directly comparable GAAP measure of the issuer; or
- Includes amounts excluded from the most directly comparable GAAP measure of the issuer.

Non-GAAP Financial Measures Exclude

- Operating/financial measures and ratios or statistical measures calculated using:
 - GAAP financial measures; or
 - Operating measures or other measures that are not non-GAAP financial measures.
- Financial measures required to be disclosed by GAAP, SEC rules, or a regulatory system applicable to the registrant.

Reg. G applies to *all public disclosures* of non-GAAP financial measures.

- Must present the most directly comparable GAAP financial measure;
- Must provide reconciliation to most directly comparable GAAP financial measure (for historical and, if practicable, forward-looking information); and
- Subject to general anti-fraud prohibitions.

For oral, telephonic, webcast, broadcast, or similar disclosures, Reg. G can be satisfied by:

- Posting the required information on the company's web site *at the time the non-GAAP financial measure is made public*; and
- Making the location of the web site public in the same presentation.

Reg. S-K Item 10(e)

Imposes similar conditions on non-GAAP financial measures included in *filings with the SEC* (but not information that is “furnished”); in addition the company must disclose:

- Why registrant’s management believes non-GAAP financial measure provides useful information to investors regarding registrant’s financial condition/results of operations; and
- Additional purposes, if any (and if material), for which registrant’s management uses non-GAAP financial measure.

Reg. G/S-K Item 10(e) – cont.

- Reg. S-K Item 10(e) imposes additional limitations/conditions on the use of non-GAAP financial measures included in SEC filings.
- Special rules apply to foreign private issuers and certain disclosures made in connection with business combinations under Reg. G/S-K 10(e).
- Reg. S-K Item 10(e) does not apply to registered investment companies.

Reg. G Liability

- Non-compliance with Reg. G will not *in itself* affect liability under Exchange Act Section 10(b) or Rule 10b-5.
- However, Reg. G adopting release makes clear that a failure to comply with Reg. G can result in an SEC enforcement action (since Section 3(b) of SOX provides that a violation of SOX or SEC's rules thereunder is a violation of the Exchange Act).
- And, if the facts and circumstances warrant, SEC can bring an action under both Reg. G and Rule 10b-5.

Reg. G/S-K Item 10(e) CDIs

- Q&As were published shortly after Reg. G/S-K Item 10(e) were adopted.
- Recently updated Reg. G/S-K Item 10(e) CDIs eliminate transition guidance and include certain substantive revisions and clarifications.

Adjustments for Recurring Items

- Reg. S-K Item 10(e) - Non-GAAP performance measure may not adjust for item identified as “non-recurring, infrequent or unusual” if reasonably likely to recur within two years or occurred within prior two years.
- **Previous Staff guidance:** Non-GAAP measures that exclude recurring items must “meet the burden of demonstrating the usefulness of that measure.”
- Positions taken in Staff comment letters made exclusion of recurring items in *filings* difficult (although not in unfiled communications).
- **New CDI:** omits this language and states that companies may not **describe** an item as “non-recurring, infrequent or unusual” if it meets the two-year rule.
- Recurring items may be excluded if the company discloses why management believes the measure is useful to investors and otherwise complies with Item 10(e).

Use of Non-GAAP Financial Measure in Managing Business

- Reg. S-K Item 10(e) requires disclosure, if material, of any additional purposes for which a company's management uses a non-GAAP financial measure.
- Apparently, in some cases the Staff had previously suggested that *only* non-GAAP measures used by management in managing the business could be presented in filings.
- New CDI makes clear that disclosing a non-GAAP measure that is not used by management is permitted.

Segment Information

- **Prior guidance:** Segment information (e.g. profit/loss or liquidity) presented in conformity with Accounting Standards Codification 280 (formerly FASB Statement 131) is not a non-GAAP financial measure. (No change.)
- ASC 280 requires that the measure be reported to the chief operating decision-maker for purposes of making decisions about allocating resources to a particular segment and assessing its performance.
- **Prior guidance:** Stated that “it would be difficult to demonstrate” that segment measures *not* reported to the chief operating decision-maker as contemplated in ASC 280 would be “useful to investors.”
- **Revised guidance:** Omits this statement and notes that such adjusted segment measures would be subject to the applicable disclosure and reconciliation requirements.

Product Revenues

- ***Prior guidance:*** A breakdown of revenues by product would not be a non-GAAP financial measure (and thus would not be subject to Reg. G/Item 10(e)) if the *aggregate revenues presented for all the products sum to the revenue amount in the company's financial statements.*
- ***Revised guidance:*** Revenue by product need not be summed to the revenue number in the financial statements and is not a non-GAAP financial measure as long as each such amount is calculated in accordance with GAAP.

Presentation in Constant Currency

- Companies with operations in foreign countries sometimes want to isolate effect of exchange rate differences in discussing various financial statement line items by presenting financial information in a constant currency.
- A company can satisfy the Reg. G/S-K Item 10(e) reconciliation requirements by:
 - presenting historical amounts and amounts in a constant currency; and
 - describing process for calculating constant currency amounts and basis of presentation.

Other Changes in Revised Reg. G CDIs

- Generally not appropriate to use a full non-GAAP income statement for purposes of satisfying reconciliation requirement. A full non-GAAP income statement may attach “undue prominence” to the non-GAAP information.
- May present an adjustment “net of tax” when reconciling non-GAAP financial measure to most directly comparable GAAP measure. The tax effect of reconciling item must be disclosed parenthetically or by footnote to the reconciliation. Or, a company may present tax effect in one line in reconciliation. Regardless of format of presentation, company must disclose how tax effect was calculated.

SEC v. SafeNet, Inc.

- First Reg. G enforcement action.
- SafeNet, Inc., former CEO and CFO and three accounting employees charged.
- Two fraudulent schemes – backdating of options and “earnings management.”
- In each case SafeNet materially misstated its financial results and disseminated materially false/misleading financial information.

Regulation G

- Applies to any public disclosure that includes a non-GAAP financial measure, which often excludes non-recurring, infrequent or unusual expenses.
- Requires companies to reconcile non-GAAP financial measure to most directly comparable GAAP financial measure.
- Prohibits companies and their employees from disseminating false or misleading non-GAAP financial measures or presenting non-GAAP financial measures in such a manner that they mislead investors or obscure company's GAAP results.

SafeNet – cont.

- SafeNet made improper accounting adjustments to various expenses including *improper classification of ordinary operating expenses as non-recurring integration expenses* (costs incurred to integrate acquired companies into current operations), and improper reduction of accruals and reserves.
- SafeNet represented to investors that its non-GAAP earnings results excluded certain *non-recurring expenses*, when, in fact, SafeNet had misclassified and excluded a significant amount of *recurring, operating expenses* from its non-GAAP earnings results, in order to meet or exceed quarterly EPS targets.

Takeaways

- SEC will use Reg. G violations in enforcement actions.
- Unlikely that Reg. G was essential to bringing SafeNet enforcement action, since SafeNet's alleged conduct appears to violate Section 10b-5/Rule 10b-5.
- Likely that Reg. G will be used by SEC in cases where non-GAAP financial measures are used to mislead investors, e.g., as in this case, by mischaracterizing items excluded from GAAP numbers. Not in cases where sole infraction is failure to comply with Reg. G presentation/disclosure requirements.

Takeaways – cont.

- Companies who comply with spirit and letter of Reg. G/S-K Item 10(e) need not hesitate to disclose non-GAAP financial measures.
- Companies who have forgone use of non-GAAP financial measures due to past Staff comments, or rumors of comments, might reconsider whether such information, presented in compliance with Reg. G/S-K Item 10(e), would be useful for investors.

Helpful Links

- [Non-GAAP Financial Measures Compliance & Disclosure Interpretations](#)
- [Securities and Exchange Commission v. SafeNet, Inc., et. al., Civil Action No. 09-2117 \(D.D.C. Nov. 12, 2009\);
Litigation Release No. 21290 / November 12, 2009;
Accounting and Auditing Enforcement Release No. 3068 /
November 12, 2009](#)

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