

**SEC UPDATES COMPLIANCE AND DISCLOSURE
INTERPRETATIONS FOR NON-GAAP FINANCIAL MEASURES****Signals Greater Flexibility in the Use of Non-GAAP Measures**

The Division of Corporation Finance of the SEC recently updated its Compliance and Disclosure Interpretations (“CDIs”) relating to Regulation G and the use of non-GAAP financial measures, superseding its previous Frequently Asked Questions Regarding the Use of Non-GAAP Financial Measures issued in 2003 (the “2003 FAQs”).¹ In particular, the Staff signaled greater flexibility regarding the use of non-GAAP financial measures that adjust for recurring items, while also providing various other helpful clarifications.

As directed by Section 402(b) of the Sarbanes-Oxley Act, Regulation G imposes restrictions on public disclosure by reporting companies of “non-GAAP financial measures.”² Regulation G prohibits companies from disseminating false or misleading non-GAAP financial measures or presenting the non-GAAP financial measures in such a manner that they mislead investors or obscure the company’s GAAP results. Regulation G requires companies to reconcile each non-GAAP financial measure to the most directly comparable GAAP financial measure and, as to non-GAAP financial measures in SEC reports, to explain why such non-GAAP financial presentation provides useful information to investors.

Over recent years, the SEC has taken a restrictive view of what non-GAAP financial measures can be provided in an SEC report. This approach has had the unfortunate result of companies excluding information that they believe is useful to investors and has led, in certain instances, to a two-tiered reporting system, where certain information that management considers important is relegated to press releases and is not included in SEC reports. At recent securities conferences, Meredith Cross, the Director of the SEC Division of Corporation Finance, and Wayne Carnall, the Chief Accountant of the Division of Corporation Finance, both acknowledged this problem; the revised CDIs are designed, in part, to address these issues so as not to discourage appropriate non-GAAP financial presentations.

¹ See www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm, updated January 15, 2010. The 2003 FAQs remain available, at least for now, at www.sec.gov/divisions/corpfin/faqs/nongaapfaq.htm.

² As defined in Rule 101(a)(1) of Regulation G, a “non-GAAP financial measure” excludes amounts that are included in the most directly comparable GAAP measure presented in the issuer’s financial statements or, conversely, includes amounts excluded from the issuer’s comparable GAAP measure.

Adjustments for Recurring Items

Under Item 10(e) of Regulation S-K, registrants are prohibited, in filings with the SEC, from

adjust[ing] a non-GAAP performance measure to eliminate or smooth items identified as non-recurring, infrequent or unusual, when the nature of the charge or gain is such that it is reasonably likely to recur within two years or there was a similar charge or gain within the prior two years.

While the 2003 FAQs recognized that there was no “per se” prohibition against removing a recurring item, they established a high bar for permitting such adjustments, based on the particular facts and circumstances. The 2003 FAQs even suggest that the inclusion of such a measure may be misleading without additional disclosure, including, among other things, how management uses the measure to conduct its business and the substantive reasons why management believes that the measure provides useful information to investors. The 2003 FAQs state, with respect to the adjustment for recurring restructuring charges, that absent unusual circumstances, it would be difficult to meet this burden of usefulness. This strict standard has been rigorously imposed on issuers through the Staff comment letter process.

The updated CDIs eliminate this previous guidance and instead clearly state:

The fact that a registrant cannot describe a charge or gain as non-recurring, infrequent or unusual, however, does not mean that the registrant cannot adjust for that charge or gain.

Registrants thus *can* make adjustments they believe are appropriate, even for recurring items, subject to the provisions of Regulation G and the other requirements of Item 10(e) of Regulation S-K.

Use of Non-GAAP Measures by Management

Unlike the 2003 FAQs, the updated CDIs state that a registrant is *not* required to use the non-GAAP measure in managing its business or for other purposes in order to be able to disclose it. The CDIs point to Item 10(e)(1)(i)(D) of Regulation S-K, which requires the disclosure of the additional purposes, “if any,” for which management uses the measure, “to the extent material.”

Other Helpful Clarifications

The updated CDIs provide numerous other helpful clarifications regarding the application of Regulation G. These include, among others:

- “Funds from operations,” as defined by the National Association of Real Estate Investment Trusts (NAREIT), is an acceptable performance measure and accordingly can be presented on a per share basis. Adjustments to such definition may also be made in compliance with Item 10(e) of Regulation S-K for a performance measure or a liquidity

measure, depending on how it is presented. If the adjusted measure is a performance measure, it may be presented on a per share basis; if it is a liquidity measure, it may not be.

- It is *not* appropriate to present a full non-GAAP income statement, even for the purpose of reconciling non-GAAP financial measures to the comparable GAAP measures.
- Registrants *may* present adjustments “net of tax” when reconciling the non-GAAP measure to the comparable GAAP measure, provided that the tax effect of each reconciling item is disclosed parenthetically, in a footnote or in a separate line item. Registrants should also disclose how the tax effect was calculated.
- A company with operations denominated in different local currencies, in order to isolate the effect of exchange rate differences, may present financial information in a constant currency. The company may provide the requisite reconciliation of this non-GAAP financial measure by presenting the historical amounts and the amounts in constant currency and describing the process for calculating the constant currency amounts.
- A note to Item 10(e) of Regulation S-K permits a foreign private issuer to include an otherwise impermissible non-GAAP financial measure if it is “expressly permitted” by the standard setter responsible for establishing the GAAP used in the company’s primary financial statements. The CDIs now explain that this requirement can be satisfied either via published views of the regulator or a letter from the regulator to the foreign private issuer indicating acceptance of the non-GAAP presentation.

Commentary:

- One should not interpret the SEC’s new flexibility regarding Regulation G as a sign that it is letting its guard down regarding non-GAAP abuses. In fact, this past November the SEC announced its first enforcement action under Regulation G against SafeNet, Inc. and certain of its former executives and accountants.³
- The SEC, in these new CDIs, appears to be trying to draw a better balance between permitted non-GAAP presentations and impermissible disclosures. The SEC complaint in the SafeNet action repeatedly emphasized that the defendants’ disclosures were materially false and misleading. Thus, even under the SEC’s updated guidance, companies should be careful not to provide non-GAAP measures (particularly if they back out recurring charges) that may present a misleading view of the company’s results.

³ See our client memorandum, SEC Brings First Regulation G Enforcement Action, dated November 25, 2009, available at http://www.willkie.com/files/tbl_s29Publications/FileUpload5686/3162/SEC%20Brings%20First%20Regulation%20G%20Enforcement%20Action.pdf.

Issuers should remember to also discuss any such recurring items in the Management's Discussion and Analysis section of their applicable SEC reports.

- Companies should ensure that their non-GAAP disclosures strictly comply with Regulation G, including by providing the requisite reconciliation and explaining, in “non-boilerplate” fashion in their SEC reports, why such presentation provides information useful to investors. As noted by the SEC in the SafeNet complaint, any adjustments or reclassifications and related assumptions should be documented, with appropriate accounting support.

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If you have any questions regarding Regulation G or these updated CDIs, please contact Jeffrey S. Hochman (212-728-8592, jhochman@willkie.com), Robert B. Stebbins (212-728-8736, rstebbins@willkie.com), or the Willkie attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000, and our facsimile number is (212) 728-8111. Our website is located at www.willkie.com.

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