

AC Insights

Insights for reviewing financial reports



Putting teeth in non-GAAP financial measures disclosures

Due to a lack of an adequate response to CSA Notices and comments on the use of and disclosure about non-GAAP financial measurements, the CSA is taking a stronger approach by mandating certain disclosures to help investors understand the non-GAAP and other financial measures used by issuers. The proposals are contained in *Proposed National Instrument 52-112: Non-GAAP and Other Financial Measures Disclosure* and *Proposed Companion Policy 52-112: Non-GAAP and Other Financial Measures Disclosure*. If adopted, this

guidance would provide authoritative securities requirements for issuers providing non-GAAP and other financial measures in all documents filed with the securities administrators as well as other written communications on websites or social media.

Both the CSA and SEC have continually raised concerns over potential misleading non-GAAP financial information included in various disclosures made by issuers. In the news release accompanying the proposals, Louis Morisset, CSA Chair and President and CEO of the Autorité des marchés financiers (Quebec) indicated, "These requirements would ... provide CSA Staff with a stronger tool to take appropriate regulatory action, when warranted."

The proposals acknowledge that non-GAAP and other financial measures may be beneficial to investors in their financial analysis of the issuer. However, the CSA has made it clear that it is an offence under securities legislation to provide false or misleading non-GAAP and other financial measures to investors.

Since 2003, the SEC has had rules outlining the conditions for the use of non-GAAP financial measures. These rules are supported by frequently asked questions and other guidance published by the SEC Staff. The CSA proposals seem to be a similar approach to put some teeth in the CSA's guidance on the use of and disclosures about non-GAAP financial measures. Other securities regulatory agencies such as the International Organization of Securities Commissions and the European Securities and Markets Authorities have also increased their efforts to regulate these types of disclosures.

Builds on, clarifies and expands guidance in current CSA Staff Notice to cover:

- Non-GAAP financial measures,
- Segment measures,
- Capital management measures, and
- Supplementary financial measures.

The proposals build on, clarify and expand the guidance in CSA Staff Notice 52-306 (Revised): *Non-GAAP Financial Measures*. There is no intention to limit the use of or prescribe any specific non-GAAP or other financial measures.

Key points

The Proposed Instrument sets out the disclosure requirements while the Proposed Companion Policy provides the CSA's interpretations of certain provisions of the Instrument and application guidance explaining and illustrating parts of the Instrument.

The proposed guidance:

- Applies to all issuers, except for SEC foreign issuers.
- Covers all documents issued by issuers, including any written communications on websites and social media.
- Updates the definition of a non-GAAP financial measure and defines the other measures subject to the disclosure requirements.
- Covers disclosures of financial measures, including ratios, that are:
 - Non-GAAP measures –
 - Financial measures that are not disclosed or presented in the financial statements or are not disaggregations of a line item in the financial statements. Examples include adjusted earnings, adjusted EBITDA, free cash flows, pro form earnings, cash earnings, distributable, cost per ounce, adjusted funds from operations, and earnings before non-recurring items.
 - Financial outlooks with no equivalent financial measure presented in the financial statements.
 - Segment measures – Financial measures of segment profit or loss, revenue, expenses, assets, or liabilities disclosed in the notes to the financial statements.
 - Capital management measures – Financial measures disclosed in notes to financial statements to evaluate the objectives, policies and processes for managing capital. An example is the measure of capital reported in the financial statements.

- Supplementary financial measures – Financial measures not disclosed or presented in financial statements that are disaggregations of line items in the financial statements intended to be disclosed periodically to present an aspect of financial performance, financial position or cash flow. Examples include key performance indicators such as same-store sales.
- Is not applicable to non-financial measures such as volumes or numbers of customers, employees, shareholders, shares, or similar items.

Request for comments

The CSA is requesting comments on the proposals by December 5, 2018.

IFRS initiative

In the IASB's project on primary financial statements, the IASB is developing targeted improvements to the structure and content of the financial statements, in particular the statement of financial performance. One focus of this project is to address the use of self-defined subtotals such as EBITDA or other similar subtotals. The IASB is considering requiring two subtotals to show (a) business or operating profit (before investing, financial and income tax), and (b) EBIT (profit before financing and income tax). Exemptions would be provided for financial and similar entities.

The IASB will also consider whether key financial performance indicators should be presented or disclosed in the financial statements. This will consider whether and how adjusted EPS or other financial measures should be included in the financial statements if presented by the company outside its financial statements.

The CSA Notice indicates that the instrument and companion policy will be modified if and when additional GAAP requirements are introduced.

What does this mean?

Companies should carefully read the new requirements and interpretative guidance and provide comments to assist the CSA in developing well-rounded requirements. The proposals expand the types of measures for which additional disclosure is required and companies should review their current disclosures for any financial measures reported and assess how those disclosures stack up against the proposals. This assessment should consider the nature of information that will be disclosed and the effort to prepare those disclosures.

In preparation for a heightened disclosures regime for non-GAAP and other financial measures, management and audit committees may want to:

- Benchmark the non-GAAP and other financial measures reported with those of their peers;
- Discuss the non-GAAP and other financial measures reported with the company's auditors;
- Assess whether the non-GAAP and other financial measures being reported are as useful and relevant to the understanding of the financial performance and position of the business; and
- Review the disclosure controls and procedures and internal control used to develop non-GAAP and other financial measures.

IFRS developments

The IASB met in July and September to discuss several topics in their current areas of focus, plus work on some maintenance projects. There were no new standards, amendments or interpretations issued by the IASB during the summer of 2018.

The IFRS Interpretations Committee met in September to discuss the customer's accounting for fees paid to access a supplier's application software running on the supplier's cloud infrastructure, but did not issue any final interpretations.

IASB's current areas of focus

Standard setting on:

- Definition of material
- Rate regulated activities

Research on:

- Business combinations under common control
- Dynamic risk management
- Financial instruments with characteristics of equity
- Goodwill and impairment
- Principles of disclosures

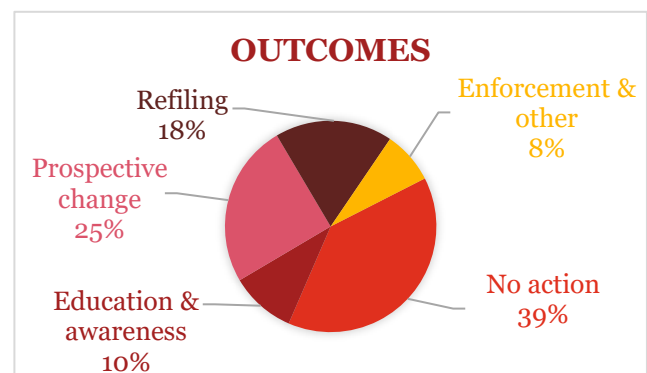
CSA developments

Action still required to improve disclosures for investors

Fifty one percent of issuers were required to take action to improve and/or amend their disclosures, with 8% of those referred to enforcement, being cease traded or placed on the default list. These outcomes from the CSA's Continuous Disclosure Review Program for the year ended March 31, 2018 indicates there is room for improvement in the disclosures made by issuers. CSA Chair, Louis Morisset commented, "Among other issues, we continue to see deficiencies in issuers' use of non-GAAP financial measures, and this remains a focus for the CSA."

The CSA completed 840 reviews in 2018 (compared to 1,014 in 2017) with 81% of these being issuer-

oriented reviews on specific accounting, legal, regulatory, emerging, or industry issues and on the implementation of new rules or guidance. The three key areas reviewed in the current cycle were disclosures of technical information in the mining, oil and gas sectors; gender diversity; and climate change.



The CSA Staff Notice: *Continuous Disclosure Review Program Activities for the fiscal years ended March 31, 2018 and March 31, 2017* presents the findings from the reviews as “Hot Buttons”. These Hot Buttons provide the basis for the CSA Staff’s observations and matters for issuers to consider. For some Hot Buttons, illustrative examples are provided to help issuers prepare more robust entity specific disclosures.

The Autorité des marchés financiers (AMF) also released its *Summary of Oversight and Regulatory Activities* in September 2018. This report includes a summary of its continuous disclosure review activities. The nature of outcomes in Quebec are the same as for Canada overall; however, frequency of outcomes vary significantly with 46% of issuers required to make prospective changes, one percent required to refile, and 26% referred to enforcement or placed on the default list.

Financial statement deficiencies

The deficiencies in financial statements noted in the CSA report include:

- *Misclassification of cash flows* primarily related to principal revenue producing activities in the statement of cash flows as investing or financing activities rather than operating activities. Examples provided referred to the classification of advances and loans by financial institutions and the classification of rent receipts and certain asset acquisitions by rental companies.
- Missing disclosures about *reclassification of items within the statement of cash flows*, including presentation of reclassifications on a comparative basis for the prior year.
- Inadequate disclosures about valuation techniques, significant unobservable inputs, and sensitivity for *Level 3 fair value measurements*, including the quantification of unobservable inputs and sensitivity effects.
- Insufficient detail in disclosures about *new IFRSs* not yet adopted. The CSA Staff expect

increasing detail as the issuer carries out its implementation activities, including possible qualitative and quantitative impacts.

- Lack of disclosure about entity-specific potential impacts from *adopting a new IFRS*, including qualitative information when the quantitative impact cannot be estimated or a statement the impact is not material, if applicable. Issuers were reminded these types of disclosures will be applicable to the implementation of IFRS 16: *Leases*, effective January 1, 2019. The AMF raised a similar comment.

MD&A deficiencies

The CSA report identified the need for improvements to:

- Qualitative and quantitative information provided for *material investments measured at fair value*, including a sufficient disaggregation of an investment portfolio to understand the associated risks and drivers of changes in fair value. Additional information is needed about material investments in a portfolio, material investments in private entities for which information is not available to the public, and summary financial information for material investees, including a discussion of its results of operations.
- Disclosures about *non-GAAP financial measures*, including the purpose and usefulness of the measures considering the nature of adjustments made. The Notice provides illustrative examples to assist issuers in preparing useful disclosures. The report also noted that real estate issuers need to more adequately explain **non-GAAP financial measures** involving management estimates such as maintenance capital expenditure reserves. The AMF also reported this issue.
- Disclosures including a *full set of financial statements for equity-accounted joint ventures* in the MD&A. Each line item in such financial statements is considered to be a non-

GAAP financial measure subject to the guidance for non-GAAP financial measures.

- Information about *projects in the early development stage*, including the overall plan for the project or business in the development stage, project timelines, budgets, regulatory and licensing requirements and status updates.
- *Related party disclosures* to identify the related party (including the name of the party if the party is a director or officer), the business purpose of the transaction, and the basis of measurement of the transaction. Issuers are cautioned not to refer to measurement basis as fair value unless such valuation can be substantiated.
- Disclosures about *forward looking information*. The Notice provides an illustrative example of how disclosures can be improved in this area.

The AMF also made comments about:

- Deficiencies in the *discussion and analysis of operating results and liquidity*. Often companies simply reproduce figures in the financial statements without providing any analysis of material changes in revenues and gross profit or any analysis of liquidity requirements. Examples were provided to illustrate how to improve deficient disclosures.
- Companies failing to include conclusions on the effectiveness of *internal control over financial reporting (ICFR)* in the MD&A and material ICFR weaknesses when the annual certification indicated there were such weaknesses. Illustrative examples were provided to assist in correcting these disclosures.

Other regulatory disclosure deficiencies

The CSA commented on several deficiencies in other regulatory disclosures related to:

- Compensation paid to named executive officers when issuers use *external management companies* to provide executive management services.
- Late filing of executive compensation disclosures.
- *Non-GAAP measures* disclosed on websites, news releases and investor presentations. The CSA also believes non-GAAP financial measures should not be the primary focus of content provided through these channels.
- Disclosures on *social media* being (a) selective or disclosed early; or (b) misleading or unbalanced.
- *Climate change*, including risk factors related to the issuer and its business that might influence investment decisions. Risks to consider are those specific to the issuer including physical, regulatory, reputational and business model risks. The financial impact should be discussed.
- Significant transactions with *family or other close relationships* need to be disclosed so an investor understands the relationships and the terms of the transaction.
- *A change of auditor notice*, including timing and content of auditors' letters.
- Scientific and technical information, including economic analysis for *mineral projects* (also reported by AMF).

The AMF also commented that some reporting insiders have failed to report or were late in reporting their trades of a reporting issuer.

Deficiencies in offering requirements

The AMF Summary highlighted the need for improvements in disclosures in prospectus offerings related to:

- Use of proceeds when the issuer has negative cash flow from operations; and
- Disclosure of non-GAAP financial measures in marketing materials without disclosure of the comparable financial statement measures.

What's next?

The reports on disclosure deficiencies provide an opportunity for companies to reassess their own disclosures and see whether improvements are needed. Proactive reviews may ensure your company is not required to refile or amend disclosures in the future.

Reflecting on director and audit committee independence

In October 2017, the CSA began a consultation project to discuss the appropriateness of the CSA's approach to determining director and audit committee member independence. A consultation paper was issued to obtain feedback. In July 2018, the CSA reported back on this consultation in CSA Staff Notice 52-330: *Update on CSA Consultation Paper 52-404 Approach to Director and Audit Committee Member Independence*.

Most respondents supported the CSA's current approach for all issuers in the Canadian marketplace. Most commenters indicated that the current approach is well understood by market participants and is consistent with the approach in the United States. Some respondents proposed enhancements, reassessments of the bright line tests in the guidance, and a principles based approach with more flexibility and discretion for boards to determine independence.

Based on the feedback received, the CSA concluded that it is appropriate to maintain its current approach for independence assessment. The CSA believes the current approach provides an appropriate balance between giving sufficient discretion to boards to determine an individual's independence and setting prescriptive conditions that preclude certain individuals from being considered independent in certain circumstances.

Other regulatory amendments

Modern slavery disclosures

The Autorité des marchés financiers published a Notice in September 2018 to provide guidance to issuers on existing disclosure requirements related to modern slavery. Modern slavery is any work or service performed by a person involuntarily and under threat of penalty, and may include forced labour, debt bondage, human trafficking, and child labour.

Through this Notice, the AMF is drawing the attention of issuers to certain disclosure requirements about the issue of modern slavery in:

- The AIF
 - Disclosure of risks such as litigation, regulatory, reputational, and operational risks (disclosure may also be required in MD&A);
 - Disclosure of social policies.
- Company's code of conduct and ethics, which are required to be filed on SEDAR.

The AMF also noted that the disclosures provided in documents should be subject to oversight by the issuer's board of directors, audit committee, and certifying officers.

The Notice highlights the AMF's findings on a review of disclosures and provides several questions issuers can ask themselves to assess whether their disclosures capture the material risks and policies related to the issues of modern slavery.

Simplifying cross border offerings by Alberta issuers

In August 2018, the ASC issued ASC Rule 72-501: *Distributions to Purchasers Outside Alberta*, which took effect on August 31, 2018. This rule expands exemptions available for an Alberta issuer to distribute securities to investors outside of Canada and provides a prospectus exemption for distributions made under an offering memorandum exemption within Canada. These exemptions require

the issuer to materially comply with the disclosure requirements in the purchasers' jurisdiction.

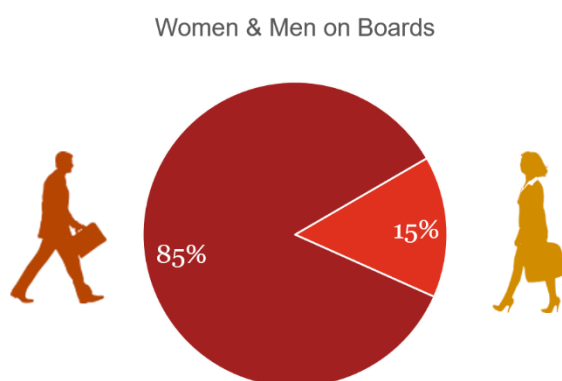
This change will allow Alberta issuers to make cross border offerings without having to apply the Alberta requirements when the offering is subject to foreign securities laws.

Women on boards

The *Report on Fourth Staff Review of Disclosure regarding Women on Boards and in Executive Officer Positions* was published on September 28, 2018 by the seven securities regulatory authorities requiring disclosure about women on boards and in executive officer positions. CSA Multilateral Staff Notice 58-310 reflects the key trends from a review of 648 issuers with year-ends between December 31, 2017 and March 31, 2018. The staff of the various securities regulatory authorities did not make a qualitative assessment of the disclosures made by issuers.

Board seats

The review found that women held overall 15% of board seats. This is a slight improvement from the prior year. Sixty-six percent of issuers had at least one woman on their board, a moderate improvement from 61% in the prior year. The number of women on the board tended to increase with the size of the issuer and varied by industry.



Executive officers

While 66% of issuers, compared to 62% in the prior year, had at least one woman as an executive officer, only four percent had a female CEO and only 14% had a female CFO.

Targets

Most issuers do not have targets for the representation of women. Only 16% and four percent of issuers had targets for board seats and executive officer positions, respectively.

Term limits and board renewal

Many companies (43%) do not have director term limits or other mechanisms for board renewal. The number of issuers with director term limits has remained static at 21%. However, 32% of issuers reported that they did have other mechanisms for board renewal.

Policies

Improvements were seen in the number of issuers adopting policies on the representation of women, increasing from 35% in the prior year to 42% in the current year. A substantial majority of companies reported that they considered the representation of women on boards when identifying and selecting directors (73%) and in executive officer positions (60%).

Next steps

The CSA is planning to review the disclosure requirements to evaluate whether and what changes are required to the disclosure requirements. The evaluation may result in new or supplemental guidelines.

The CSA Staff is further studying the issuers by:

- Consulting with a variety of stakeholders to better understand their needs and perspectives (through forums, consultation papers, roundtables, meetings, and email communications);

- Updating research on (a) gender diversity considering approaches used outside of Canada, proxy-voting guidelines, and academic and other studies, and (b) director term limits.
- Considering the key trends for the four disclosure reviews.

More details

The *Report* contains various details and analysis resulting from the review. A copy of the report can be obtained from your provincial or territorial securities regulatory authorities' website.

SEC developments

Simplifying and updating disclosure requirements

In August 2018, as part of the SEC's disclosure effectiveness project and implementation of the *Fixing America's Surface Transportation Act*, the SEC approved several amendments to its disclosure requirements. SEC Release No. 33-10532: *Disclosure update and simplification* is a 314-page release to amend disclosure requirements that were duplicative, overlapping, outdated or superseded, considering other SEC disclosure requirements, US GAAP, IFRS, and changes in the information environment. The amendments also introduce some new disclosure requirements.

The SEC release is very technical and affects disclosures for annual filings, periodic filings and offering documents made by US domestic issuers, foreign private issuers and Regulation A issuers.

In this article, we have only highlighted some examples of the amendments that affect Canadian issuers that are foreign private issuers. For Canadian issuers eligible to use the multi-jurisdictional disclosure system (MJDS), the changes will have minimal impact as the disclosures for MJDS filers are largely driven by Canadian securities requirements. For Canadian issuers filing using the US domestic system (10-Ks and 10-Qs), the amendments may have a more dramatic effect.

If you are interested in a more in-depth understanding of the various changes, a copy of the release can be found at www.sec.gov under Regulation/Final Rules.

Nature of amendments

The SEC has categorized the disclosures affected by the amendments:

- Redundant or duplicative disclosures, which are SEC disclosures identified as being substantially similar to those required by US GAAP, IFRS, or other SEC disclosure requirements. These amendments eliminate redundant or duplicative requirements; however, these eliminations do not affect the underlying requirement.
- Overlapping disclosures, which are SEC disclosures that cover the same topics as in US GAAP, IFRS or other SEC disclosures, but are not the same as those disclosure requirements. These overlaps were addressed by either (a) eliminating the disclosure requirements, (b) integrating them with other disclosure requirements, or (c) referring them to the FASB for possible incorporation into US GAAP.
- Outdated disclosures resulting from changes in facts and circumstances. These disclosures have either been modified or deleted. Some of these are outdated references to dates or location of filings.
- Superseded disclosures resulting from changes to accounting, auditing, legal or regulatory requirements. These requirements were either modified to current terminology or

circumstances or deleted if they were stale-dated.

In some cases, the SEC requires additional information to that required under US GAAP. The SEC has retained these requirements for the time being and referred them to the FASB for potential incorporation into US GAAP. Topics referred to the FASB include disclosures about major customers, computation of earnings per share, revenue from products and services, income tax, the presentation of discounts on shares, and several other topics. The SEC requested the FASB to complete its work on these points within 18 months after the release is published in the Federal Register. The SEC will decide further action once the FASB has considered these matters in their current or future agenda. There does not appear to be any request for the IASB to consider these matters.

Impact on foreign private issuers

In our initial review of the release, we have noted some eliminations, an addition, and a modification to the disclosure requirements affecting foreign private issuers. A further study of the release may indicate other relevant changes.

Disclosures eliminated

- Disclosure of foreign exchange rates compared to the US dollar for certain periods and at the latest practicable date.
- Amounts spent on company sponsored research and development for the last three financial years.
- Disclosure of dividend restrictions.
- Exhibit showing calculation of earnings per share.
- Disclosure of ratio of earnings to fixed charges and related exhibit showing the calculation of ratio of earnings to fixed charges.

Disclosure added

- Disclosure of issuer's internet address, if available.

Disclosure modified

- Price history of securities replaced with requirement to identify principal markets and corresponding trading symbols for each class of common equity.

Next steps

These amendments will become effective 30 days after they are published in the Federal Register and are expected to be applicable to filings after that date. SEC registrants will need to understand the impact these changes will have on their SEC filings made on or after the effective date. For foreign private issuers, it is likely that the next SEC annual filings may be affected.

Smaller reporting company guide

As reported in our last edition of *AC Insights*, in June 2018, the SEC raised the thresholds in the smaller reporting company ("SRC") definition. This change will allow more smaller companies to be eligible for the scaled disclosure requirements in several SEC regulations. The new SRC definition and other amendments coinciding with this change in definition were effective on September 10, 2018.

Under the new SRC definition, a company with less than \$250 million of public float will be eligible to provide scaled disclosures. Companies with less than \$100 million in annual revenues and either no public float or a public float that is less than \$700 million will also be eligible to provide scaled disclosures.

In August 2018, the SEC Staff prepared *A Small Entity Compliance Guide for Issuers* explaining the new definition, the available scaled disclosures, and other changes to facilitate smaller companies. This guide is available at www.sec.gov under Divisions & Offices/Corporate Finance/Current Topics.

Auditing developments

CAQ resource on CAMs

In July 2018, the Center for Audit Quality (CAQ) published a new resource, *Critical Audit Matters: Key Concepts and FAQs for Audit Committees, Investors, and Other Users of Financial Statements*, to help audit committees and investors understand the reporting of critical audit matters (CAMs) in the new PCAOB auditor's report. The new resource focuses on the auditor's responsibility to determine and communicate CAMs.

A CAM is any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee; and that:

- Relates to accounts or disclosures that are material to the financial statements, and
- Involved especially challenging, subjective, or complex auditor judgment.

The reporting of CAMs will begin to take effect for audits of large accelerated filers for fiscal years beginning on or after June 30, 2019.

The publication looks at the identification of CAMs and their communication in the auditor's report and compares the PCAOB model to that applied in other jurisdictions having similar models. Several frequently asked questions and responses are provided for a deeper insight into the reporting of CAMs.

A copy of the resource can be found at www.thecaq.org under Resources/Publications.

Investor confidence in market oversight

Each year since 2007, the CAQ has conducted a survey of retail investors to assess the trust these investors place in the US capital markets system. In September, the CAQ released its 2018 *Main Street Investor Survey*. The survey of 1,100 American investors was conducted in August 2018. The survey indicated a high-level of confidence, particularly for US markets.

The survey measured investor confidence in a number of areas as noted in the table.

	2018	2017	2016
US markets	74%	85%	74%
Markets outside US	56%	54%	42%
US publicly traded companies	78%	83%	81%
Audited financial statements	75%	78%	75%
Public company auditors	81%	84%	81%
Independent audit committees	80%	82%	77%
Financial analysts	79%	80%	76%
Stock exchanges	77%	82%	76%
Financial advisors & brokers	75%	79%	75%
Credit rating agencies	71%	71%	76%
Investigative journalists	69%	65%	68%
Corporate management	63%	69%	68%
Government regulators	62%	58%	54%
Corporate boards of directors	59%	63%	61%
Congress	44%	32%	34%

The key drivers of investors' confidence in the markets and public companies was largely based on the strength of the economies and the performance and resilience of the capital markets. Investors raised several concerns including the lack of leadership in the Trump administration and Congress, fear about trade wars and uncertainty of trade agreements, fear of unstable and corrupt foreign governments, US problems affecting foreign markets, benefits from corporate performance only flowing to certain individuals, unethical practices of corporations, transfer of US jobs overseas, and corporations being too profit driven.

Investors expressed confidence in audited financial statements primarily because the reputations of companies are at stake if they get it wrong, auditors provide honest and independent third party scrutiny, and auditing is well regulated. Confidence in audited financial statements was diminished by concerns that companies were not trustworthy and companies or auditors have conflicts of interest.

The levels of confidence in the audit committees and auditors indicate investors value the oversight and assurance provided by the audit committees and auditors in ensuring financial statements are reliable.

AC Insights provides audit committee members with a summary of financial reporting developments for public companies using IFRS, how those developments might affect your company and things you may want to think about when reviewing financial reports. The insights are provided for developments to the end of the current quarter-end. Developments may occur subsequent to the quarter-end which change the guidance issued or perspectives on the guidance. Such changes will be reflected in subsequent editions of *AC Insights*.

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