Simpson Thacher

Memorandum

IOSCO Issues Report on Non-GAAP Financial Measures

August 18, 2016

Introduction

In the wake of guidance issued by the U.S. Securities and Exchange Commission ("SEC") in May 2016 on the subject of non-GAAP financial measures,[1] the International Organization of Securities Commissions ("IOSCO") issued a report (the "Report") in June 2016 on the subject of financial measures not calculated in accordance with International Financial Reporting Standards ("IFRS") or another applicable set of generally accepted accounting principles ("GAAP").[2] Like the SEC guidance, the Report was the culmination of a long review process involving the re-examination of the scope and manner of disclosure of non-GAAP financial measures; in the case of IOSCO, this review began with the publication of a proposed statement in September 2014 and the subsequent receipt of public comments thereto, in response to which IOSCO has adopted certain amendments or clarifications.

Because IOSCO is a consensus-driven supranational organization, its guidance is broader and less specific than the corresponding SEC guidance, and it is subject to interpretation and implementation by relevant national authorities. Accordingly, the implementation of the IOSCO guidance can be expected to differ somewhat from jurisdiction to jurisdiction. Nevertheless, we expect IOSCO's guidance will have substantial influence in European and other international markets, especially where national authorities have not previously issued their own specific guidance on the subject of financial measures not calculated in accordance with applicable accounting standards or principles.

1 *See* Simpson Thacher Memorandum, "SEC Issues Guidance on Non-GAAP Financial Measures" (May 23, 2016), describing Compliance & Disclosure Interpretations ("C&DIs") recently issued by the SEC.

2 Statement of Non-GAAP Financial Measures – Final Report, IOSCO Publication FR05/2016 (June 2016).

Purpose and Scope of the Report

IOSCO has acknowledged that non-GAAP financial measures can be useful to investors because they can provide additional insight into (and numerical measures of) an issuer's financial performance, financial condition and/or cash flow, beyond those provided by GAAP measures.[3] With this in mind, the Report is "intended to assist issuers in providing clear and useful disclosure for investors and other users of non-GAAP financial measures, and to help reduce the risk that such measures are presented in a way that could be misleading."

IOSCO's guidance applies to issuers preparing their financial statements in accordance with IFRS, as well as issuers using other forms of GAAP, and broadly covers non-GAAP financial measures disclosed outside of financial statements, including disclosures included in press releases, management discussion and analysis sections in periodic reports, disclosure documents filed with securities regulators or stock exchanges (including prospectuses), and other communications with investors and market participants. However, operating measures and statistics – e.g., number of stores or units – are excluded from the scope of this guidance (other than adjusted operating metrics which include financial information, e.g. adjusted EBITDA per unit). Similarly, the disclosure of non-GAAP financial measures required to be disclosed by an issuer due to other applicable legal requirements (such as banking or insurance regulations) are also excluded from the scope of the guidance. We also expect that this guidance will influence disclosure practices in the private placement and institutional investor securities markets, even if offering documents prepared in such contexts are not specifically subject to review or comment by securities regulatory authorities.

A 12-Point "Frame of Reference"

The Report sets forth 12 principles as the "frame of reference" for the presentation of non-GAAP financial measures. This frame of reference is intended help issuers structure their disclosure in a way which enables investors and other users to understand the messages that the non-GAAP measures are meant to convey, while avoiding confusion or misleading disclosures. It is also expected that the application of the 12 guiding principles will increase reliability and comparability of financial metrics over time. While many of the guiding principles are already in common use, collecting them in one place provides a comprehensive and coherent framework for the disclosure of non-GAAP financial information.

Set forth below are the 12 principles in IOSCO's framework as presented in the Report, together with the subheadings under which they are organized:

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3 The Chairman of the International Accounting Standards Board speculates that the prevalence and importance of non-GAAP financial measures for issuers who present their financial statements in accordance with IFRS may stem in part from the fact that IFRS "prescribes very little in the way of formatting the income statement… The enormous flexibility under existing accounting standards is an open invitation for non-GAAP to step in." *See* Speech delivered by Hans Hoogervosrt, Chairman of the International Accounting Standards Board, at the Annual Conference of the European Accounting Association in Maastricht, available at: http://www.ifrs.org/About-us/IASB/Members/Documents/Hans-Hoogervorst-EAA-Annual-Conference-11-May-2016.pdf (accessed August 10, 2016).

Defining the Non-GAAP Financial Measure

1. Define each non-GAAP financial measure presented and provide a clear explanation of the basis of calculation.

2. Non-GAAP financial measures should be clearly labelled in a way such that they are distinguished from GAAP measures. Label should be meaningful and should reflect the composition of the measure. [4]

3. Explain the reason for presenting the non-GAAP financial measure including an explanation of why the information is useful to investors, and for what additional purposes, if any, management uses the measure.

4. Explicitly state that the non-GAAP financial measure does not have a standardized meaning prescribed by the issuer's GAAP and therefore may not be comparable to similar measures presented by other issuers.

Unbiased purpose

5. Non-GAAP financial measures should not be used to avoid presenting adverse information to the market.[5]

Prominence of Presentation of GAAP measures versus Non-GAAP Financial measures

6. When an issuer presents non-GAAP financial measures, those measures should not be presented with more prominence than the most directly comparable measure calculated and presented in accordance with GAAP. Presentation of non-GAAP financial measures, including information provided by reference, should not in any way confuse or obscure the presentation of the GAAP measures.[6]

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[4] IOSCO has observed the following common terms used to identify non-GAAP financial measures, among others, and notes that different issuers may use the same term to refer to different calculations: "underlying earnings," normalized profit," "pro forma earnings," "cash earnings," "adjusted earnings," and "earnings before non-recurring items."

[5] The Chairman of the International Accounting Standards Board identifies the possible use of non-GAAP financial measures to avoid the presentation of adverse financial information as a key danger in the use of such measures. The Chairman has asserted that 88% of S&P 500 companies currently disclose non-GAAP measures, of which 82% "show increased net income and are clearly designed to present results in a more favorable light," and that securities regulators in non-U.S. markets are "also concerned that non-GAAP numbers are getting increasingly detached from reality." The Chairman has also observed a link between the use of non-GAAP financial measures and management remuneration, pointing out that pay packages are commonly based on (favorably) adjusted measures.

[6] Question 102.10 in the SEC's updated C&DIs address this topic as well, though the SEC provides more detailed guidance regarding what "equal or greater prominence" means in practical terms.

Reconciliation to Comparable GAAP Measures

7. Provide a clear and concise quantitative reconciliation from the non-GAAP financial measure to the most directly comparable GAAP measure presented in the financial statements. The adjustment should be explained.

8. If the reconciling items are derived from items reported in the GAAP financial information, they should be reconcilable to the financial statements. When a reconciling item cannot be extracted directly from the financial statements, the reconciliation should show how this figure is calculated.

Presentation of Non-GAAP Financial Measures Consistently Over Time

9. If an issuer chooses to present non-GAAP financial measures, it should provide the same measures for comparative periods.

10. The non-GAAP financial measures presented by an issuer should generally be presented consistently from period to period. Further:

    - If an issuer chooses to change the composition of the non-GAAP financial measure, the issuer should explain any changes and the reason for marking them, and provide comparative figures for the prior period with such figures adjusted to reflect the change in composition.[7]
    - If an issuer determines it will no longer present a particular non-GAAP financial measure, the reason for this determination should be explained.

Recurring Items

11. In presenting non-GAAP financial measures, issuer sometimes seek to adjust for items that are reasonably likely to recur in the foreseeable future, or are activities that affected the entity in the recent past. In IOSCO's experience there are rarely circumstances where a sufficient explanation could be provided that results in restructuring costs or impairment losses being described as non-recurring. Such items should not be described as non-recurring, infrequent or unusual without sufficient explanation.[8]

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7 Question 100.02 in the SEC's updated C&DIs makes this point as well, but can be construed more liberally than the IOSCO guidance. In particular, the SEC suggests disclosing and explaining any change in the basis of calculation of a non-GAAP measure between present and prior periods, and that "depending on the significance of the change, it may be necessary to recast prior measures to conform to the current presentation and place the disclosure in the appropriate context." Unlike the IOSCO formulation, however, the SEC does not appear rigidly or presumptively to require recalculation of the measure for prior periods in *all* cases of change.

8 Questions 100.01 and 102.03 in the SEC's updated C&DIs concern this issue. The SEC's guidance contains a warning against "presenting a performance measure that excludes normal, recurring, cash operating expenses necessary to operate a registrant's business," as well as expresses concern with identifying items as non-recurring if they are, in fact, reasonably likely to recur within two years. Furthermore, Hoogervorst opines in his speech that restructuring

Access to Associated Information

12. The information that issuer provide regarding non-GAAP financial measure should be readily and easily accessible to investors and other users of financial information. Information is readily and easily accessible if it accompanies the non-GAAP financial measure or a reference is provided to where the information is available.

In general, the recent SEC guidance on the subject of non-GAAP financial measures is far more detailed and prescriptive than the IOSCO Report. There are a number of points on which the SEC and IOSCO largely agree and overlap; however, some of the points emphasized in the SEC guidance do not find their way into the Report's 12 principles. For example, the SEC's warning against non-GAAP revenue measures which accelerate the recognition of subscription or long-term contractual revenue which the relevant GAAP requires to be recognized over time does not appear in the IOSCO Report. Similarly, the SEC's specific warning against presentation of non-GAAP liquidity measures on a per-share basis, the guidance on the definition of "funds from operations," and the SEC's discussion on the specifics of income tax adjustments each do not have direct parallels in the IOSCO Report.

It must be emphasized, though, that IOSCO guidance does not preclude or supersede applicable national law, and that compliance with the Report's guidance is not a substitute for compliance with national law. Accordingly, for public securities offerings, or issuers with public securities in issue that are making periodic disclosures, guidance should be sought on the applicable stock exchange rules and any applicable national legal or regulatory requirements.

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and impairment charges are "part of daily life of any big company and should be considered normal operating expenses."

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