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Mind the GAAP: Don't Get Tripped Up by the New Financial Measure Disclosure Requirements

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Before the year-end, Canadian reporting issuers will have to contend with new rules that govern the disclosure of non-GAAP and other financial measures.[1] These new Financial Measure Rules mark a significant departure from the policy-based approach that has shaped non-GAAP financial measure disclosure for decades. They also expand the universe of regulated financial measures beyond traditional "non-GAAP financial measures." Reporting issuers with a December 31, 2021 year-end will first need to comply with the Financial Measure Rules in their fourth quarter earnings release and annual MD&A for 2021.

Specific disclosure in respect of non-GAAP financial measures has never been mandated under Canadian securities laws. Non-GAAP financial measure disclosure has instead been shaped over the decades through policy-based CSA guidance. This approach has afforded issuers some flexibility in determining how best to disclose their non-GAAP financial measures, bearing in mind the measure being disclosed and the context for that disclosure. In contrast, the Financial Measure Rules will apply a very prescriptive rules-based approach. Under these new rules, there is no general exception from making a prescribed disclosure on the basis that it would not be necessary to ensure a financial measure is not misleading. Nor do these rules provide an issuer with any latitude to substitute equivalent disclosure that would be equally (or perhaps more) helpful to a reader in circumstances where the prescribed disclosure is inappropriate or impractical.

While adhering in principle with existing guidance, the required disclosure for non-GAAP financial measures under the Financial Measure Rules will depart from current market practice in a number of meaningful ways. These new rules will also govern new categories of financial measures for which additional disclosure has never been required. The result is that reporting issuers may find a number of "gaps" between their current reporting of financial measures and their required reporting under the new rules.

Scope and Application

Generally speaking, the Financial Measure Rules apply where a Canadian reporting issuer discloses a specified financial measure in a public document. The "specified financial measures" covered by the rules span five categories: non-GAAP financial measures; non-GAAP ratios; segment measures; capital management measures; and supplementary financial measures. The Financial Measure Rules prescribe the manner in which a specified financial measure may be disclosed, and require additional disclosure depending on the category of that measure. Generally speaking, non-GAAP financial measures require the most additional disclosure and the other four categories require some subset of those disclosures; however, there are some notable differences.

Subject to limited exceptions, the Financial Measure Rules cover all publicly filed documents as well as other written communications that are intended to be, or are reasonably likely to be, made available to the public (including websites and social media platforms). They also apply to an IPO prospectus or similar document of a non-reporting issuer.[2]

These Financial Measure Rules do not apply to investment funds or to SEC and other designated foreign issuers. In addition, certain disclosures are exempt from the requirements of the Financial Measure Rules, including financial measures:

- that are disclosed in respect of an issuer's mineral projects or oil and gas activities whose disclosure is specifically mandated under applicable Canadian securities legislation;

- that are disclosed in pro forma financial statements or material contracts that are required to be filed under securities law, oral statement transcripts or third party reports (e.g., analyst reports or fairness opinions);
- that are disclosed as required under law or by an SRO of which the issuer is a member and determined in accordance with that law or SRO's requirements; or
- whose calculation is derived from a financial covenant in an agreement (e.g., a credit agreement or indenture).

The companion policy to the Financial Measure Rules (the companion policy) explains how the CSA interprets or applies certain provisions of these rules.

Non-GAAP Financial Measures

The definition of a non-GAAP financial measure under the Financial Measure Rules aligns with current practice. To qualify, it must be a financial measure that is not disclosed in an issuer's financial statements (including the notes) and that depicts an issuer's historical or expected future financial performance, financial position or cash flow. That measure is defined to be a "non-GAAP financial measure" if 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 an issuer's "primary" financial statements (i.e., the financial statements excluding the notes). Ratios, fractions and percentages for which a non-GAAP measure is a component are carved out of this definition and dealt with separately as "non-GAAP ratios."

The Financial Measure Rules also helpfully distinguish between historical and forward-looking non-GAAP financial measures.

Historical Measures

An issuer disclosing a historical non-GAAP financial measure must:

- label that measure using a term that, given its composition, describes the measure and distinguishes it from the totals, subtotals and line items disclosed in the issuer's primary financial statements;
- identify that measure as a non-GAAP financial measure;
- in the same disclosure document,
  - disclose the most directly comparable financial measure (the comparable GAAP measure) in the issuer's primary financial statements to which the non-GAAP measure relates (comparable GAAP measure disclosure), and
  - present the non-GAAP financial measure with no more prominence than that comparable GAAP measure (the prominence requirement); and
- make a number of additional disclosures in proximity to the first instance where the non-GAAP financial measure is disclosed in a document (collectively, the first instance disclosures), including
  - an explanation of the measure's composition (the composition disclosure);
  - an explanation of how the measure provides useful information to an investor and the additional purposes (if any) for which management uses it (usefulness disclosure);
  - a quantitative reconciliation of the measure to the comparable GAAP measure for both the current and, if required, the comparative period (the reconciliation requirement) in the "permitted format"; and
  - the reason for any change in the label or composition of the measure from what was previously disclosed (change disclosure).

Prominence Requirements. Issuers may need to rethink the manner in which they have previously highlighted non-GAAP financial measures in order to comply with the prominence requirement noted above. In the companion policy, the CSA provides a number of examples where, in its view, the prominence requirement would not be satisfied. This includes a news release with a headline or caption that includes a non-GAAP financial measure but omits the comparable GAAP measure, or using a text format that emphasizes a non-GAAP financial measure over the comparable GAAP measure.

First Instance Disclosures. Issuers should also be mindful that some of the above disclosures must be made in proximity to the first instance of their disclosure. Helpfully, the companion policy allows issuers to satisfy these first instance disclosures through a cross-reference to a separate section of the document (or another document, if incorporation by reference is permitted) that includes those disclosures. This cross-reference could be included in a footnote to the applicable financial measure that, if applicable, also identifies the measure as a non-GAAP financial measure.

Reconciliation Requirement. While the above reconciliation requirement aligns with current disclosure standards for non-GAAP financial measures, the requirement that this reconciliation be in a "permitted format" is new and may require issuers to revisit their historical reconciliations. The reconciliation must, among other things, be disaggregated quantitatively in a way that would allow a reader to understand the reconciling items and must explain each reconciling item. The companion policy provides detailed guidance from the CSA on ways to satisfy this permitted formatting requirement.

In addition to the required disclosures noted above, if the non-GAAP financial measure is disclosed in MD&A or an earnings release, that same measure must be disclosed for a comparative period, determined using the same composition, unless it is impracticable to do so (comparative period disclosure).[3] In the companion policy, the CSA says it does not consider the cost or time to prepare this comparative period disclosure to be a sufficient rationale for an issuer to assert it is impracticable to disclose.[4] As a result, in considering whether to introduce a new financial measure or a change to an existing financial measure, an issuer should consider whether it has or can obtain the necessary data from the prior period to construct that new or amended measure using the same composition.

Forward-Looking Measures

Where a non-GAAP financial measure is forward-looking information (i.e., in respect of a future period), the Financial Measure Rules do not require a quantitative reconciliation of that forward-looking measure. However, the issuer is required to disclose in the same document the equivalent historical non-GAAP financial measure that, in turn, implicates all of the non-GAAP financial measure disclosures described above for that equivalent historical measure.

In addition, the issuer must use the same label for the forward-looking non-GAAP measure as it uses for the equivalent historical non-GAAP measure, and may not present the forward-looking measure with greater prominence than that equivalent historical measure. Finally, in proximity to the first instance where the forward-looking non-GAAP measure is disclosed in a document, the issuer must disclose any significant differences between that measure and the equivalent historical measure.

Non-GAAP Ratios

Consistent with current disclosure practice, the Financial Measure Rules clearly distinguish between non-GAAP financial measures and ratios that use those measures as one or more of their components. In other words, the non-GAAP ratio itself is not a non-GAAP financial measure. When disclosing a non-GAAP ratio, an issuer is required to disclose each non-GAAP financial measure that is used as a component of that ratio. That component is, in turn, subject to all of the attendant disclosures referred to above for non-GAAP financial measures. In addition, the non-GAAP ratio will itself be subject to almost all of the same disclosure requirements that would have applied were it a non-GAAP financial measure, including comparative period disclosure (unless the ratio is forward looking). However, there is no reconciliation requirement for a non-GAAP ratio as this is adequately addressed by virtue of the reconciliation of the component non-GAAP financial measure(s).

The prominence requirement applicable to a non-GAAP ratio differs from the prominence requirement for a non-GAAP financial measure . For non-GAAP financial measures, the comparable GAAP measure is the most directly comparable financial measure. In contrast, a non-GAAP ratio cannot be presented with more prominence in a document than "similar financial measures" disclosed in the

issuer's primary financial statements. The Financial Measure Rules do not define what constitutes a similar financial measure for this purpose. The companion policy provides that in cases where a non-GAAP ratio has a most directly comparable financial measure,[5] the comparable GAAP measure should be used to satisfy this prominence requirement. In other cases, the determination as to what constitutes similar financial measures is less clear and may depend on the context in which the non-GAAP ratio is disclosed.

Other Specified Financial Measures

The Financial Measure Rules have varying requirements for the three other categories of specified financial measures – namely, "supplementary financial measures," "capital management measures" and "total of segments measures."

Supplementary Financial Measures

A supplementary financial measure is a financial measure that is (or is intended to be) disclosed by an issuer on a periodic basis to depict the historical or expected future financial performance, financial position or cash flow of the issuer, but is not disclosed in the issuer's financial statements (including the notes) and is not a non-GAAP financial measure or a non-GAAP ratio. Financial measures that issuers commonly refer to as "key performance indicators" or "key performance measures" may fall into this category.

Of all the specified financial measures, this category has the fewest disclosure requirements. To disclose a supplementary financial measure, an issuer must simply (1) provide composition disclosure in proximity to where that measure is disclosed and (2) comply with labelling requirements equivalent to those applicable to historical non-GAAP financial measures.

Capital Management Measures

A capital management measure is a financial measure that is (1) intended to enable an individual to evaluate the issuer's objectives, policies and processes for managing its capital and (2) disclosed in the notes to the issuer's financial statements. However, it does not include a measure that is disclosed in, or is a component of a line item disclosed in, the issuer's primary financial statements. When disclosing a capital management measure, an issuer must comply with most of the same requirements that apply to a historical non-GAAP financial measure – namely, the composition and usefulness disclosures and the prominence and reconciliation requirements. However, in contrast with non-GAAP financial measures, the prominence requirement applicable to capital management measures refers to similar financial measures disclosed in the issuer's primary financial statements. The Financial Measure Rules take the same approach with non-GAAP ratios. An issuer must also disclose any non-GAAP financial measures used to calculate a capital management measure.

If the capital management measure is included in MD&A or an earnings release, the issuer must also disclose that measure for a comparative period, determined using the same composition, unless it has not been previously disclosed.

Total of Segments Measures

A total of segments measure is a financial measure that is a subtotal or total of two or more reportable segments of an entity and is disclosed in the notes to the issuer's financial statements (but not disclosed in, or a component of a line item disclosed in, the issuer's primary financial statements). When disclosing a total of segments measure, an issuer must comply with a subset of the requirements that would have applied if it were a historical non-GAAP financial measure – namely, the comparable GAAP measure disclosure and the prominence and reconciliation requirements. If the total of segments measure is included in MD&A or an earnings release, the issuer must also disclose that measure for a comparative period, determined using the same composition, unless it has not been previously disclosed.

Incorporating by Reference

In order to eliminate unnecessary repetition, issuers were hopeful that they would be permitted to incorporate the required specified financial measure disclosures by referring to their existing disclosure record. While some incorporation is permitted under the Financial Measure Rules, there are a few notable limitations. First, an issuer is permitted to incorporate only from its previously filed MD&A. Second,

an issuer cannot incorporate any of the required disclosure into its interim MD&A. Finally, an issuer is not allowed to incorporate quantitative reconciliations into an earnings release.

Effective Date and Transition

The Financial Measure Rules come into force on August 25, 2021. However, these rules do not apply to a reporting issuer in respect of documents filed for a financial year ending before October 15, 2021. As a result, issuers with a December 31, 2021 year-end will first need to comply with the Financial Measure Rules in their fourth quarter earnings release and annual MD&A for 2021.

[1] All of these new rules are set out in National Instrument 52-112 – *Non-GAAP and Other Financial Measures Disclosure* (Financial Measure Rules), published by the Canadian Securities Administrators (CSA).

[2] Non-reporting issuers are also subject to the Financial Measure Rules where they disclose specified financial measures in any document filed with a regulator in connection with a distribution made in reliance on the offering memorandum exemption under National Instrument 45-106 – *Prospectus Exemptions*.

[3] In the companion policy, the CSA clarifies that the adoption of a new accounting standard, or a change in accounting policy, in the most current reported period should not change the composition of a non-GAAP financial measure for purposes of this requirement. While that changed accounting standard or policy may modify measurement and recognition of transactions which will have an impact on the components of that financial measure, the composition of the measure would not change. As a result, this requirement would not require a retrospective restatement of the non-GAAP financial measure presented for the comparative period (unless required under the issuer's financial reporting framework). In those circumstances, the issuer could instead disclose that the comparative period measure reflects the prior accounting standard or policy.

[4] The CSA's only example of "impracticability" is that of an issuer that had no operations in the prior period and no comparative period actually exists; in other words, where providing the comparative period is impossible, not just impractical.

[5] As an example, the companion policy notes that "earnings per share" is the comparable GAAP measure for "adjusted earnings per share."

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