"How to Control the Non-GAAP" - From Standards to Reporting

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FEI Canada is the all-industry professional membership association for senior financial executives. With twelve chapters across Canada and more than 1,500 members, FEI Canada provides professional development, thought leadership and advocacy services to its members. The association membership, which consists of Chief Financial Officers, Audit Committee Directors and senior executives in the Finance, Controller, Treasury and Taxation functions, represents a significant number of Canada's leading and most influential corporations.

The Committee on Corporate Reporting (CCR) is one of the few thought leadership committees of FEI Canada. CCR is devoted to improving effectiveness, the awareness of issues and educating FEI Canada members on the implications of the issues it addresses and is focused on continually improving the standards and regulations impacting corporate reporting.

Background

Transition to Fair Value Accounting

Over the past few decades, the International Accounting Standards Board (IASB) has been slowly transitioning the International Financial Reporting Standards ("IFRS") towards the concept of fair value Accounting. Under the fair value measurement principles, assets and liabilities are re-measured periodically to reflect changes in their value, with the resulting change impacting either income statement or other comprehensive income for the period. The result is a balance sheet that aims to better reflect the current value of assets and liabilities. However, at times this comes at the expense of greater volatility in the reported information caused by changes in fair values. This also gives rise to increased number of non-cash line items in the income statement.

Rising Gap in the Non-GAAP Measures

Most of the Non-GAAP financial measures are derived from an Issuer's GAAP/IFRS based income statements and are generally calculated by omission or addition of selected items, which, according to the Issuer, present a more relevant picture of financial performance. Such non-GAAP financial measures may include "adjusted earnings", "cash margins", "free cash flow", "adjusted EBITDA", "adjusted income/ (loss)", "earnings before non-recurring or unusual items".

Historically, users of the financial statements (mainly the investors and stock analysts), either adjust the sub-totals, or recalculate financial measures using alternative methods that are not used by the IFRS. The past fifteen years has seen a growing trend where the Issuers of financial statements are providing increasing use of Non-GAAP financial measures and other non-financial measures in their disclosure documents.

Regulators' Concerns

The increasing prominence, extensive use and highlighted commentary around Non-GAAP financial measures and other non-financial measures (jointly referred as Alternative Performance Measures) is a big concern for most regulators.

Since 2001, the U.S. Securities and Exchange Commission (SEC) has been issuing various regulatory documents and cautionary statements to Issuers and users of financial statements on this subject. In 2003, the Ontario Securities Commission published Staff Notice 52-306 on the use of Non-GAAP or (Non-IFRS measures) which was updated over the years, with the latest version of the Notice released in 2016. Among other things, the Notice outlines general disclosure and reconciliation guidelines and provides guidance on disclosing certain subtotals from the financial statements in press releases prior to the financial statements being available. The intention of the guidance is to help ensure that the users of the financial statements are not misled by the extensive use of Non-GAAP terms that often lack standard meanings and different Issuers may use the same term to refer to different calculations.

Purpose

Need for a framework

FEI Canada has been part of various focussed group discussions in Canada on the increasing use of Alternative Performance Measures ("APM"). These discussions highlight the need for such measures, while at the same time addressing regulators concerns. An ongoing theme underlying the discussions is the need of an enterprise-wide approach to the use of APMs. While some regulators have laid out specific guidelines and rules around such disclosures, there is still a void to be filled in terms of a governance framework that can oversee the end to end process, and better manage the use and disclosures of APMs. Participants in the focused group discussions have continually highlighted the risks associated with the extensive use of APMs. Some examples of potential risk areas include: APMs tied to executive compensation, the use of certain non-financial measures used by organizations to obtain permits or licences to operate, etc. With the increased automation and the use of AI in processing data, these risks cast a wider and more pervasive impact then often perceived.

Objective of this document

The objective of this document is to recommend guidelines for an APM Control framework that addresses enterprise wide risks associated with the increased use of APMs. An implementation of a sound control framework around APMs will increase regulators' and users' confidence on the disclosures.

For the scope of this document, Alternative Performance Measures include:

- Non-GAAP or Non-IFRS financial measures
- Hybrid measures (which include both Non-GAAP financial and operational data)
- Operational measures

This document does not address GAAP or IFRS financial measures, as those areas are generally addressed by existing internal controls over financial reporting.

The framework recommended in this document addresses five key components:

- Control environment and governance
- Oversight and monitoring
- Scope and measurement
- Change management
- Information and communication

FEI Canada acknowledges that there are many differing regulatory, stakeholder and industry requirements relating to the use of APMs. Therefore, it is incumbent on management to determine if and how to adopt the APM Control framework to enhance the organization's ability to create, use and report value added information.

This document is drafted for a diverse audience depending on their management roles and responsibilities. The scope of the document is to address key risk areas for board level oversight and executive management audience with the intent of summarizing the importance and benefits of APM Controls.

Components of APM Control Framework

Control Environment and Governance

The control environment is the basis for all other components of an internal control framework. The board of directors and executive management are responsible for establishing the tone at the top regarding the importance of internal control around APMs. The control environment provides discipline, process, and structure. Any non-compliance with the APM Controls must be addressed with the same level of rigour and scrutiny as GAAP or IFRS measures. The board should also maintain its independence when assessing management's compliance with the APM controls. Furthermore, compliance with the APM controls should be part of the Code of Ethics program.

Oversight and Monitoring

In recent years, many of the boards are working diligently on how to improve their effectiveness. This includes strengthening their mandates and policies, reasserting their roles and establishing board-level risk committees. At the same time, the management teams have committed resources to enhancing governance frameworks. Governance frameworks set the tone at the top. In the same note, all performance measures either cascade down or roll up. The most effective tool to enforce a strong control framework around APMs also starts from the top. This includes but is not limited to: Audit & Risk Committee Mandate, including clear roles and responsibilities on the oversight and governance role of an APM Control framework. Additionally, the review and approval of APMs should be a regular part of quarterly Audit and Risk Committee meeting agenda.

Boards need to ensure that the following principles of reporting are built into the APM framework:

- **Discipline**: a defined framework exists, which is governed by an APM Policy and Procedure document
- **Transparency**: the ease with which an outsider can understand and interpret the APMs.
- **Fairness**: management is not biased in giving prominence to one measure over another; acknowledgement of, respect for and balance between the rights and interests of the organisation's various stakeholders (internal and external)
- **Accountability and responsibility**: each APM cascades down and is linked to a position of trust in the organization; the officer in the position of trust must be responsible for validating and signing off on the APM
- **Independence**: Board's remuneration should be kept independent from the APMs

The Audit & Risk Committee should ensure the management has an APM **Policy and Procedure** document. This document should capture the principles and detailed controls that management has put in place to oversee the APMs.

The Compensation Committee should also ensure that any APMs used for the **Executive Compensation Plan** should be subject to the control framework.

As well as this, review of all APMs should become part of the **Disclosure Committee** mandate, prior to review by the Board and the Audit Committee.

CEO and CFO **Certification** should specifically include a statement of fair presentation of Alternative Performance Measures.

Scope and Measurement

The list of Alternative Performance Measures varies from industry to geography. While cash measures may be more preferable among the investor community in one country, other jurisdictions may focus on earnings-based data. Use of a same set of APMs is a pretty common practice within a sector of the industry, especially where companies are competing in the same capital markets. One common grievance from the investor and regulatory community is that one may expect differentiation in the use of an APM across sectors, but the same APMs should not use different formulas or calculation methods within the same sector.

While some not for profit organizations such as the World Gold Council have defined certain APMs, it is still mostly up to the entity's management on how they define and calculate an APM.

The following controls may help the entity create more validity, relevance and reliability around its APMs:

- The inclusion of a new APM in the disclosure document must be made only if it incrementally provides useful information and does not create confusion in the mind of the reader
- The management must describe clearly in a section in the MD&A the criteria according to which a new measure will be included or amended
- Such criteria may include change in underlying standards, regulations, change in business conditions, and so on

Management should also document **a list or inventory of approved Alternative Performance Measures**. This inventory should include the reportable APMs (externally disclosed to the users of the financial statements) and non-reportable APMs (that are calculated or monitored by the organization and roll up into an APM).

Any **changes** (additions, deletions, or changes in formulas) to the APMs included in the approved inventory list should be **approved by the Audit Committee**.

Management should conduct an **annual risk assessment** on the approved list of APMs, which should outline what are the likelihood and impact of something going wrong for each measure, and what controls management has put in place to mitigate the risks.

All APMs should be **clearly defined** in the disclosure documents along with the **formula** used to calculate the APM (if applicable).

In order to avoid confusion by the user of the information, the disclosure should refer to the APM with a single title, instead of using multiple titles for the same measure. Examples of using multiple titles include: Net free cash flow vs. free cash flow, cash operating costs vs. cash costs.

Where an APM refers to an external benchmark that is predefined by a third-party definition or formula, this fact should be cross referenced in the disclosure to improve validity.

All disclosure documents should either include reconciliation or should reference to a publicly available document that contains the reconciliation. The reconciliation should include:

- Non-GAAP Financial APMs **reconciled** to a GAAP/IFRS measures (e.g. EBITDA to Net Income)
- Hybrid APMs that contain both non-GAAP financial and operational data (e.g. cash costs per unit) **reconcile** the non-GAAP financial data to a GAAP measure
- Operational APMs should be **reviewed and certified** as fair and true by an internal qualified person (QP), such as Chief Operating Officer or VP Operations

Change Management

A key area of concern for regulators and users of financial statements is the frequency of change in the APMs. Performance measures are tied to the strategic direction of the company. While in long term review of APMs to ensure relevancy may be encouraged, short term, frequent changes in APMs may mislead the user. According to a survey conducted by an audit firm, quite a few issuers selectively added or omitted APMs from quarter to quarter. Furthermore, there was also a high frequency of changes in method of calculation or formula on a prospective basis, making the financial information non-comparable with prior quarters. The following steps will ensure that changes to APMs are made in a controlled manner:

- Any changes in the approved list of disclosed APMs or changes in method /formula should only be made in the **beginning of the year** (first quarter)
- Once a change is made in an APM, the company should not change the list or the formula for a period of two subsequent financial years (**stand-still period**)

Exceptions to the two rules above are acceptable only in rare circumstances, which include:

- A business combination (merger, acquisition, divestment)
- Change in accounting policy or an accounting pronouncement

Any changes made in the list or the method/formula should be approved by the Audit & Risk Committee. In case of a formula change, management should present to the Audit & Risk Committee a summary of impact of the change for the past four quarters and an estimate of impact for future quarters.

Information and Communication - Disclosure of the Framework

Comprehensive, timely and transparent disclosures are a key pillar of good governance. Frameworks that support such pillars should, themselves be disclosed and discussed, at least on an annual basis. Such disclosures are critical to allowing shareholders to evaluate the extent to which management and the board is aligned with concerns and needs of the users.

As an example, Glass Lewis recognizes performance metrics must vary depending on the entity and sector, among other factors and may include a wide variety of measures as well as industry-specific performance indicators. Glass Lewis believes companies should disclose why the specific performance metrics are used in determining executive compensation, were selected.

Management should discuss the control framework around its APMs in the **Annual Information Form** under the risk and uncertainties section as well highlight management's control over APMs that are tied to executive compensation in the **Management Information Circular**. This will provide additional comfort to regulators, users and independent third party assessment entities.

As part of good governance, management should also consider preparing proforma disclosures when introducing changes to the APMs as a measure to enhance understanding of the changes and the implications for the readers. The pro forma disclosures should disclose past and current changes.

Assessing Effectiveness

An effective system of internal control provides reasonable assurances regarding achievement of the underlying objectives. To have an effective system of internal control, each of the components above must be present and operate together in a manner that reduces the risk of misuse of APMs by an entity.

All entities must include the APM Control Framework as part of their **annual certification process**, which should be duly audited (externally and/or internally), and the existence of any material weakness (with respect to external financial reporting objectives) or non-conformity (with respect to APMs relevant to operations, or non-financial reporting objectives) should be reported to the Audit Committee on a period by period basis.

Conclusion

APMs have become a hot topic for the regulators and investors. While there is no standard list or definition of APMs being used by various industries, it is the preparers responsibility to design and implement a transparent and due-process to oversee the use of such measures. A strong control framework will increase investor confidence and reduce regulator concerns.