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# Thoughts On Non-GAAP Financial Measures

Non-GAAP financial measures continue to be an area of scrutiny for the SEC Staff, and a company's handling of non-GAAP financial measures in its SEC filings, as well as in its earnings releases, earnings call discussions and investor slides, continues to generate SEC Staff review and comment. Below are some thoughts to consider in connection with use of non-GAAP financial measures:

- Avoid the term "non-recurring" or "one-time" in connection with non-GAAP financial measures, as you may be put to the test of demonstrating the applicability of such terms (often a difficult burden). Better to use terms such as "special items."
- The Staff has been providing a comment to companies that if particular non-GAAP financial measures appearing in earnings releases or earnings presentations are of particular significance, the company needs to consider whether they likewise need to be included in its SEC periodic filings. The SEC Staff recently indicated, however, that inclusion of such non-GAAP financial measures in the corresponding SEC periodic filing generally will not be mandated, so long as the "elements" comprising the non-GAAP financial measure are sufficiently included and described in the corresponding SEC filing so that an investor has the opportunity to understand the significance of those adjusting items.
- The Staff continues to look for "consistency" in the use of all non-GAAP financial measures, to ensure, among other things, that such measures are not misleading and do not distort or mask a company's financial results (for example, by indicating a rosier situation than actually exists or by not providing the appropriate balance of information).
- Consistency in the use of non-GAAP financial measures across reporting periods is also important. Non-GAAP financial measures should be used not only when an "exclusion" favorably impacts a particular operating or liquidity measure, but also when a non-core "benefit" has enhanced GAAP operating performance or liquidity (for example, the realization of a non-core tax benefit or the release of a material existing reserve). In other words, non-core benefits and exclusions should be handled in an evenhanded, consistent manner across reporting periods.
- Non-GAAP measures should never be used in a misleading manner or to smooth earnings.
    - The chief accountant at the SEC Division of Enforcement recently identified non-GAAP measures as a"fraud risk indicator."
- Company management must ensure that allocations to non-GAAP financial measures are done in accordance with U.S. GAAP, as an SEC enforcement action recently highlighted (*SEC v. SafeNet, Inc.*, Civil Action No. 09-2117 (D.D.C. 2009); improper and misleading classification of ordinary operating expenses as non-recurring acquisition integration costs.
- For example, where "restructuring charges" are an exclusion in calculating a particular non-GAAP financial measure, costs and expenses allocated to such restructure charges must be determined in accordance with U.S. GAAP. The fact that the "adjusted" financial measure is a non-GAAP financial measure does not change that result. Allocations to a non-GAAP financial measure or, more likely, to special items excluded from (or included in) that non-GAAP financial measure that have not been determined and allocated in accordance with U.S. GAAP would be misleading and, depending upon the significance, could potentially subject the company and its executives to liability and enforcement action (see *SafeNet*, above).
- The SEC Staff continues to apply the "equal or greater prominence" test under the non-GAAP rules to headlines of press releases. Where a headline includes one or more non-GAAP financial measures, the corresponding GAAP financial measures likewise should be included in the headline.

- Where an adjustment used to arrive at a non-GAAP financial measure is "net of tax," the actual tax effect and the manner in which it was calculated needs to be disclosed.
- If one or more of a company's non-GAAP financial measures uses a generic term as its description, companies should appropriately identify how that financial measure is calculated and indicate that other companies may calculate such measure differently.