

# Essentials of GAAP vs. Non-GAAP Adjustments: Understanding, Communicating, and Managing the Differences

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## Clarity in Compliance

### EXECUTIVE SUMMARY

In today's complex financial environment, companies and their legal advisors must navigate the nuanced world of Generally Accepted Accounting Principles (GAAP) and non-GAAP financial measures. These metrics not only influence investor perceptions but also carry significant legal, regulatory, and reputational risks if misunderstood or miscommunicated. This whitepaper offers a deeper dive into practical strategies for legal and finance professionals to ensure clarity, compliance, and strategic alignment when presenting financial data.

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## Understanding the Framework: GAAP vs. Non-GAAP

- **The Role of GAAP:** GAAP provides a standardized framework ensuring consistency, transparency, and comparability of financial statements. It governs revenue recognition, expense categorization, and disclosure rules, forming the backbone of financial reporting in the U.S.
- **The Rise of Non-GAAP:** Companies increasingly use non-GAAP metrics (like adjusted EBITDA or core earnings) to provide an alternative view of financial performance, excluding items such as restructuring costs, stock-based compensation, or one-off legal expenses.
- **Legal Implications:** Mischaracterizing these adjustments can mislead investors and trigger regulatory enforcement. Legal advisors must scrutinize these measures to ensure compliance with Regulation G and Item 10(e) of Regulation S-K.

### Example:

A global SaaS company highlights “adjusted revenue” excluding foreign currency impacts. Legal and finance must ensure this metric is reconciled to GAAP revenue with clear explanations to avoid misleading stakeholders.

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## Navigating Disclosure Requirements: Clarity and Transparency

- **Clear Reconciliation:** Companies must provide a quantitative reconciliation of non-GAAP to GAAP measures. This includes detailed tables in filings (10-K, 10-Q), earnings releases, and investor presentations, ensuring transparency for stakeholders.
- **Management’s Rationale:** Firms must disclose why management believes non-GAAP measures provide useful insight, such as highlighting operational performance by excluding non-recurring costs.

### Example:

During an earnings call, a biotech firm presents adjusted EPS excluding litigation expenses. The GC collaborates with the CFO to prepare a clear reconciliation table and a narrative explaining how these exclusions provide clarity on core operations.

### Best Practice:

Use simple tables with clear headers, a consistent format, and accompanying footnotes. Ensure every figure is supported by documentation to withstand potential regulatory scrutiny.

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## Legal and Reputational Considerations: Mitigating Risks

- **Regulatory Risk:** The SEC closely monitors non-GAAP disclosures. Failure to provide accurate reconciliations or explanations can result in comment letters, enforcement actions, and reputational damage.
- **Litigation Exposure:** Shareholders may allege securities fraud if non-GAAP disclosures are deemed misleading or incomplete, especially if the metrics significantly deviate from GAAP performance.
- **Reputational Impact:** Public perception can be harmed if a company is seen as “massaging numbers.” Clear, accurate, and timely disclosures reinforce credibility.

### Example:

A public retailer omitted reconciliation tables for “adjusted operating income” in a press release. Following SEC inquiry, the company faced shareholder lawsuits and a temporary drop in stock price. A proactive GC could have averted this with early intervention.

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## Communicating Effectively: Simplify, Align, and Educate

- **Speak the Audience's Language:** Replace jargon with clear terms. For example, rather than citing "non-GAAP EPS excluding stock-based compensation," explain how this reflects "earnings from core operations without non-cash expenses."
- **Visual Aids:** Use decision trees, summary tables, and traffic light indicators to highlight reconciliation items, risk levels, and financial impacts.
- **Engage the Board and Executives:** Provide pre-read memos summarizing key non-GAAP issues, highlighting legal considerations, and aligning messaging.

Example:

A GC at a fintech firm used a two-slide visual: one slide showing GAAP vs. non-GAAP metrics side by side, and another summarizing regulatory compliance steps, ensuring clear understanding among board members.

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## Proactive Risk Management: From Reaction to Anticipation

- **Preemptive Legal Review:** GCs should work closely with finance teams before public disclosures to identify potential red flags.
- **Scenario Planning:** Prepare for multiple outcomes—regulatory inquiries, investor pushback, or market volatility.
- **Integrate Legal Early:** Embed legal checkpoints in the financial reporting process, including pre-release reviews and drafting sessions.

Example:

A manufacturing firm faced a surprise SEC inquiry after reporting non-GAAP revenue excluding "temporary plant closures." A more proactive approach could have flagged the need for explicit reconciliation and explanations before the release.

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## Practical Tips for Success: Enhancing Clarity and Credibility

- **Know the Adjustments:** Understand common exclusions—restructuring costs, litigation expenses, non-cash charges—and their justifications.
- **Align with Key Stakeholders:** Coordinate with the CFO, investor relations, and external auditors to ensure consistency and accuracy.
- **Use Pre-Reads:** Distribute a concise, bullet-point pre-read memo outlining non-GAAP disclosures and legal considerations before board meetings.
- **Maintain Transparency:** When uncertain, provide clear disclaimers, e.g., "This reconciliation assumes X adjustments remain non-recurring."
- **Crisis Readiness:** Keep a playbook for managing potential inquiries or misinterpretations of non-GAAP disclosures.

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## Common Pitfalls to Avoid: Lessons from Real-World Missteps

- **Overly Complex Reconciliations:** Dense tables with unclear headings or inconsistent formats create confusion and risk.
- **Vague Rationales:** Statements like "management believes this is a useful metric" without clear reasons invite skepticism.
- **Inconsistent Metrics:** Changing definitions of non-GAAP metrics across reporting periods without explanation undermines credibility.
- **Reactive Legal Involvement:** Waiting until the final stages of disclosure preparation to involve legal increases the risk of errors.
- **Assuming Audience Sophistication:** Not all board members or investors are financial experts—simplicity and clarity win.

## CONCLUSION

# The Strategic GC and Finance Leader Partnership

The strategic use of GAAP and non-GAAP metrics is a shared responsibility of legal, finance, and communications teams. GCs must transcend the role of compliance enforcer and become proactive business advisors, ensuring transparency, credibility, and legal integrity in financial reporting. By mastering the nuances of these disclosures and embedding legal insights early in the process, GCs and finance leaders safeguard the company's reputation, strengthen investor trust, and drive long-term value creation.