

## Legal update

### Non-standard accounting measures: the media, regulators, and shareholders zero in

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**September 2016**

**Corporate and commercial**

**Litigation**

**Special situations**

Non-standard accounting practices have been gaining in popularity among Canadian publicly traded companies. Issuers that rely solely on standard accounting metrics now make up a small minority of the companies listed in the S&P 500 and S&P/TSX 60.

Many issuers believe that non-standard measures are a better reflection of performance than Generally Accepted Accounting Principles (GAAP), which for Canadian issuers typically conform to International Financial Reporting Standards (IFRS). Yet there are growing concerns that non-GAAP measures are being used to inflate earnings and present a more positive picture of financial performance. These concerns have been expressed in the media, including in recent articles in the [Wall Street Journal](#) and the [Globe and Mail](#) and, even more significantly, have received and are expected to continue to receive increased regulatory attention. Shareholders and other stakeholders of public companies are paying attention too. In the past year, Norton Rose Fulbright's Special Situations team has been consulted by a number of investors and other parties contemplating launching activist campaigns that focus specifically on an issuer's accounting practices.

In light of these developments, issuers should ensure that their accounting and related disclosure practices align with the expectations and requirements of investors and regulators.

#### Criticisms of non-standard accounting metrics

The most frequently noted concern with non-GAAP measures is that they may appear to inflate earnings artificially. For some Canadian issuers, the result is a large gap between adjusted and non-adjusted earnings. An additional concern is that because these measures are non-standard, it may be difficult for investors to understand how they are calculated. This means they may also vary from company to company, rendering comparisons difficult.

Regulators are following these developments closely. In a June speech, SEC Chair Mary Jo White [said](#) that “[i]n too many cases, the non-GAAP information, which is meant to supplement the GAAP information, has become the key message to investors, crowding out and effectively supplanting the GAAP presentation.” The Canadian Securities Administrators' (CSA) [Staff Notice 52-306 \(Revised\) \(Staff Notice 52-306\), published in January of this year](#), states that “Staff is concerned that investors may be confused or even misled by non-GAAP financial measures.” In a [2013 review](#) of compliance by reporting issuers with the prior iteration of the Staff Notice, the Ontario Securities Commission (OSC) described the results of its review as “disappointing.”

## Legal considerations for Canadian Reporting Issuers

There remain valid reasons why issuers may choose to disclose non-GAAP measures. Staff Notice 52-306 specifies the principles that should guide issuers who wish to do so, which principles are in addition to other general requirements relating to accounting principles and financial statement disclosure under Canadian securities laws. To summarize, issuers should:

- State explicitly that the non-GAAP financial measure does not have any standardized meaning under the issuer's GAAP and therefore may not be comparable to similar measures presented by other issuers;
- Name the non-GAAP financial measure in a way that distinguishes it from disclosure items specified, defined or determined under an issuer's GAAP and in a way that is not misleading. For example, in presenting EBITDA as a non-GAAP financial measure, it would be misleading to exclude amounts for items other than interest, taxes, depreciation and amortization;
- Explain why the non-GAAP financial measure provides useful information to investors and the purposes, if any, for which management uses the non-GAAP financial measure;
- Present with equal or greater prominence to that of the non-GAAP financial measure, the most directly comparable measure specified, defined or determined under the issuer's GAAP presented in its financial statements;
- Provide a clear quantitative reconciliation from the non-GAAP financial measure to the most directly comparable measure specified, defined or determined under the issuer's GAAP and presented in its financial statements, referencing to the reconciliation when the non-GAAP financial measure first appears in the document, or in the case of content on a website, in a manner that meets this objective (for example, by providing a link to the reconciliation);
- Ensure that the non-GAAP measure does not describe adjustments as non-recurring, infrequent or unusual when a similar loss or gain is reasonably likely to recur in the next two years, or has occurred in the past two years; and
- Present the non-GAAP financial measure on a consistent basis from period to period; however, where an issuer changes the composition of the non-GAAP financial measure, explain the reason for the change and restate any comparative period presented.

In Staff Notice 52-306, the CSA "cautions issuers that regulatory action may be taken if an issuer discloses information in a manner considered misleading and therefore potentially harmful to the public interest." We expect an increase in regulatory reviews and enforcement.

Use of non-GAAP measures in a manner that leaves a misleading impression of the issuer's true financial position may also expose an issuer to class action risk. Provincial securities legislation contains statutory causes of action for misrepresentations in offering documents and continuous disclosure.

As scrutiny on this issue sharpens, Canadian public companies should carefully review their accounting and related disclosure practices to ensure adequate transparency with respect to non-GAAP metrics. This is better done proactively than at the behest of a regulator, in the teeth of an activist attack, or in the glare of media scrutiny.

If you have questions about anything discussed in this update, please contact a member of our Special Situations team.

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