Consultation paper

11 April 2017

FINANCIAL MARKETS AUTHORITY

TE MANA TATAI HOKOHOKO - NEW ZEALAND

Consultation Paper: Improving financial information in an equity PDS

About this consultation

We intend to issue guidance for equity issuers on how to disclose financial information in product disclosure statements (PDS) in a clear, concise and effective manner. The guidance will be used as a key reference point for our work and updated as necessary.

The guidance will also include our interpretation of the regulations giving issuers the option to add or substitute information into financial tables.

We want your feedback to ensure the guidance will promote the best disclosure of financial information for investors.

Submissions close on Wednesday 31 May 2017.

Next steps

After we consider all of the submissions, we will finalise this guidance and publish it on our website.

Who needs to read this consultation paper?

This consultation is for issuers, their advisors, investors and other interested parties.

We're seeking feedback on our proposed guidance and interpretations of the regulations.

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About this guidance

Since the introduction of the Financial Markets Conduct Act 2013 (FMC Act), we've been working with issuers and their advisers to review their product disclosure statements (PDS) before they go to market.[1] One of the key areas of debate has been the financial information section.

We think the financial information section has become unnecessarily complicated. In particular, we have seen issuers overuse non-GAAP financial measures, resulting in crowded financial tables and complex footnotes that are difficult for investors to understand.

This paper provides:

- guidance on how issuers should disclose and improve their financial information
- our interpretation of the requirements in the Financial Markets Conduct Regulations 2014 (the Regulations) that allow issuers to add or substitute information in financial tables.

Issuers who don't follow our guidance run the risk of their PDS failing to be clear, concise and effective and misleading investors. If we consider a PDS does not meet those requirements, we can extend the waiting period and/or issue stop orders. However, our preferred approach is to engage early with issuers to ensure they have an acceptable standard of financial information.

We acknowledge issuers may have previously taken alternative approaches and interpretations but this guidance is intended to be used as our key point of reference for future PDS reviews.

This guidance complements other guidance, (currently being revised at the date of this publication) about disclosing non-GAAP financial information and pro-forma financial information. That guidance outlines the general principles for disclosing non-GAAP financial information.

[1] These reviews are pre-registration reviews of offer documents and therefore our concerns, may have resulted in changes to the documents prior to being publicly available. This is voluntary service provided by the FMA. More information is available here.

Background

1. The default requirements

Under the FMC Act, disclosure for regulated offers of financial products has two key components; a PDS and a series of entries on the Disclose Register.

The PDS must provide information to assist a prudent, but non-expert, investor to decide whether to or not to invest in the product(s) on offer. A PDS has a prescribed structure and content to make it user-friendly. It must be clear, concise and effective and not misleading.[2]

The structure and content of a PDS for an offer of equity securities is set out in Schedule 3 of the Regulations. This includes a section on the issuing group's financial information.

One of the key financial tables for the financial section is Table 1: *Selected financial information*. The measures in Table 1 impact Table 2: *Capitalisation,* and Table 3: *Investment metrics*.[3] Full financial statements are included on the Disclose Register.

The default measures for Table 1 must be determined and calculated using GAAP and are presented over a period of up to five years. They include:

- revenue
- earnings before interest, tax, depreciation, and amortisation (EBITDA)
- net profit after tax (NPAT)
- operating cash flow
- total assets
- debt.

These measures alone may not always provide the best selection of information for investors. For example, they may not reflect:

- measures commonly used to compare the relative valuation of companies in the issuer's industry
- the way the issuer measures its own performance or determines its dividends
- the current business structure of the issuer.

Therefore the Regulations provide issuers with options to add or substitute information provided certain tests are met.

[2] See sections 49, 61 and 82

[3] Clauses 33-39. Tables 2 and 3 are only required for a PDS where the equity securities are going to be listed on a financial product market eg. NZX

2. Options for adding and substituting information

Clause 39 sets out the options and tests for when issuers can add or substitute information in the financial tables.

The three primary options are presented below.

1. Other financial measures and non-financial information may be **added** to a table if the issuer reasonably considers that the added information is likely to be useful for investors.

2. Another GAAP financial measure or non-GAAP financial measure may be **substituted** for EBITDA or debt if the issuer reasonably considers that the other financial measure is likely to be more useful to investors.

3. If there are any factors that would materially affect the comparability or usefulness of the information reflected in a table (for example, changes to accounting policies, business combinations, or dispositions),—

    (i) pro-forma financial information **may be added to a table or substituted** for financial information for a period; or

    (ii) the PDS must include explanatory notes about those factors if those notes are necessary or desirable to explain the effect of the factors on that comparability or usefulness: [4]

Issuers should note the differences in the tests for when you can add or substitute information.

If an issuer only wants to add financial measures to a table, they only need to consider it is likely to be useful to investors. This test is lower than the other options and reflects that the default GAAP measures are not being substituted.

However, if an issuer wants to substitute EBITDA or debt, they must reasonably consider that the replacement measure is *more* useful than EBITDA or debt (as applicable). If an issuer is making that assessment, the issuer should note that the substituted measure is required to flow through to the calculation of the investment metrics in Table 3. Therefore, they should consider common investment metrics for companies in the same industry, eg, for some capital intensive industries it may be more useful to use EBIT, which takes capital expenditure into account, rather than EBITDA.[5]

If an issuer wants to use pro-forma financial information[6] there must be factors that "*materially affect the comparability or usefulness of the information.*" We consider this wording is a high threshold aimed at fundamental changes to the issuer's business or how that is accounted for, eg a PDS for a proposal to merge two businesses where the issuer intends to present the merger as if it had taken place at the start of the financial year. In this case, the threshold is high because it permits an issuer to add pro-forma information to a table or to substitute the GAAP information and present a potentially significantly different picture.

We also highlight that under this clause if an issuer is including pro-forma information it applies "*for a period*". This means all of the measures in that period need to be provided, including NPAT, operating cash flows and total assets and debt. By including all these measures, it more accurately reflects the impact any fundamental changes would have on the issuer's business. This also means issuers cannot use this clause to substitute only selected measures in a financial table.

[4] See FMC Regulations 2014, Schedule 3, clause 39(e),(f),(h),(l). – emphasis added.

[5] Refer to MBIE's commentary on the draft PDS regulations available online (page 8) here: http://www.mbie.govt.nz/info-services/business/business-law/financial-markets-conduct-act/documents-images-library/exposure-draft-of-disclosure-requirements.pdf

[6] Pro-forma financial information is a particular type of non-GAAP financial information used to explain a hypothetical situation. Our guidance on pro-forma information generally is currently being revised is available on our website. For international requirements refer to United States SEC Regulation S-X Article 11, and EU Prospectus directive 809/2004/EC.

Guidance

While issuers can add or substitute financial information to the financial tables in a PDS, it still needs to be clear, concise and effective and not misleading.

1. Focus on the key measures

We have seen issuers overuse non-GAAP financial measures, resulting in crowded financial tables and complex footnotes that are difficult for investors to understand. Issuers shouldn't make multiple immaterial adjustments because it can give investors a false impression of the precision and reliability of the resulting financial information.

Instead, we expect issuers to focus on the purpose of the offer and the most useful financial measures and adjustments. The financial information should be consistent with the overall themes and risks in the PDS. Focusing on the most useful measures and keeping adjustments to a minimum reduces the amount of commentary to explain them. This makes the PDS more likely to be clear and concise and easier for investors to assess the merits of the offer.

2. Disclosing appropriate non-GAAP financial information

Issuers need to be particularly careful if disclosing non-GAAP financial information. Non-GAAP financial measures can vary by issuer and what is appropriate for one issuer may not be appropriate for another.[7] As such, non-GAAP information can be misleading to investors if not presented or explained clearly.

There are specific rules around the use of non-GAAP information in a PDS. These require issuer to identify any non-GAAP information, provide explanations, and refer investors to where they can find reconciliations to the corresponding GAAP information on the Disclose Register.[8]

In addition, we expect issuers to follow the key principles in our guidance note on disclosing non-GAAP financial information.[9]

3. Substituting EBTIDA appropriately

Issuers can consider substituting statutory EBITDA with a non-GAAP profit measure if they think it better reflects their operating performance. In these cases issuers may be considering adjusting their non-GAAP measure for particularly large expenses that impacted previous accounting periods unequally. However, we caution issuers and their advisers to consider these adjustments very carefully as they often reflect information that is important to investors.

a. Adjusting operating items

Unusually large operating costs (eg impairments of inventory or bad debts), should not be adjusted for in operating profit measures. These expenses reflect the risks of business and should be explained to investors in a clear and concise way. Where relevant, this can be cross-referenced to the risk section.

Issuers that try to normalise or remove these costs can present investors with an oversimplified trend that misleads them about the risks to the issuer's earnings. Even worse, it can present a simple upward trend that could mislead investors about the growth prospects of the issuer.

Analysts often calculate investment metrics based on normalised profit measures. We don't consider that our guidance will impact the usefulness of the required prospective financial statements or investment metrics –

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[7] For a regulated offer of equity clause 2 of Schedule 3 of the Financial Markets Conduct Regulations 2014 defines GAAP and non-GAAP financial information/measures.

[8] See Schedule 3 clauses 2(2), 39(l) & (m).

[9] This guidance is currently being revised and is available on our website.

particularly for the second forecast period. This information is based on management's best estimate of the future financial performance of the business therefore it would be unusual to see adjustments for large operating items.

b. Explaining other items

Issuers need to clearly and concisely explain other adjustments such as impairments of goodwill or investments. These adjustments provide investors with valuable information about management decision-making and risks to the company's future earnings.

Both operating and other adjustments cause volatility in issuers' performance on an ongoing basis. To help investors appreciate this volatility, it is often appropriate to still include statutory EBITDA in the financial table even if it is substituted with another measure.

c. Specific items

Restructuring costs

For many issuers restructuring is an on-going part of their business and should *not* be adjusted for in earnings measures or referred to as a non-recurring cost.

Closed stores/operations

Investors need to understand how well management has performed in the issuer's industry. Issuers should *not* make adjustments for the underperformance of closed or sold stores / operations related to their on-going core business.

For example, an issuer may have operated 50 stores but closed five as they were not profitable. The closed stores should not be removed from profit measures. The closures reflect the reality of business and should be explained to investors clearly and concisely.

4. Quantifying adjustments in the PDS

We have seen adjustments to GAAP measures described in a PDS but no dollar value has been provided. Issuers should include a summary reconciliation between the GAAP and non-GAAP measures in a PDS. This is often the most transparent way to present adjustments to investors, and allows them to understand what's driving the difference between GAAP and non-GAAP financial measures.

5. Ensuring information between the PDS and the Disclose Register is consistent

Key financial themes should be captured in the financial section in a PDS and reflect more detailed information on the Disclose Register.

Issuers should read the financial section of the PDS from start to finish. They should see if it covers the issues in a balanced way and gives a similar impression as the financial information on the Disclose Register.

Issuers should check if the financial information in the PDS is significantly different from the statutory financial information on the Disclose Register. If so, issuers should clearly and concisely explain the difference between the two sets of financial information in the PDS.

This will help investors navigate the information, understand how the underlying businesses performed and challenge any non-GAAP and pro-forma assumptions.

Questions

1. Where do you agree with our guidance?
2. Where do you disagree with our guidance?
3. Do you think our guidance will result in high quality information for investors?
4. Are there situations where you think our guidance would lead to information that was not appropriate for investors?
5. Do you agree with our interpretation of when to add and/or substitute information?
6. If you disagree, please outline what you would consider the appropriate interpretation to be?
7. Are there additional areas or specific examples where you think we should provide guidance?

Glossary of terms

GAAP	Generally Accepted Accounting Practice, which has the meaning given to it by section 8 of the Financial Reporting Act 2013. For most issuers complying with GAAP means preparing financial statements that comply with the New Zealand equivalents of the International Financial Reporting Standards (NZ IFRS).
GAAP financial measure	Means a numerical measure of an issuer's or issuing group's historical or future financial performance, financial position, or cash flows, determined in accordance with GAAP.
Issuer	For equity securities (ie shares) it is the company or other business which the security is for.
Non-GAAP financial measure	Means a numerical measure of an issuer's or issuing group's historical or future financial performance, financial position, or cash flows used as an alternative to, or to supplement, a GAAP financial measure.
Non-GAAP profit measure	Means a non-GAAP financial measure used as an alternative to, or to supplement, net profit after tax.
Pro-forma financial information	Is non-GAAP financial information intended to show the effects of proposed, completed or hypothetical events or transactions on the financial position of a business, its performance, cash flows and/or prospects.

Feedback form: Consultation paper: Improving financial information in an equity PDS

Please submit this feedback form electronically in both PDF and MS Word formats and email it to us at consultation@fma.govt.nz with 'Improving financial information in a PDS: [your organisation's name]' in the subject line. Thank you.

Submissions close on Wednesday 31 May 2017.

Date: Number of pages:

Name of submitter:

Company or entity:

Organisation type:

Contact name (if different):

Contact email and phone:

Question number	Response
Q1	
Q2	
Q3	
Q4	
Q5	
Q6	
Q7	

Feedback summary – *if you wish to highlight anything in particular*

Please note: Feedback received is subject to the Official Information Act 1982. We may make submissions available on our website, compile a summary of submissions, or draw attention to individual submissions in internal or external reports. If you want us to withhold any commercially sensitive or proprietary information in your submission, please clearly state this and note the specific section. We will consider your request in line with our obligations under the Official Information Act.

Thank you for your feedback – we appreciate your time and input.