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First SEC enforcement action under Regulation G for Misleading Non-GAAP Financial Measures

On November 12, 2009, the SEC announced that it had settled charges against SafeNet, Inc. and some of its former officers, employees and accountants, in connection with earnings management and options backdating schemes. This case represents the SEC's first enforcement action brought under Regulation G, and it provides important reminders to issuers on financial reporting practices.

Refresher on Regulation G

Regulation G, enacted in 2003 pursuant to the Sarbanes-Oxley Act of 2002, prohibits a registrant, or a person acting on its behalf, from making public a "non-GAAP financial measure" that, taken together with the information accompanying that measure and any other accompanying discussion of that measure, contains an untrue statement of a material fact or omits to state a material fact necessary in order to make the presentation of the non-GAAP financial measure, in light of the circumstances under which it is presented, not misleading. Non-GAAP financial measures may be misleading to the extent that they exclude recurring, frequent or usual expenses. The SEC has issued answers to frequently asked questions and numerous comment letters to registrants cautioning against the use of potentially misleading non-GAAP financial measures and questioning the legitimacy of certain types of excluded expenses or included gains.

A "non-GAAP financial measure" is a numerical measure of a registrant's historical or future financial performance, financial position or cash flows that:

- 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 the issuer; or

- includes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded from the most directly comparable measure so calculated and presented.

A non-GAAP financial measure does not include operating and other financial measures and ratios or statistical measures calculated using exclusively one or both of:

- financial measures calculated in accordance with GAAP; and

- operating measures or other measures that are not non-GAAP financial measures.

A non-GAAP financial measure does not include financial measures required to be disclosed by GAAP, by SEC rules, or a system of regulation of a government or governmental authority or self-regulatory organization that is applicable to the registrant, and in the case of foreign private issuers, refers to the accounting principles pursuant to which their primary financial statements are prepared.

Regulation G also requires companies to reconcile the non-GAAP financial measure to the most directly comparable GAAP financial measure disclosed by the issuer on the face of its financial statements.

Item 10(e) of Regulation S-K further restricts the use of non-GAAP financial measures in reports that are filed (not furnished) with the SEC.

The Complaint

In the SEC's complaint, it was alleged that the defendants, including SafeNet's former chairman and chief executive officer, chief financial officer, comptroller and director of external reporting, knew that SafeNet would be unable to meet its earnings targets as communicated to the market.

The SEC alleged that at the direction of certain of the other defendants, SafeNet made improper accounting adjustments to various expenses including the improper classification of ordinary operating expenses (such as ongoing advertising expenses and compliance costs) as non-recurring integration expenses (costs incurred to integrate acquired companies into current operations), and the improper reduction of accruals for certain professional fees and inventory reserves, and then recorded the inappropriate adjustments in SafeNet's books and records.

The defendants allegedly knew, or should have known, or were reckless in not knowing, that these adjustments were improper because they: (i) were made solely for the purpose of meeting or exceeding earnings targets; (ii) were made without any support or as a result of unsupported assumptions, (iii) created the false and misleading appearance that SafeNet had met or exceeded its quarterly earnings targets through its normal business operations; and (iv) in a number of instances, resulted in SafeNet not complying with GAAP. In several instances, certain defendants were charged with having instructed subordinates to knowingly misclassify certain recurring expenses as non-recurring expenses;

Certain defendants were reported to have represented to investors that SafeNet's non-GAAP earnings results excluded certain non-recurring expenses when, in fact, SafeNet had knowingly 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.

In the course of this "earnings management" scheme, certain defendants prepared, reviewed and or signed SafeNet's materially false and misleading securities filings and press releases, and issued materially false and misleading statements during SafeNet's earnings calls with analysts.

In the SEC's view, the wrongful conduct was aggravated by the warnings that SafeNet's auditors had provided concerning SafeNet's non-GAAP adjustments. Despite these warnings, SafeNet continued these practices of reporting non-GAAP adjustments.

The Settlement

SafeNet and the defendants settled the matter by consenting to the entry of a judgment that:

- permanently enjoins SafeNet and the other defendants from violating Regulation G and other antifraud provisions of the federal securities laws;
- requires SafeNet to pay a civil penalty of $1 million;
- permanently enjoins the other defendants from aiding and abetting violations of the reporting, books and records and internal control provisions of the federal securities laws;
- finds individual defendants liable for disgorgement, prejudgment interest and penalties;
- in the case of those defendants that were officers, bars them from acting as an officer or director of a public company for five years;
- in the case of those defendants that were accountants, bars them from appearing before the SEC for periods ranging from one to five years (taking into account the cooperation of certain defendants).

Take-Aways for Public Companies

While the alleged conduct of the defendants can be discarded as intentional and fraudulent, the SafeNet release provides a useful opportunity to review best practices in financial reporting:

- Companies should review their use of non-GAAP financial measures in their written and oral communications, and make certain the non-GAAP financial measures comply with Regulation G and are not misleading;

- Companies should avoid excluding from non-GAAP financial measures expenses that may be recurring in nature;

- Companies should also avoid including extraordinary gains in non-GAAP financial measures that exclude corresponding expenses;

- Audit committees should regularly review the use of non-GAAP financial measures and communicate with outside audit firms (in executive session as appropriate) on the adjustments to non-GAAP financial measures and review management's support and conclusions;

- Companies may and should continue to communicate non-GAAP financial measures that are useful to understanding their underlying business, financial condition and results of operations, taking care to:

  - document factual support as to the non-recurring nature of excluded items;

  - present the corresponding GAAP financial measure with equal or greater prominence;

  - include explanations as to why the non-GAAP financial measures are useful to management and investors;

  - clearly reconcile the non-GAAP financial measures to their corresponding GAAP results; and

  - avoid adjustments to non-GAAP financial measures that could be viewed in hindsight as misleading or confusing to investors in light of the actual financial results reported in accordance with GAAP.

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