June 2013

THE NEW ZEALAND LAW JOURNAL

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New Zealand Law Journal
June 2013

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Citation
[2013] NZLJ (page)
ISSN 0028-8373

Technical editing
Maribel Espinas
LexisNexis NZ Limited

Printing
Printlink
A Division of Blue Star
Group (New Zealand Ltd)

Publisher
LexisNexis NZ Limited

Non-GAAP financial measures

John Karayan, Woodbury University and Ashley Burrowes, Te Whare Wānanga o Awanuiārangi, Whakatane

navigate the FMA's new guidance

A key point in the Prime Minister's 29 January 2013 *Statement to Parliament* is that the government will continue its agenda for overhauling the regulation of financial markets. Implicit in the *Statement* is the government's approval of the regulatory approach taken by the nascent Financial Markets Authority (FMA). On 13 February, the FMA detailed its 2013 agenda for company financial disclosures. High among these is monitoring compliance with the FMA's *Guidance Note* entitled *Disclosing non-GAAP Financial Information* (September 3, 2012, enforcement began 1 January 2013. The final text, and its history, are available at fma.govt.nz).

This article is intended to help counsel to advise issuers, and users, of financial disclosures on the salient features of the new disclosure standard. The bottom line is that the FMA allows non-GAAP disclosures, but the release of such information is guided with the goal of reducing the risk of users being misled. In addition, the *Guidance* does not change the rules on disclosures within statutory financial statements, but instead focuses on market communications (eg, announcements, road shows, analyst briefings, and press releases) and transaction documents (eg, prospectuses), particularly in forward looking (eg, pro forma) financial projections. Finally, the *Guidance* provides a principles-based focus on how non-GAAP information can be presented (eg, its prominence, labeling, and relationship to audited financial information) to reduce the risk of misleading users.

BACKGROUND

An understanding of the causes of the new rules should help in applying them. Modern mixed economies customarily regulate financial disclosures by publicly traded entities to help ensure the probity of this key source of investment information. Financial regulators throughout the developed world generally approach this responsibility by requiring that financial disclosures must fairly represent the financial condition of the issuer. In particular, financial information must be presented in accordance with generally accepted accounting practice (GAAP).

The most common investor yardsticks, in turn, are derived directly from audited financial statements. Examples include earnings per share, the current ratio, free cash flow, the asset turnover ratio, and earnings before interest, taxes, depreciation, and amortization. Being based on financial disclosures which are GAAP-compliant, which in turn reasonably assures that the numbers are reliably and consistently derived, these measures provide comfort to users desiring to compare a firm's performance over time, as well as compare it with other firms. Over the last decade, however, publicly traded firms have increasingly reported non-GAAP performance measures to investors and their advisors. (For an excellent overview, see Fortin and others "SEC Interventions and Industry Guidance: The Effect on Non-GAAP Financial Disclosures", *Proceedings of the Canadian Academic Accounting Association Annual Conference 2009*).

NON-GAAP FINANCIAL DISCLOSURES

Non-GAAP measures cannot be derived by investors, or their advisors, directly from audited financial statements. Examples include "funds from operation", "normalized profits", "adjusted operating margin", and "adjusted trailing average free cash flows". For an discussion of these, and other such measures, *see* Burrowes & Karayan, "Limiting the Market for Excuses in the US and Aotearoa", [2012] August *Chartered Accountants Journal* 52–55.

The rub is that non-GAAP disclosures may be built from GAAP-based information, and look like GAAP-based ratios, but include or exclude amounts which management feels are unusual or otherwise unrepresentative (and thus, in management's opinion, are neither predictive of future results nor suitable for measuring management's past performance). Common adjustments include putatively one-off expenses related to natural disasters such as earthquakes, tsunamis, or typhoons, unrealized losses due to financial system meltdowns, or uncontrollable costs such as unexpected tax increases or new regulatory regimes. For an incisive commentary on how top New Zealand firms are using these, see Gaynor B, "Changing the Scores Unfair to Investors", *The New Zealand Herald* (3 September 2011).

Although US GAAP specifically allows certain extraordinary items to be removed from operating income and instead be shown on separate lines, such items are rare. The US approach was rejected a decade ago by the leading international accounting standards setter, the International Accounting Standards Board. Its International Financial Reporting Standards (IFRS) are, in turn the basis for New Zealand's GAAP (NZ IFRS). Adjusting financial results for extraordinary items has not been added to NZ IFRS. Indeed, issuers were explicitly prohibited from presenting extraordinary items in audited financial statements and notes. This suggests that even though non-GAAP measures may, indeed, be useful, they may mislead investors.

Another concern is the forums, and formats, in which non-GAAP performance measures most often appear. They generally are issued in more ephemeral corporate communications, such as press releases, market announcements, and tender offers. This may raise the risk of that investors will not subject the disclosures to the same level of critical analysis devoted to the far more detailed, comprehensive, and reliable information provided by audited financial statements.

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The second step focuses on the prominence given to the non-GAAP measures. They should be less prominent than similar GAAP measures. For example, GAAP measures should be shown before non-GAAP measures in the body of the communication. This standard is quite flexible. It specifically allows non-GAAP figures to be included in the headline of an announcement. To the extent practical, the related GAAP measures should also be included in the headline. However, if impractical, the GAAP information can merely be shown in the 'forefront", of the body.

Appropriate labeling also can serve as a prophylactic. All terms should not only 'accurately describe' the non-GAAP measure, but also distinguish it from similar GAAP measures. How this is done depends on the 'nature' of the disclosure, again providing flexibility so long as labels for non-GAAP disclosures do not cause confusion in the minds and hearts of the users of the disclosures.

Firms should take appropriate steps to ensure that users understand how the non-GAAP measure was calculated. This should clearly be explained in a narrative. More importantly, directors are charged with authorizing a 'more fulsome' internal policy as to the 'consistency, completeness, and accuracy' of the adjustments made to related GAAP measures.

Along this line, non-GAAP measures should be accompanied by a reconciliation. This should explicitly detail the adjustments to GAAP which were made in deriving the non-GAAP items. If, for example, the reconciling items can be found in statutory financial statements, this not only should be disclosed, but a road map also should be provided. This road map should clearly indicate where the information can be located. Furthermore, if the non-GAAP measure spans accounting years, the reconciliation should also do so.

Consistency is crucial. Non-GAAP measures which also were provided in prior years should be calculated in the same way. However, demonstrating again the FMA's flexibility, if there are changes they should be reported just like changes in GAAP accounting methods: an explanation of the nature and reasons for the change should be provided, along with an analysis of the impact of the change.

Similarly, if non-GAAP measures are based on adjustments to GAAP measures, similar adjustments must be made for all non-GAAP measures. For example, if a "one-off" expense (eg, from an earthquake) is excluded from an income related measure, so should related profit measures (eg, related cash flows from insurance policies or government grants).

Along this line, non-GAAP measures should be unbiased. A firm's directors should not approve of disclosures which "give an overly optimistic impression of performance"; careful consideration should be given to the incentives for senior management if bonuses are based on non-GAAP measures such as "normalized profits" rather than GAAP measures.

The *Guidance* also highlights one more area where consistency is king. Many non-GAAP measures exclude or include certain items which are not excluded or included when calculating or presenting GAAP based measures. Such items which are being justified because they are unusual, extraordinary, non-recurring, or one-off should not have occurred in the firm's past, nor should they be reasonably anticipated to occur in the firm's future.

Finally, to the extent that non-GAAP measures are based on statutory financials, or those which otherwise have been reviewed or audited, this should be clearly indicated in the communication.

CONCLUSION

Although readers of new regulatory pronouncements may prefer "bright line" tests, the FMA has wisely avoided them in this *Guidance*, and thus avoided the gaming which otherwise might result. This also has the benefit of recognizing that one size does not fit all. While it may be frustrating to some that the FSA has chosen to feel its way with a continuation of an adapted principles approach, this *Guidance* does an excellent job of apprising firms, and their advisers, of the FMA's expectations, and thus probable future responses. ❐

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Again, this is not sufficient to exclude review, especially as the Ombudsmen's recommendations are non-binding (*Grant* at 190).

Overall, therefore, balancing the factors does favour subjecting VUW to public law control. There is nothing specific about the decision itself, such as commerciality, that would suggest limitation of the available grounds due to insufficient publicness (contrast *Mercury Energy Ltd v Electricity Corp of New Zealand Ltd* [1994] 2 NZLR 385 (PC) and *Lab Tests*). These conclusions are consistent with strong authority, both New Zealand (*Norrie* at 135) and overseas (*R v Manchester Metropolitan University, ex p Nolan* [1994] ELR 380 (QB) at 392–393; *R v Cambridge University, ex pPersaud* [2001] EWCA Civ 534; *Tang* at [110]).

Bell and other university decisions satisfy the public nature test for reviewability at common law. The point is to underline why, if the common law tests are applied prior to coming to the JAA, there can be no question of excluding reviewability at the statutory stage.

CONCLUSION

VUW's concession that DAC's decision was reviewable may have been a mistake. While review is available by dint of the University's undeniable publicness, close examination of the type of decision in issue may have resulted in some grounds being unavailable, or at least limited in the intensity with which they were entertained. The decision in question was one calling for academic judgement, and aside from procedural fairness and high-level legality, it should not have been subjected to intensive review from a non-expert court. Substantive consideration of reviewability may also have avoided repetition of the unfortunate but persistent error of assuming that jurisdiction flows from the JAA, rather than the common law, and the distraction of *Tang*. In any event, given the decision's location some distance from the undisputed heart of judicial review's territory, critical analysis by the Court would not have been unwelcome as a matter of general contribution to the common law. Inevitably, students will continue to be dissatisfied with decisions of their universities; proper consideration needs to be given to what degree of judicial supervision of such decisions is appropriate. While the outcome in *Bell* may have been roughly correct, the case was in this respect a missed opportunity. ❐