

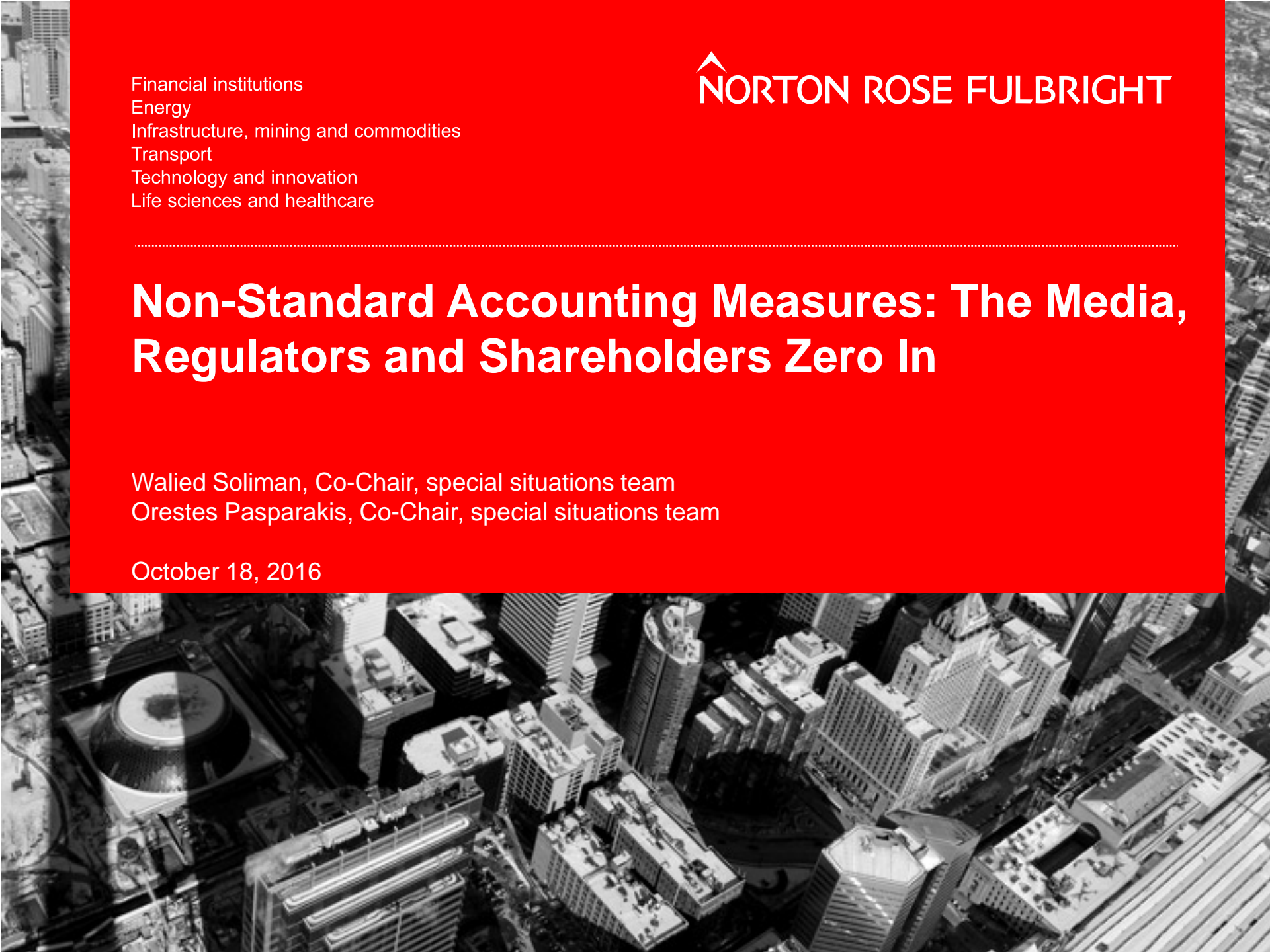
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 **NORTON ROSE FULBRIGHT**

Non-Standard Accounting Measures: The Media, Regulators and Shareholders Zero In

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The general concern

- **Non-GAAP is often extremely useful for companies and investors**
- **Examples of non-GAAP measures: cash earnings, operating earnings, EBITDA, same-store sales, adjusted funds from operations**
- **Non-GAAP is *not* inherently problematic**
- **Widespread concern that non-GAAP is being used to inflate profits and present a biased picture**
 - **A Calcbench/Radical Compliance study of 816 US-listed companies' 2015 earnings releases found non-GAAP net income \$164.1 billion higher than GAAP net income**
- **Issuers need to create confidence that they are presenting investors a true picture of their performance**

An acute issue

1. Initial regulatory intervention (2001-2003)

Enron collapses
(December, 2001)

Sarbanes-Oxley passes
(July, 2002)

New US rules on non-GAAP
(March, 2003)

Canada: CSA Staff Notice
52-306 (November, 2003)

2. First decade of enforcement (2004-2014)

SEC prosecutes SafeNet
(November, 2009)

SEC issues new
guidance, widely seen as
more flexible (January,
2010)

CSA issues several
revisions to Staff Notice
52-306

3. Non-GAAP reaches new high (2015)

Use of non-GAAP steadily
increases since regulations
first introduced

94.3% of S&P 500
companies close books
using at least one non-
GAAP measure in 2015, vs.
75% in 2006, per Audit
Analytics figures in *WSJ*

All but one of the S&P/TSX
60 used some non-GAAP
measure in their annual
reports for 2015, vs. just a
handful a decade earlier, per
Veritas Investment Research
figures in *Globe*

4. Regulators intervene again (late 2015-present)

SEC Chair gives speech
indicating concerns about
use of non-GAAP
(December, 2015)

SEC Chair gives speech
indicating potential
crackdown: “Your investor
relations folks, your CFO,
they love the non-GAAP
measures because they tell
a better story [...] We have
urged for some time that
companies take a very hard
look at what you are doing
with your non-GAAP
measures.” (March, 2016)

Canadian regulators issue
revision to Staff Notice 52-
306 (January, 2016)

SEC announces new
guidance on non-GAAP
(May, 2016)

Investors' and companies' perspectives: a mixed view

- **Investors' perspective:**
 - 2015 UK survey : 61% of respondents routinely use adjusted measures reported by management in their analysis
 - But... a majority (about 60%) of respondents said they trust GAAP measures more than adjusted numbers
- **Companies' perspective:**
 - 2016 BDO survey of 160 public company directors: 51% were for new regulatory guidance on non-GAAP and 49% against
 - 46% identified EBITDA as the metric that gives them the greatest concern, followed by restructuring costs (14%); stock-based compensation (13%); and acquisition integration costs (13%)

Companies are responding

- US regulators have stepped up enforcement action
 - Since the new guidance the SEC has sent >30 comment letters to companies about their use of non-GAAP metrics
 - On September 8, SEC charged two executives of a REIT with manipulating a non-GAAP accounting measure
- There is evidence that companies are responding pro-actively to this renewed attention
 - A US law firm looked at 100 earnings releases for Fortune 500 companies in which non-GAAP was used (all issued since the new guidance). 79 contained altered presentations of non-GAAP measures compared with those made in previous earnings releases
 - Among the S&P 500 companies reporting results since the start of July, 81% have given prominence to GAAP figures in their news releases, whereas only 52% did so for first-quarter results, according to Audit Analytics figures in *The Wall Street Journal*

Where non-GAAP makes sense

- CFO.com has ranked the uses of non-GAAP adjustments from most to least acceptable:
 - Most acceptable: Eliminating the impact of accounting standard changes
 - Mostly acceptable: Eliminating the impact of changes in pension costs and discontinued operations
 - Generally acceptable: Eliminating the impact of restructuring, mergers and acquisition-related expense, gains or loss on sale of a business, and asset write-downs
 - Most controversial: Eliminating the impact of current economic conditions on performance (e.g., currency rates, interest rates, etc.)

Key areas of concern

- **Subtracting arguably relevant costs from earnings calculations**
 - **eg.: subtracting acquisition-related costs for a company that has experienced fast growth by acquisition**
 - **treating recurring restructuring costs as one-time expenses**
- **Using both GAAP and non-GAAP measures, without being clear about which is which or how they are calculated**
- **Large gaps between adjusted and non-adjusted earnings**
 - **eg.: the gap between adjusted and non-adjusted earnings for some TSX issuers exceeds 1000%, according to Veritas Investment Research figures in the *Globe***
- **Using unconventional measures that are not industry-standard**

Who is paying attention: the media

- The mainstream business media have increasingly sounded the alarm about potential abuse of non-GAAP:
 - The *Financial Times* (May 11, 2016): “‘Misleading’ numbers used to boost management pay”
 - The *Wall Street Journal* (June 28, 2016): “Accounting choices blur profit picture”
 - The *Globe and Mail* (September 23, 2016): “Canadian securities regulators on high alert over misleading earnings statements”
 - The *Globe and Mail* (September 23, 2016): “It's gotten out of control': How accounting games are fooling TSX investors”
- Canadian regulators have been following closely, and have indicated they may step up enforcement if necessary

Who is paying attention: shareholders

- **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**
- **Criticism of non-GAAP accounting practices can be a powerful tool for firms publicly criticizing companies as part of short strategies**

Regulatory guidance on accounting disclosure

- For issuers who use non-GAAP measures, CSA Staff Notice 52-306 (Revised) contains seven key principles on how to disclose non-GAAP measures. To summarize, when using a non-GAAP metric, companies should:
 - State explicitly it does not have any standardized meaning under GAAP, may not be comparable to similar measures presented by other issuers
 - Name it in a way that clearly distinguishes it from GAAP measures, does not mislead
 - Explain why it is useful and how management uses it
 - Present the most directly comparable GAAP measure with equal or greater prominence
 - Present a clear quantitative reconciliation, referencing it where the measure first appears (or in a way that meets this objective for a website, eg. hyperlink)
 - Ensure it does not describe adjustments as non-recurring, infrequent or unusual if a similar loss/gain is reasonably likely to recur in the next two years, or has occurred in the past two years
 - Present it on a consistent basis from period to period; if it is changed, explain why and restate any comparative period presented

Avoiding attacks on your company's accounting practices: some tips

- (1) **Comprehensively evaluate how and why your company uses non-GAAP measures**
 - The goal should be *creating confidence* that management is giving a true picture of performance
 - Management alone cannot create confidence in a company's accounting practices: exercise should also involve senior management, audit committee, disclosure committee, external auditors
 - BDO survey: 67% of respondents said auditor involvement would provide higher investor confidence in the reporting of non-GAAP measures
 - Pay attention to accounting practices in your industry and what regulators say about them (eg.: OSC [Staff Notice 51-724](#) about REIT accounting practices)
- (2) **Make sure that going forward, the disclosure of financial measures is evaluated in *all relevant communications***
 - Press releases, investors presentations, websites, and conference calls

Avoiding attacks on your company's accounting practices: some tips

- **(3) Communications should be clear and straightforward, addressing concerns an objective investor might have**
 - **Foreground GAAP measures**
 - **Clearly contrast GAAP and non-GAAP measures**
 - **Provide clear explanations of reconciliations**
 - **Refrain from misleading highlighting and formatting**
- **(4) Your company should be in close contact with its shareholder base and think like activists**
 - **Have a communications strategy to explain and justify any deviations from GAAP**

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Walied Soliman is co-chair of our Canadian special situations team, which encompasses Canada's leading hostile M&A, shareholder activism and complex reorganization transactions. Over the past several years, Mr. Soliman has been involved in almost every major proxy battle in Canada, acting for both issuers and activists. He is widely regarded as one of the leading special situations practitioners in Canada. In addition, his practice focuses on mergers and acquisitions, restructurings, financings, corporate governance and structured products.

Rankings and recognitions:

- Ranked in *Chambers Canada*, 2017
- *Best Lawyers in Canada*, 2014-2017 – Mining Law; Natural Resources Law
- *Canadian Legal Lexpert Directory*, 2016; recommended in Corporate Mid Market
- Named as one of the 25 most influential lawyers in Canada by *Canadian Lawyer* magazine in 2014
- Ranked as one of the Top 40 lawyers under 40 in Canada by *Lexpert* magazine in 2009

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Orestes Pasparakis is co-chair of our Canadian special situations team, which encompasses Canada's leading hostile M&A, shareholder activism and complex reorganization transactions.

Mr. Pasparakis focuses on high-stakes disputes that often proceed in "real time" or on an urgent basis. His approach is practical and results-oriented. Many of his cases are international, involving cross-border issues.

Mr. Pasparakis has specific expertise with complex commercial litigation, financial restructurings, insolvency proceedings, injunctions and class actions.

Mr. Pasparakis is widely regarded as one of Canada's leading experts in proxy contests.

Mr. Pasparakis has appeared as lead counsel before the Supreme Court of Canada and courts at all levels in Ontario, British Columbia, Alberta, Quebec, New Brunswick and the federal courts, the Ontario Securities Commission, the Competition Tribunal and the Tax Court of Canada, as well as numerous arbitral and other administrative tribunals.

Rankings and recognitions:

- *Chambers Canada*, 2016: Dispute Resolution: Ontario
- *Canadian Legal Lexpert Directory*, 2013-2016: repeatedly recommended in Insolvency & Financial Restructuring
- *Canadian Legal Lexpert Directory*, 2016: most frequently recommended in Litigation – Corporate Commercial; Litigation – Securities
- *Chambers Global: Canada*, 2011-2015: Dispute Resolution: Ontario; Restructuring & Insolvency
- LMG Life Sciences Award 2016, Canadian IP Contentious Impact case of the year

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