CSA raises the bar for non-GAAP disclosure

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The slicing and dicing of financial results by issuers (and the analysts who follow them), and the publication of the resulting financial measures, has a long history and can provide useful information to investors and the issuers themselves. Unlike measures calculated under generally accepted accounting principles (GAAP) such as International Financial Reporting Standards, however, there is no standard way of calculating non-GAAP measures.

Due to concerns about non-comparability between issuers' use of non-GAAP terms, inconsistent calculation of measures by individual issuers from period to period, and the potential for investors to be misled, securities regulators, including the Canadian Securities Administrators (CSA) and the U.S. Securities and Exchange Commission, have attempted to impose some discipline on the market in the use of non-GAAP measures. The CSA first did this in 2003 with the publication of CSA Staff Notice 52-306 *Non-GAAP Financial Measures* (SN 52-306). New National Instrument 52-112 *Non-GAAP and Other Financial Measures Disclosure* (NI 52-112) takes the regulation of non-GAAP measures to a new level. As a national instrument, NI 52-112 will have the force of law and provide greater scope for Canadian securities regulators to regulate disclosure and impose penalties for failure to comply.

NI 52-112 is scheduled to come into force on Aug. 25, 2021, and will apply to reporting issuers' disclosure regarding financial years ending on or after Oct. 15, 2021, and certain non-reporting issuers' filings starting Jan. 1, 2022. Below we discuss highlights of the new instrument. In light of its technical nature, issuers should refer to the actual text of NI 52-112 and the companion policy, which contains useful commentary and helpful examples.

Characterizing financial measures

The disclosure requirements provided in NI 52-112 depend on the characterization of an issuer's disclosed financial measures. Accordingly, the instrument defines non-GAAP financial measures, non-GAAP ratios, and certain other financial measures and distinguishes between the disclosure requirements for each.

A **non-GAAP financial measure** is one disclosed by an issuer that:

- Depicts the historical or expected future financial performance, financial position or cash flow of an entity;
- With respect to its composition, excludes an amount that is included in, or includes an amount that is excluded from, the composition of the most directly comparable financial measure disclosed in the primary financial statements of the entity;
- Is not disclosed in the financial statements of the entity; and
- Is not a ratio, fraction, percentage or similar representation.

Primary financial statements means any of an issuer's statement of financial position, statement of profit or loss and other comprehensive income, statement of changes in equity, and statement of cash flows, but does not include the notes to the financial statements. Examples of terms often used to identify non-GAAP financial measures include: adjusted earnings, adjusted EBITDA, free cash flow, pro forma earnings, cash earnings, distributable cash, adjusted funds from operations, or earnings before non-recurring items.

Non-GAAP ratios refer to financial measures that:

- Are presented by an issuer in the form of a ratio, fraction, percentage or similar representation;
- Have a non-GAAP financial measure as one or more of its components; and
- Are not disclosed in the financial statements of the entity.

Examples of non-GAAP ratios include: adjusted EBITDA per share, free cash flow per ounce, funds flow per barrel of oil equivalent, or the equivalent future measures of such ratios.

Other financial measures

In addition to non-GAAP financial measures and non-GAAP ratios, NI 52-112 addresses other financial measures that could be misleading if disclosed outside the context of an issuer's financial statements. For example, **capital management measures** covers certain measures related to capital management disclosed in the notes to the financial statements but not in the primary financial statements. An example of a capital management measure is "adjusted debt". NI 52-112 also covers **supplementary financial measures** (for example, "same-store sales" where this is calculated in accordance with GAAP), and **total of segments measures** (for example, "entity-adjusted EBITDA"). The disclosure requirements for non-GAAP measures, or requirements similar to them, may apply in certain contexts to these other financial measures.

Requirements regarding non-GAAP disclosure

Non-GAAP financial measures

If an issuer discloses in a document a non-GAAP financial measure that is *historical information*, it must:

- Identify the measure as a non-GAAP measure and label it with a term that appropriately describes the measure and distinguishes it from totals, subtotals and line items disclosed in the primary financial statements;
- Also disclose in the document the most directly comparable financial measure from the primary financial statements;
- Not give the non-GAAP financial measure greater prominence than the most directly comparable financial measure. Examples include using a non-GAAP measure in a press release headline without including the comparable GAAP measure, or using bold, italicized, underlined, or a larger font size on the non-GAAP measure;
- If the non-GAAP financial measure is disclosed in MD&A or in an earnings release of the issuer, disclose the non-GAAP financial measure for a comparative period, determined using the same composition, unless it is impracticable to do so; and
- In proximity to the first instance of the non-GAAP financial measure in the document, explain that the non-GAAP measure is not a standardized financial measure under the financial reporting framework used to prepare the related financial statements and might not be comparable to similar financial measures disclosed by other issuers. The document should also, either directly or by incorporation by reference:
    - explain the composition of the non-GAAP financial measure;
    - explain how the non-GAAP financial measure provides useful information to an investor and any additional purposes, if any, for which management uses the measure;
    - in the case of MD&A or an earnings release, disclose a quantitative reconciliation (in the format permitted by the instrument) of the non-GAAP financial measure for the current and comparative period to the most directly comparable GAAP financial measure; and
    - explain any change in label or composition of the non-GAAP financial measure from previous disclosure.

Similarly, NI 52-112 provides certain requirements for disclosing a non-GAAP financial measure that is *forward-looking information*:

- The document must disclose an equivalent historical non-GAAP financial measure;
- The measure must be labelled with the same label used for the equivalent historical non-GAAP financial measure;
- The measure must be presented with no more prominence than the equivalent historical non-GAAP financial measure; and
- In proximity to the first instance of the forward-looking non-GAAP financial measure in the document, the document must disclose, directly or by incorporation reference, a description of any significant difference between the forward-looking non-GAAP financial measure and the equivalent historical non-GAAP financial measure.

Non-GAAP ratios

NI 52-112 includes similar requirements for disclosing non-GAAP ratios. These include specific disclosure requirements in relation to the labelling and composition of non-GAAP ratios, and also permit certain disclosure to be incorporated by reference.

Incorporating non-GAAP disclosure by reference

A welcome provision is that an issuer may satisfy some disclosure requirements by incorporating by reference from its MD&A. The issuer must specify the location of the information in the MD&A and note that the MD&A is available on SEDAR.

Applicability

NI 52-112 will apply to all reporting issuers in respect of any disclosure that is intended to be, or reasonably likely to be, made available to the public. Exceptions include investment funds, SEC foreign issuers, and designated foreign issuers. This includes both documents filed on SEDAR and information found on social media or disclosed on an issuer's website.

NI 52-112 will also apply to non-reporting issuers in connection with certain offering or transaction documents. This includes disclosure subject to National Instrument 41-101 *General Prospectus Requirements*, disclosure filed with a regulatory or securities regulator in connection with a distribution made under the offering memorandum exemption in section 2.9 of National Instrument 45-106 *Prospectus Exemptions*, or disclosure submitted to a recognized exchange in connection with a qualifying transaction, reverse takeover, change of business, listing application, significant acquisition, or similar transaction.

NI 52-112 also provides, among others, exceptions for disclosure required pursuant to specific securities laws, such as National Instrument 43-101 *Standards for Disclosure for Mineral Projects* or, in certain circumstances, to the policies of an SRO, disclosure of a transcript of an oral statement, disclosure of a specified financial measure if the calculation of the specified financial measure is derived from a financial covenant in a written agreement, or disclosure prepared by someone other than the issuer. The instrument, except for certain exceptions, does not apply to disclosure in relation to executive compensation.

Implications

For years, the CSA and the provincial securities regulators have conducted continuous disclosure reviews. For example, in 2018, the CSA reviewed and assessed the non-GAAP financial measures disclosure of 47 REITs or REOCs. As a result, 72 per cent of the issuers received a comment letter and six per cent had to restate their MD&A.

Similarly, in 2013, the Ontario Securities Commission reviewed the non-GAAP disclosure of 50 reporting issuers and identified concerns in 86 per cent of the reviews. The CSA's initial request for comments on NI 52-112 noted that replacing SN 52-306 "will provide CSA Staff with a stronger tool to take appropriate regulatory action as needed". Accordingly, disclosure reviews following the implementation of NI 52-112 may be accompanied by greater enforcement activity in relation to the use of non-GAAP financial measures.

Regardless of whether there is any change in enforcement, issuers should become familiar with the new rules and examine their disclosure practices to ensure they are in compliance.

Reach out to either of the key contacts below, or your usual contact at BLG, if you have any questions related to NI 52-112, or for more information on any other continuous disclosure obligations.

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