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Canadian securities regulators on high alert over misleading earnings statements

JANET MCFARLAND

Canadian regulators are warning companies not to mislead investors with non-standard financial measures in their press releases and other securities filings, and have asked some companies to change their practices or refile statements.

Ontario Securities Commission chief accountant Cameron McInnis said securities regulators across Canada have seen the growing use of non-standard accounting measures in recent years, and issued new guidelines to companies earlier this year to stress that the numbers must be presented fairly.

“We all recognize there’s a lot of non-GAAP out there, and we want to be able to make sure issuers are doing it in a way that’s fair and careful for investors,” he said in an interview.

While financial data prepared under generally accepted accounting principles (GAAP) must be used in audited financial statements, companies can use many non-GAAP measures in other filings such as management discussion and analysis documents, press releases and marketing materials.

Non-GAAP measures are not standardized by accounting regulators or verified by auditors, and companies can define them differently, which can make it hard to compare.

A new report from Toronto-based accounting firm ***Veritas Investment Research*** shows rapid growth in the use of non-GAAP measures over the past decade, with over 70 per cent of companies in the S&P/TSX 60 index reporting some form of internally adjusted net income figure in their filings in 2015, compared with fewer than 10 per cent in 2004. The report said 85 per cent to 90 per cent of non-GAAP measures it studied over the past five years had the effect of improving a company’s financial picture.

Veritas chief executive officer ***Anthony Scilipoti***, who co-wrote the report, said Canadian regulators have non-mandatory guidelines about how companies present non-GAAP measures, but should make them mandatory regulations. The U.S. Securities and Exchange Commission has similar standards for non-GAAP reporting but they are regulations.

Mr. McInnis, however, said the OSC has not had a problem enforcing its guidelines in their current form.

“Over the years, we haven’t had significant difficulty in enforcing our guidelines. … Our approach up to now has been pretty effective,” he said. “When we need to raise an issue with an issuer, it works.”

He said the OSC could consider a change, however, if it felt companies were flouting the standards because they are only guidelines.

Securities regulators have issued several public warnings to companies in the past three years, stressing they must make it clear when a number is a non-GAAP measure, must present GAAP numbers more prominently than non-GAAP calculations in their disclosures, and should provide a direct comparison to the closest GAAP calculation.

An OSC review of 50 Ontario-based companies in 2013 concluded the use of non-GAAP measures was "disappointing," with OSC staff identifying concerns with the use of non-GAAP measures at 86 per cent of companies reviewed.

In July, 2016, Canadian securities regulators published the results of a more recent review of financial disclosures at companies across Canada, saying some have been asked to make changes in the future or refile documents. The OSC could not say how many of the changes it requested involved the use of non-GAAP measures.

"We screen on a regular basis and where we see something that could be amiss, we start reaching out to the companies and we ask them to explain themselves," said OSC corporate finance director Huston Loke.

The ***Veritas*** report looked at the most recent annual reports of S&P/TSX 60 companies and identified 30 instances where ***Veritas*** felt the use of non-GAAP financial measures would run afoul of OSC guidelines.

Mr. Loke said the regulator is examining those findings, and "will use research such as this to inform our supervisory activities."

While securities regulators have primary authority over how companies report non-GAAP measures, Canada's accounting-standard-setting body is also considering changes to GAAP rules to address the issue.

Linda Mezon, chair of Canada's Accounting Standards Board, said the board is participating in an international review of the use of non-GAAP measures to consider whether some of the calculations should be adopted as formal GAAP accounting rules.

For example, many companies are presenting their own adjusted operating income figures to exclude various costs, arguing they want investors to know how the core business operations are performing on a continuing basis. Ms. Mezon said the popularity of the disclosures could signal that GAAP rules need to evolve to cover more non-GAAP operating income calculations.

"We are asking what we can do to make the GAAP results more relevant, and whether there are steps we should take to pull into GAAP some of these measures," she said in an interview.

The benefit of making the calculations part of the legal GAAP framework is that they would be audited and standardized so they can be compared across different companies, she said.

"If there are some basic metrics where the standard setter could step in and define them, I think we would all benefit from that," she said.

The ***Veritas*** report also suggested regulators could simply ban the use of non-GAAP financial metrics from all financial filings, but acknowledged the measure would be draconian.

Ms. Mezon said she would not support eliminating all use of non-GAAP measures. She said companies should have flexibility to tell the full story about what has happened in a reporting period, and a ban would create an uneven playing field globally.

However, she said her personal view is that Canadian securities regulators could turn non-GAAP regulatory guidance into mandatory regulation because most companies already view the guidance as rules anyway, so it would have a significant impact only on those who are not adhering to the guidance.

"I would support it because in my mind it was a regulation anyway, but not everybody sees that," she said.

As the former chief accountant at Royal Bank of Canada, Ms. Mezon said she has always been suspicious about companies that use numerous non-GAAP measures in their announcements, and said she is happy to see more public attention on their use.