MAKING SENSE OF NON-GAAP FINANCIAL MEASURES

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Categories: Insights, Publications

Often, there is confusion in the marketplace regarding the use of non-GAAP financial measures. Reporting issuers frequently use non-GAAP financial measures, non-GAAP ratios or other specified financial measures, such as "adjusted EBITDA", "pro forma earnings", and "free cash flow per ounce", in the documents they prepare and file to fulfill their continuous disclosure obligations. Such use tends to be problematic, however, as it often lacks context, standardized meanings and transparent calculations when disclosed outside of financial statements. As a result, the threat that such financial measures could mislead investors is real. Canadian securities regulators have helpfully provided new regulatory requirements and guidance around the use of non-GAAP financial measures which seek to alleviate confusion in the use of such financial measures.

On May 27, 2021, in order to better protect investors and bring consistency to the marketplace, the Canadian Securities Administrators (the "**CSA**") published National Instrument 52-112 *Non-GAAP and Other Financial Measures Disclosure* (the "**NI 52-112**") and Companion Policy 52-112 *Non-GAAP and Other Financial Measures Disclosure*, while also consequently amending the following:

- Multilateral Instrument 45-108 *Crowdfunding*;
- Companion Policy 45-108 *Crowdfunding*;
- Companion Policy 51-102 *Continuous Disclosure Obligations*;
- Companion Policy 51-105 *Issuers Quoted in the U.S. Over-the-Counter Markets*; and
- Companion Policy 52-107 *Acceptable Accounting Principles and Auditing Standards*.

NI 52-112 and related materials seek to provide clarity and consistency on continuous disclosure obligations of reporting issuers when using non-GAAP financial measures and other specified financial measures. The goal is to improve the quality of information provided to investors, allowing investors to better evaluate and consider different financial measures used by companies and the industries in which they operate, through standardization and transparency.

Background to NI 52-112

CSA Notice

NI 52-112 substantially incorporates the disclosure requirements contained in CSA Staff Notice 52-306 (Revised)

Non-GAAP Financial Measures ("**CSA Notice 52-306**"), giving such requirements the force of actual securities regulation. It also expands and updates such requirements, including the definition of "non-GAAP financial measures", bringing Canada's disclosure requirements for non-GAAP financial measures closer in line with those of other jurisdictions, such as the United States.

The CSA initially introduced guidelines with respect to non-GAAP financial measures in January 2016 through CSA Notice 52-306. Over time, the CSA, stakeholders and investors alike found that CSA Notice 52-306 inadequately addressed the use of non-GAAP financial measures and ineffectively protected investors. As a result, the CSA proposed to replace it with actual securities regulation, and in that regard, initially proposed an instrument in September 2018. The initial form of the proposed instrument was revised and reissued in February 2020 following feedback and outreach sessions. After further consideration of stakeholder comments, the CSA published the final form of NI 52-112 on May 27, 2021.

Application

NI 52-112 applies to all reporting issuers, with an exception for investment funds (as such term is defined in National Instrument 81-106 *Investment Fund Continuous Disclosure*) and designated foreign issuers and SEC foreign issuers (as such terms are defined in National Instrument 52-107 *Acceptable Accounting Principles and Auditing Standards*). It also applies to non-reporting issuers when a specified financial measure is publically disclosed in a document related to an initial public offering, offering memorandum or related marketing materials, or in documents submitted to a stock exchange in connection with a qualifying transaction, reverse takeover, change of business, listing application, significant acquisition or similar transaction.

NI 52-112 prescribes specific disclosure requirements for the following financial measures (all such terms being defined therein):

- non-GAAP financial measures (both historical and forward-looking);
- non-GAAP ratios;
- capital management measures;
- supplementary financial measures; and
- total of segments measures.

(together, the "**specified financial measures**")

If a financial measure is identified only by label without a corresponding numerical amount or measure, a specified financial measure has not been disclosed and the disclosure requirements within NI 52-112 do not apply.

Subject to certain exceptions, in the event a specified financial measure is disclosed in a document intended to be, or reasonably likely to be, made available to the public, NI 52-112 applies. The instrument has broad application and applies not only documents filed on the *System for Electronic Document Analysis and Retrieval* ("**SEDAR**"), but also information posted on a website or provided through social media platforms. However, transcripts of oral statements, such as an earnings call transcript, are not subject to NI 52-112.

Examples of specified financial measures which may be subject to NI 52-112 include "adjusted earnings", "free cash flow", "cash earnings", "distributable cash", "cost per ounce", "adjusted funds from operations", and "earnings before non-recurring items". Non-financial metrics such as the number of units, subscribers or employees, volumetric information, environmental measures such as greenhouse gas emissions, information on major shareholdings, acquisitions or disposals of the reporting issuer's own shares and the total number of voting rights are generally not subject NI 52-112. Further, qualitative disclosure of targets, benchmarks or covenants are also not subject to NI 52-112, as long as such disclosure is not accompanied by disclosure of a financial numerical amount.

Other types of disclosure are exempt. For example, NI 52-112 does not apply to certain disclosure required for companies with mineral projects or oil and gas activities (except for disclosure using oil and gas metrics). Nor does NI 52-112 apply to:

- third party reports;
- pro forma financial statements required to be filed under securities legislation;
- certain disclosure required to be disclosed in a Statement of Executive Compensation;
- certain disclosure made by registered firms;
- certain documents required to be filed by reporting issuers, including documents affecting the rights of securityholders and material contracts;
- documents containing specified financial measures calculated pursuant to a financial covenant in a written agreement; and
- documents containing specified financial measures required by law or by an self regulatory organization (SRO) of which an issuer is a member.

If an issuer discloses a financial measure that is not specifically required to be disclosed by law or SRO requirement, such financial measure may be considered a specified financial measure and thus, within the scope of NI 52-112. For example, National Instrument 43-101 *Standards of Disclosure for Mineral Projects* ("**NI 43-101**") prescribes specific disclosure, which requires the use of certain financial measures. Because these financial measures are prescribed, they fall outside the scope of NI 52-112. However, if a reporting issuer provides further disclosure using additional financial measures not prescribed by NI 43-101, such disclosure may be captured by the disclosure requirements of NI 52-112. The same applies in circumstances where a pro forma financial statement is voluntarily disclosed.

Disclosure Requirements

While each specified financial measure has its own specific disclosure requirements, NI 52-112 broadly addresses four areas of concern when such measures are used in disclosure documents that are publicly available:

- **Proper labelling and identification** – labels used to identify a specified financial measure must be distinct and appropriate given the nature of information disclosed; consideration must be given for the composition of a specified financial measure when determining which term to attribute to such measure. Non-GAAP financial measures must also be explicitly identified as such. Overly optimistic or misleading labels are prohibited.
- **Comparatives** – certain specified financial measures require disclosure of the most directly comparable financial measure disclosed in the reporting issuer's primary financial statements. When specified financial measures are used in management's discussion and analysis ("**MD&A**") or earnings releases, further disclosure is required, including the disclosure of the same measure in a comparative period, determined using the same composition.
- **Prominence of use** – to avoid misuse of specified financial measures, such measures must be displayed with equal or less prominence than the most directly comparable financial measure disclosed in the reporting issuer's primary financial statements. Reporting issuers must avoid using a style of presentation (i.e. bold and underlined text) that emphasizes a specified financial measure over the comparable financial measure.
- **Proximate explanations of composition, usefulness and purpose** – in proximity to the first instance a specified financial measure is used, reporting issuers must explain the composition of such measure and its usefulness to investors, as well as any additional purposes for which the measure is used by management.

The use of certain specified financial measures may also require a quantitative reconciliation in a format prescribed by NI 52-112. This ensures that a consistent form of reconciliation is provided to investors. As specified financial measures are not standardized under any financial reporting framework, such measures may not be comparable to those used by other issuers or in other industries. Although NI 52-112 does not standardize the use of such specified financial measures, it requires issuers to use specified financial measures in a consistent manner in all disclosure documents that are publicly available. Any changes in the calculation, labelling or usefulness of a specified financial measure are required to be disclosed and explained.

Incorporation by Reference

In order to streamline disclosure, NI 52-112 permits certain required disclosure to be incorporated by reference into the disclosure documents (that require such disclosure) that are publicly available. Incorporation by reference must be made to a reporting issuer's MD&A. A reporting issuer may only rely on an MD&A that has already been filed or is being filed contemporaneously on SEDAR with the document which incorporates the MD&A by reference. Further, a MD&A cannot be incorporated by reference into another MD&A, as MD&As are intended to be the main source for most recent disclosure relating to specified financial measures. The specific location of or a hyperlink to the information being incorporated by reference must be provided to make things accessible and easy for investors and reporting issuers must comply with the terms of incorporation by reference in NI 52-112.

Effective Date

NI 52-112 and all other related materials are expected to come into force on August 25, 2021, with an application to reporting issuers for disclosure in financial years ending after October 15, 2021 and non-reporting issuers after December 31, 2021. Reporting issuers with a year-end of October 31 must comply for their Q4/annual 2021 filings however, those with a financial year-end of December 31 need not comply for their Q3/interim 2021 filings. Instead, such reporting issuers must comply for their Q4/annual 2021 filings (and in effect, are afforded more time to comply).

As a final long form prospectus filed after December 31, 2021 must comply with NI 52-112, if a private entity files a preliminary long form prospectus prior to December 31, 2021 but does not anticipate filing a final long form prospectus until after December 31, 2021, the private entity should consider preparing the preliminary prospectus in accordance with NI 52-112 to avoid a larger headache down the road.

Upon coming into force, all reporting issuers subject to NI 52-112 will be required by law to comply with the provisions therein. Many of the continuous disclosure requirements demand reporting issuers to apply judgement when determining how best to comply in the circumstances.

Please contact a member of McMillan's Capital Markets and M&A Group if you have any questions with respect to the application of NI 52-112.

by Leila Rafi and Ashley E. Brown

A Cautionary Note