



Non  
GAAP

## **Improved Communication with Non-GAAP Financial Measures**

General Principles and Guidance for Reporting EBITDA and Free Cash Flow



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# PREFACE

*Improved Communication with Non-GAAP Financial Measures – General Principles and Guidance for Reporting EBITDA and Free Cash Flow* is published by CICA's Canadian Performance Reporting Board (CPRB). It contains general principles for reporting non-GAAP financial measures, and recommendations specifically directed at reporting Earnings Before Interest, Taxes, Depreciation, and Amortization, (EBITDA) and Free Cash Flow. The guidance should be useful in reporting any non-GAAP measure in any type of entity, wherever the measure is publicly reported, for example in Management's Discussion and Analysis, earnings press releases, and the CEO's letter in the annual report.

Non-GAAP financial measures have become increasingly popular among preparers and investors who find they provide additional insight into an entity's performance and financial condition. Indeed, the popularity of such measures extends beyond financial reporting and many financial agreements contain conditions that are determined by reference to a non-GAAP financial measure.

While non-GAAP financial measures are widely used, there are few rules governing their construction and disclosure. This leads to varied practices in reporting these measures, even among entities competing in the same industry. More standardization in their reporting, combined with more transparency in their disclosure, should improve their comparability between entities and enhance financial reporting communications. This is especially important in today's reporting environment where analysts' reports are demanded immediately after publication of an entity's results. Improved comparability and transparency should lead to more reliable non-GAAP financial measures and a reduction in uncertainty for investors, and consequently lower risk premiums in valuing investments.

While investors want more standardization in reporting non-GAAP financial measures, management needs to be able to tell its story. Accordingly, any guidance that advocates standardization needs to recognize that management must also be able to communicate non-GAAP financial measures that contain unique entity-specific matters which management believes investors should consider.

The general principles in this guidance discuss the characteristics of non-GAAP financial measures. Four general characteristics are identified: the measures rely on historical information in their construction; the measures are drawn from items included in the financial statements; the measures involve subjective judgement and estimates; and the measures are selective in the information they utilize. These characteristics are then reviewed in terms of their strengths and limitations. The general principles also discuss communications strategies for non-GAAP financial measures that emphasize their strengths and complement their limitations.

The guidance directed at reporting EBITDA and Free Cash Flow contains recommendations that address three pieces of information that investors need.

1. *Is the measure comparable between entities and consistent from period to period?*

For each of EBITDA and Free Cash Flow, the guidance recommends reporting a standardized measure that has a specified GAAP starting point and defined adjustments that are extracted directly from the financial statements. Accordingly, irrespective of the entity or the industry in which it operates, the standardized EBITDA and Free Cash Flow measures should always contain the same components and those components will have been constructed from the rigorous GAAP framework that applies to all entities.

2. *How and why does the entity-specific measure vary from the standardized measure?*

Entities often want to communicate entity-specific information in a non-GAAP financial measure. For example, management may wish to exclude a non-recurring expense from EBITDA that is retained in the standardized calculation. They may believe that such a cost is not representative of operating costs on an ongoing basis. The guidance recognizes the need for such entity-specific measures and recommends various disclosures that should accompany them. The purpose for each entity-specific adjustment should be explained. As well, to facilitate an understanding of the differences between the standardized and entity-specific measures, the entity-specific measure should be reconciled to the standardized measure. Finally, any entity-specific adjustment should be related to the relevant item in the financial statements, so that the reader is able to identify the amount of the item included in the financial statements and the financial statement caption in which that item is presented.

3. *What other information is necessary to understand the non-GAAP financial measure?*

By their nature, most non-GAAP financial measures use selective information from the financial statements. Accordingly, the guidance advocates additional disclosure to put the measure in context. For example, while Standardized Free Cash Flow is an indicator of the entity's continuing capacity to generate discretionary cash from operations, the entity's other financing and investing activities compete with or complement Free Cash Flow. Therefore, the guidance recommends additional disclosures that explain the relationship of the entity's Standardized Free Cash Flow to its other investing and financing activities.

While this guidance focuses on reporting EBITDA and Free Cash Flow, the CPRB believes that the general principles, entity-specific guidance, and complementary disclosures should be helpful in deciding how to report any non-GAAP financial measure. This material does not purport to deal with every issue encountered when providing disclosures about EBITDA and Free Cash Flow. Accordingly, future

releases may be necessary to address issues within these measures, for example in EBITDA, normalized earnings and issues from Other Comprehensive Income, such as foreign currency gains and losses from translation of foreign subsidiaries. As well, future releases may be needed as Canada moves to International Financial Reporting Standards.

*Improved Communication with Non-GAAP Financial Measures* was developed by the Beyond-GAAP Measures Task Force of the CPRB. Task Force members are drawn from the preparer, investor, academic, and auditor communities, and the development process involved consultation with preparers, investors, and securities regulators. The CPRB would like to thank the Beyond-GAAP Measures Task Force for their dedication in developing this material. The CPRB would also like to thank all those who provided advice to the Task Force during the material's development.

This guidance has taken into consideration comments received on an earlier draft that was published in February, 2008. The more significant changes are set out in the appendix. The CPRB plans to monitor application of this material and consult further with preparers and users about any additional revisions. This guidance complements earlier material that provided a framework for reporting distributable cash in income trusts and other flow-through entities. The distributable cash material may, at some future time, be incorporated into this document.

The CPRB encourages comments on this guidance that should be sent to:

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# I. GENERAL PRINCIPLES

## A. INTRODUCTION

### Objective of non-GAAP financial measures

Non-GAAP financial measures, such as Earnings Before Interest, Taxes, Depreciation<sup>1</sup> and Amortization (EBITDA), Distributable Cash, and Free Cash Flow, are widely used by both management and investors. They provide management and users with additional analytical insight into an entity's performance and financial condition, expanding on the information provided by GAAP financial statements.

### Nature of CPRB guidance

This guidance provides general recommendations on the preparation and disclosure of non-GAAP financial measures to assist preparers in effectively communicating and users analyzing those measures. These general principles discuss the characteristics of the measures, and advocate the use of standardized and entity-specific measures and disclosure of contextual and complementary information that can enhance users' understanding of the measures. The general principles were developed in conjunction with guidance for the specific non-GAAP financial measures EBITDA, Free Cash Flow and Distributable Cash. These principles, however, together with the recommendations related to entity-specific measures and disclosure of contextual and complementary information, should provide useful guidance for reporting any non-GAAP financial measure, including EBIT and adjusted earnings per share.

### Importance of non-GAAP financial measures

The importance of non-GAAP financial measures is demonstrated by their use in many contexts beyond financial reporting to investors. Debt covenants may stipulate that an entity shall maintain a defined EBITDA measure in excess of a specific amount (or in a ratio greater than a specific number). Executive compensation plans may incorporate various measures of corporate performance, including measures of EBITDA, to determine levels of compensation. Purchase and sale agreements for a business may stipulate either an initial purchase price or additional contingent consideration based upon an EBITDA measure. The incorporation of such measures in private contracts supports the conclusion from interviews with preparers and investors that such non-GAAP financial measures provide incremental information value beyond that found in GAAP information.

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<sup>1</sup> For financial statement presentation and disclosure, many entities refer only to amortization, the term used in the *CICA Handbook* that includes both depreciation and depletion.

#### Location of non-GAAP financial measures and related disclosures

Management decides whether to report non-GAAP financial measures and related disclosures in an entity's MD&A and other communications. This material has been developed to assist preparers and users by offering presentation and disclosure guidance that preparers may use to improve comparability, consistency and transparency of reporting and expedite users' understanding of such measures. While this guidance focuses on reporting in MD&A, it is equally applicable in any public document, for example a press release or the CEO's letter<sup>2</sup>.

## B. THE OBJECTIVE OF CPRB RECOMMENDATIONS FOR NON-GAAP FINANCIAL MEASURES

#### Wide variety of practices in reporting non-GAAP financial measures

Prior to this guidance, there were no standard definitions of non-GAAP financial measures. There have been a wide variety of practices observed in their reporting, even among entities competing in the same industry. For example, some companies exclude non-recurring items such as restructuring costs in an attempt to arrive at a normalized amount while others do not. Despite such observations, non-GAAP financial measures are informative and their disclosure is often driven in part by investors. Investors find managements' insights into the recurring and non-recurring nature of events useful, and frequently employ such classifications themselves.

#### Responding to investors' needs

Investors have indicated that it would improve the process of comparing and assessing performance if there were standard definitions for these measures. This is particularly important in the current environment where analysts' reports are expected immediately after management has published information. In addition, investors want disclosures that explain the reasons for entity-specific adjustments and how an entity's non-GAAP financial measures relate to its environment.

#### Improve comparability without sacrificing informativeness

The reorganization of non-GAAP financial measures into standardized and non-standardized or entity-specific elements such as recurring and non-recurring components should enhance the communication process without sacrificing informativeness.

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<sup>2</sup> When the information is forward-looking, it should be accompanied by the disclosures specified by the securities regulators.

In addition, the information value of non-GAAP financial measures is further enhanced by the presentation of a suite of complementary information in the same manner that notes to financial statements complement the GAAP numbers. This information should help the investor appreciate why management believes entity-specific adjustments are important to understanding the entity's performance, how entity-specific adjustments are computed, and how they relate to items reported in the financial statements. As well, the complementary information provides context for understanding a measure and its limitations.

The combination of improved comparability and increased transparency that the guidance advocates should lead to less uncertainty for investors. This should result in investors applying lower premiums in a valuation model. For example, investors have told us that net debt to EBITDA is an important ratio in many circumstances, but one that does not receive the attention it deserves because investors often have little confidence in the EBITDA element of the ratio.

## C. THE CHARACTERISTICS OF NON-GAAP FINANCIAL MEASURES

A consideration of the characteristics of non-GAAP financial measures helps to identify the components that should be incorporated in a standardized measure and areas where additional contextual information should be provided. Four general characteristics of most common non-GAAP financial measures have been identified: first, they generally rely on historical information; second, they are drawn from items included in the financial statements; third, they frequently involve subjective judgements and estimates; and fourth, they provide selective information in an accounting sense.

### Historical information

Investors generally seek information on the future cash flows that they can expect from their investments. This could be accommodated by entities' publication of forecasted measures. However, the institutional framework governing the presentation and disclosure of forward-looking financial information in Canada, including forecasts of financial information, adds significant responsibilities for issuers of such information. In light of these responsibilities, and the related legal liabilities of the entity and its officers and directors, many issuers are reluctant to publish forward-looking financial outlooks or statements.

Consequently, financial information in an MD&A, including non-GAAP financial measures, is often restricted to historical information that facilitates the analysis of important trends and developments. If preparers present a non-GAAP financial measure in their MD&A, there should be no requirement for the measure to use

forward-looking information. It is expected that users of financial statements will be able to form their own forward-looking expectations by extrapolating trends evident in the historical data, and using their judgement on how future events will affect those trends. Such extrapolations would undoubtedly be assisted by the provision of contextual information that is pertinent to their cash flow forecasts.

#### Drawn from items included in the financial statements

Non-GAAP financial measures are drawn from items included in the financial statements that are prepared in accordance with the rigorous framework of GAAP, and where a reasonable degree of assurance is already provided by the auditor, at least annually. Non-GAAP measures also inherit the limitations of the GAAP measures from which they are derived. Variations in GAAP accounting policies between entities in the same business can extend to non-GAAP financial measures that incorporate amounts affected by such policies, leading to a lack of comparability in their respective EBITDAs.

Non-GAAP financial measures usually cover the same time period as the related financial statements. In interim financial reports, however, an entity may wish to disclose a measure on a trailing 12 month basis. When an entity makes such a determination, the 12 month period should include the cumulative period addressed by the related financial statements and should explain why a trailing 12 month basis provides meaningful information.

#### Use of subjective judgements and estimates

To provide effective communication, non-GAAP financial measures should enable preparers to convey their perspective on information that may not be evident from the constraints of GAAP-prepared financial information. In some cases, such information will convey management's judgement of the likelihood that an event will recur, e.g., classifying a transaction or event as "non-recurring."

Management may believe that such non-GAAP information provides valid insights into the entity's future income stream or cash flows. On the other hand, the signals conveyed by the non-GAAP information may in fact be invalid, i.e. the managerial expectations or characterization of the event may be mistaken. Non-recurring transactions may in fact recur, or the characterization of "non-recurring" may be biased, focusing only on the elimination of expenses and not providing an equivalent characterization of revenues.

A strength of non-GAAP financial measures is that they add an additional characterization of events not found in the financial statements. A limitation is that they may be based on subjective judgements and may be subject to bias. For such measures to be informative, an entity should be able to establish a credible basis for making such statements, apply it equally to all circumstances, and communicate that credibility to the user.

## Selective information

Non-GAAP financial measures either omit certain attributes of the GAAP measure or add in amounts omitted in the nearest GAAP measure. For example, management may omit an item expensed in the period's financial statements because it considers that item to be not strategically relevant or not representative of the cost of its replacement. This characteristic can lead to non-GAAP numbers that are positive when the relevant GAAP number is negative, i.e. a loss. The non-GAAP number can be used to generate inter-period comparative ratios such as percentage changes that would not be meaningful if the negative GAAP number were to be used. Research indicates that EBITDA measures are more prevalent in firms that incur losses measured in accordance with GAAP<sup>3</sup>. The ability to facilitate comparisons with positive numbers is undoubtedly a benefit of such measures. The limitation is that the message embedded in the negative GAAP measure may be overlooked – if it is relevant. An EBITDA measure, for example, may fail to indicate that an entity is unable to recover its initial investment in capital assets – which may be relevant if the assets need to be replaced for the entity to continue in business.

## Distinguish between objective and entity-specific measures

The above-noted analysis indicates two types of characteristics related to non-GAAP financial measures: those that are objective and drawn from the financial statements, and those that are subjective and judgmental, related to the specific circumstances of the entity. These translate to two types of non-GAAP financial measures: standardized measures and entity-specific measures.

## D. COMMUNICATIONS STRATEGIES THAT EMPHASIZE THE STRENGTHS AND COMPLEMENT THE LIMITATIONS OF NON-GAAP FINANCIAL MEASURES

The general purpose of this guidance is to provide preparers with recommendations that will enhance the communication of the information in non-GAAP financial measures. There are two types of Recommended Practices that should accomplish this objective: first, the employment of standardized definitions in the disclosure of non-GAAP financial measures with separate discussion of entity-specific adjustments; and second, the provision of information that complements such measures.

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3 See "Voluntary Disclosure of Free Cash Flow Information," A. Adhikari and A. Duru, *Accounting Horizons* (Vol. 20, No. 4 December 2006) pp. 311-332.

#### Standardized measures supplemented by entity-specific information

To provide a basis for improved consistency, comparability and transparency in reporting, the CPRB recommends that entities adopt a standardized calculation for reporting EBITDA, Distributable Cash and Free Cash Flow. The guidance for those measures provides elements to be included and excluded from such standardized calculations. To convey information not found in such a standardized measure that management judges to be relevant to an entity, this guidance contemplates “Adjustments” to standardized measures. Such adjusted amounts would be identified separately using appropriate terminology. This approach permits entities to convey both standardized and entity-specific information to investors.

#### Complement the measure with additional information

Non-GAAP financial measures reflect only selected aspects of GAAP. Accordingly, this guidance advocates disclosure of a suite of additional information to complement the measure and enable the user to assess the implications of the measure. For example, the EBITDA measure excludes the effects of financing and taxation, which may depend on the culture and history of the entity. To complement the EBITDA measure, investors could be informed of the entity’s financing strategy and the manner in which the entity considers financing matters in maximizing shareholder value or creditor security. Similarly, non-GAAP financial measures that focus on liquidity, such as Distributable Cash and Free Cash Flow, could be complemented by discussions of the other investing and financing transactions, and their significance for understanding the entity’s sources and uses of cash. These matters are more completely discussed in the recommendations addressing specific non-GAAP financial measures.

#### Relationship of CPRB guidance to securities regulators’ requirements

Securities regulations require various disclosures when issuers report non-GAAP financial measures. These requirements include reconciliations of non-GAAP financial measures to the most directly comparable GAAP number, disclosure of the purpose for the measure, and how the measure is used in managing the business<sup>4</sup>. Securities regulators also provide a definition for a non-recurring item.

The CPRB hopes that this guidance’s additional specificity about components of measures and expanded disclosures will complement the securities regulators’ material and provide a framework for disclosure.

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<sup>4</sup> CSA Staff Notice 52-306

## E. SUMMARY OBSERVATIONS

Non-GAAP financial measures are an important part of the financial reporting process, and are useful in communicating information that complements and supplements the financial statements. Such measures have their strengths and limitations. These recommendations address issues that have challenged users who have been dealing with those limitations. Standardized definitions would improve the communication of the basic message. Entity-specific adjustments should be presented after the standardized measure has been calculated. Contextual information that complements the limitations of a specific non-GAAP financial measure enhances the user's understanding of the measure. Using these principles, the CPRB is publishing recommendations on selected specific measures in the belief that they will benefit entities wishing to improve the communication process and users wishing to enhance their comprehension of an entity's performance.

The following recommendations address specific matters that arise from the use of EBITDA and Free Cash Flow. There is no finite universe of non-GAAP financial measures: the initial recommendations focus on the most commonly used measures. As previously noted, the CPRB believes that the general principles identified here can be usefully applied in most circumstances involving non-GAAP financial measures, and encourages preparers and users to employ these general principles wherever possible.



## II. EBITDA

Following the general principles set out in Section I, this guidance: (i) provides a standardized definition of EBITDA; (ii) encourages entity-specific EBITDA disclosures; and, (iii) recommends contextual disclosures that complement EBITDA.

EBITDA is the most common non-GAAP financial measure and is widely used by investors. Accordingly, the CPRB encourages entities to present EBITDA measures. Such information, presented in accordance with this guidance, should lead to more effective and comparable communications.

### A. USES FOR EBITDA

#### EBITDA as a measure of operating performance

EBITDA is conventionally measured as net income before discontinued operations, as reported in accordance with GAAP, plus interest expense, taxes, depreciation<sup>5</sup>, and amortization (all elements being as reported in the GAAP financial statements). Stated directly, EBITDA is the entity's revenue less its operating costs before the costs of consuming capital assets, financing, and taxes. As such, EBITDA is a measure of income, specifically directed at an entity's operating performance without the effects of its finance strategy or the recognition of certain costs for its tangible and intangible capital assets. EBITDA has application beyond financial reporting and is often the operating performance measure used in debt covenants and executive compensation plans.

#### EBITDA as a facilitator for valuation

EBITDA is frequently used to facilitate an “enterprise-level” valuation of an entity - that is, a valuation of the entity's total assets excluding the effects of taxation and financing<sup>6</sup>. For these purposes, EBITDA is multiplied by a factor or “EBITDA multiple” that is based on observed or inferred relationships between EBITDA and market values to determine a first approximation of Enterprise Value – an entity's total asset value without considering the value of the obligations it has assumed. Such estimates are then corroborated by other methods, such as discounted cash flow analysis or a valuation based on gross revenues. The equity value of an entity is then determined using some assumptions about the magnitude and characteristics of debt

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5 For financial statement presentation and disclosure, many entities refer only to amortization, the term used in the CICA Handbook that includes both depreciation and depletion.

6 For an example of the discussion of the valuation of an entity's assets employing independent valuation, financing and tax attributes, see M. Grinblatt and S. Titman, *Financial Markets and Corporate Strategy*, McGraw Hill: 1998 pp 455 – 464.

and other obligations. This valuation is then compared with other equity valuation techniques, such as earnings per share models.

#### EBITDA as a proxy for cash flow

Occasionally, EBITDA is described as a proxy for cash flows from operations<sup>7</sup>. There are some potentially significant differences, however, between EBITDA and cash flows from operating activities, particularly as the latter is currently defined in North American GAAP. Even ignoring the cash costs of financing activities and taxes, there is no recognition in EBITDA of the effects of changes in operating working capital balances. These may have significant effects on cash flows when an entity is growing quickly, or in a seasonal business that involves variations in inventory levels. If working capital balances fluctuate significantly, there will be material variations between cash flow from operating activities before financing costs and taxes and the EBITDA calculation.<sup>8</sup>

For these reasons, a direct cash measure such as the actual cash flows from operating activities or a non-GAAP measure such as Free Cash Flow may be a more appropriate proxy for cash flow to be used in a valuation model. Both will vary as seasonal and other factors affect cash receipts and disbursements.

Despite these observations, it is likely that EBITDA will continue to be used as a proxy for steady-state estimates of operating cash flows. Its ease of computation and exclusion of significant “IT” and “DA” charges will undoubtedly contribute to its continued use for this purpose.

## B. ADJUSTMENTS MADE IN ARRIVING AT EBITDA

In formulating a definition for Standardized EBITDA and types of contextual information that will complement the measure, it is useful to consider the adjustments made in arriving at EBITDA.

#### Cost of consuming capital assets

By design, EBITDA does not recognize any expense for the consumption of capital assets. Despite this limitation, management and investors still consider EBITDA a relevant performance measure for several reasons:

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7 See F.K. Reilly and K. C. Brown, *Investment Analysis and Portfolio Management*, Thomson South-Western (2006) pp 304 – 307.

8 Research has shown that there is a significant correlation between EBITDA and operating cash flows before these provisions, but the correlation breaks down when changes in working capital are eliminated from operating cash flows. See Foster, *Financial Statement Analysis*(2<sup>nd</sup> ed.) p. 80. “When more refined adjustments to derive a cash flow measure are made, the resultant series is much less correlated with the original net income series.”

- Amortization under GAAP is generally determined by reference to a historical cost measure (“generally” because this would not be true for newly acquired or recently written down assets). In essence, income computed including this cost may indicate management’s “stewardship” of their original investment, but may not be indicative of the costs to replace that capacity, if it is so desired. Clearly, historical cost amortization does not provide users with information they would need to estimate “economic earnings” or act as a proxy for future cash outflows to maintain that capacity.<sup>9</sup>
- Even assuming GAAP amortization measures are investor-relevant, they may not be comparable between entities because of inconsistencies in the treatment given to internally developed and externally acquired assets. Two technologically identical entities with significant intangible assets such as brand names, innovative technologies, or customer contracts, may have very different amortization costs. One entity may capitalize and amortize intangibles because they arose as a result of acquisitions. The other may have no amortization expense as the intangibles are developed internally and are not capitalized. In these two entities, the operating income after amortization will not be comparable. After the period of development or acquisition of intangible assets, however, their respective EBITDA should be comparable measures of operating performance.
- Ignoring tax consequences, the cost of past investment decisions (or the amortization thereof) is not a factor in determining the entity’s future cash flows for any group of assets.<sup>10</sup> Once the decision has been made to invest in a plant, particularly one which is incapable of being used for any other purpose - such as a mine -- its cost may not be relevant at all. The only economic attribute of interest would be the future revenues from its operation or sale. Its historical costs are irrelevant to decisions such as the rate of exploitation or sale or abandonment. Hence, a measure of returns such as EBITDA that excludes the historical cost of capital assets may be very relevant to management and investors when evaluating strategic decisions.

## Interest costs and taxes

By eliminating interest expense and, more generally, financing charges and income taxes, EBITDA presents a measure of the ability of an entity’s assets to generate earnings separate from management’s decision to apply financial leverage. EBITDA thus provides a basis for comparing entities’ performance that is independent of financing arrangements and accordingly simplifies comparisons between entities that have different financial structures. As a pre-tax measure, EBITDA is also free from the effects of tax policies, the impact of which will be dependent in part on an entity’s financing strategy. Accordingly, to value an entity’s equity from a measure of

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9 SEC Accounting Series Release 142

10 This may not be true for rate regulated industries, or industries in which there is a “normalized” return on assets.

EBITDA, users must estimate the extent to which the entity will employ leverage and incur taxes.

#### Non-recurring items

Operating charges reported in accordance with GAAP often include amounts that management may consider to be one-time or non-recurring, such as restructuring, gains and losses on investments, and other unique transactions. Management frequently excludes such amounts from EBITDA in an attempt to produce an EBITDA that represents “normalized” operating income. On the one hand, excluding non-recurring items from EBITDA introduces the possibility of selecting only unfavourable transactions as non-recurring, substantially increasing the risk of generating a measure that is biased and inconsistent. On the other hand, leaving non-recurring items in EBITDA provides more complete information about operations that, being specific to the entity, have a cost in reduced comparability. Analysts indicate that they do desire information about non-recurring items. However, analysts also want to decide for themselves how to incorporate such items into their models.

## C. DEFINITION AND DISCLOSURE OF EBITDA

Users have indicated that a degree of standardization in the definition of EBITDA is desirable for the measure to be comparable across entities. Managements, however, use EBITDA to communicate qualitative information about certain components of the earnings process – the likelihood of persistence of specific expenditures, for example. Accordingly, a standardized approach to the communication of EBITDA needs to also recognize management’s desire to provide qualitative information. Therefore, the approach should provide comparable elements, i.e. standardized elements, as well as enable the disclosure of entity-specific elements. To do this, the CPRB recommends that entities prepare EBITDA disclosures in accordance with the following guidance.

#### A Standardized Definition of EBITDA

A standardized definition for EBITDA should reflect the elements of EBITDA that are drawn from objective data. In particular, the CPRB believes that Standardized EBITDA should reflect EBITDA in its simplest form – E-B-I-T-D-A, where all the adjustments are items reported in the financial statements. The CPRB also believes that Standardized EBITDA should be accompanied by a brief explanation of what the measure represents.

#### *Recommended Practice*

**A Standardized definition of EBITDA (in indirect form) is:**

- (i) **net income or net loss before discontinued operations as reported in the GAAP**

financial statements, including that net income or net loss related to any non-controlling interest, excluding amounts disclosed in arriving at net income or net loss in accordance with GAAP for:

- i. income taxes;
- ii. interest expense; and
- iii. amortization and impairment charges for capital assets.

The Standardized EBITDA calculation should be reconciled to net income or loss for the period determined in accordance with GAAP. It should also be accompanied by the following explanation of what the measure represents:

Standardized EBITDA represents an indication of the entity's capacity to generate income from operations before taking into account management's financing decisions and costs of consuming tangible and intangible capital assets, which vary according to their vintage, technological currency, and management's estimate of their useful life. Accordingly, Standardized EBITDA comprises revenues less operating costs before interest expense, capital asset amortization and impairment charges, and income taxes.

To avoid confusion, a measure of EBITDA that varies from the above-noted definition should not be described as Standardized EBITDA.

The standardized measure includes amounts related to any non-controlling interest as 100% of the assets of the consolidated subsidiary are included on the consolidated balance sheet (less inter-company accounts). Similarly, since investors use EBITDA to evaluate the continuing entity, this guidance excludes from EBITDA the results of discontinued operations that will not feature in future earnings.

### Entity-specific EBITDA disclosures

Management may wish to communicate entity-specific items that are not addressed in the standardized EBITDA definition. In that event, an entity-specific EBITDA should be presented in addition to Standardized EBITDA. The CPRB recommends distinguishing between the Standardized EBITDA measure and entity specific amounts because such a distinction promotes comparability while highlighting important entity-specific adjustments without requiring significant work by the user.

### *Recommended Practice*

The CPRB recommends that when additional entity-specific adjustments are made in the computation of EBITDA:

- i. these amounts should be separately disclosed after the computation of Standardized EBITDA;
- ii. the adjusted amount should be reported as Adjusted EBITDA;

- iii. the purpose for each adjustment should be discussed;
- iv. a reconciliation should separately disclose each adjustment between Adjusted EBITDA and Standardized EBITDA;
- v. for each adjustment, the corresponding item in the financial statements should be quantified; and,
- vi. the financial statement component which contains the corresponding item should be identified.

*Consistency in reporting entity-specific amounts*

These Recommended Practices should assist investors to quickly assimilate and understand the nature, amounts, and reasons for entity-specific adjustments. This is facilitated when the nature of entity-specific adjustments is consistent from period to period, both with respect to the types of items adjusted and their computation. As well, adjustments should be consistent within the period. For example, when an adjustment is made for non-recurring costs, there should also be an adjustment for any non-recurring income. When a change is made to the components of the entity-specific measure, users' understanding will be enhanced if the reason for the change is explained and comparative amounts are presented in accordance with the new basis.

*Considerations in determining entity-specific adjustments*

Many entity-specific adjustments to Standardized EBITDA will likely reflect incremental information about non-recurring expenses such as merger and acquisition expenses, restructuring costs and litigation settlements. There is no GAAP definition of "non-recurring". However, guidance on use of this term is provided by the securities regulators in CSA Staff Notice 52-306. Following that guidance should assist in ensuring that the same criteria are applied by all entities.

In addition to non-recurring items, the following are examples of other matters that entities have adjusted in arriving at an entity-specific measure:

- i. **Rent payments** Under GAAP, capital leases are treated by the lessee as capital assets that are depreciated over their useful lifetime and by the lessor as discounted or interest-bearing obligations for rent. In the standardized calculation of EBITDA, amortization charges for assets acquired through capital leases would be added back (under the indirect method). Similarly, the interest element of the capital lease payment would also be added back. Operating leases, on the other hand, are expensed, generally in a straight-line manner over the term of the lease. They are not added back when only amortization and interest are considered in the computation of EBITDA.

Management may believe that both capital and operating lease contracts provide substantively the same service. The pro-forma capitalization of operating leases by credit rating agencies in the determination of credit risk analysis may reinforce this view. Management may therefore conclude that EBITDA should be

measured after adding back lease or rent payments for operating leases.

As noted, the definition of Standardized EBITDA does not contemplate the adding back of rent payments on operating leases. The treatment of operating lease expenses as capital assets when calculating standardized EBITDA would be a challenging task in the current GAAP environment. The re-characterization of operating lease expenses as capital items would involve a significant work effort that may challenge preparers who commonly acquire items such as photocopiers and office premises under operating leases. Hence, the CPRB believes that the add-back of operating lease payments or expenses should be considered only as an entity-specific adjustment.

- ii. **Asset retirement obligations** The calculation of Standardized EBITDA adds back amortization and hence eliminates the asset retirement obligation (ARO) expense related to the amount that is capitalized into the cost of assets. Unlike the related capital assets, however, expenditure on AROs is not elective. Accordingly, management may conclude that such amounts should be addressed in an entity-specific adjustment. Alternatively, these obligations should be taken into account in any discussion of an entity's financing policies.
- iii. **Post-employment benefit under/over-funding** The calculation of Standardized EBITDA includes any amounts charged to expense that arise from pension accounting under GAAP. The GAAP treatment of pension obligations and other post-retirement benefits involves calculations that do not reference the entity's actual cash contribution rate. An entity's funding may be more or less than the amount expensed in a year, which may involve amortization of actuarial gains and losses, unfunded opening balances, and a variety of other non-cash items. Significant costs or benefits may therefore exist that are not recognized in EBITDA (an issue that also exists in net income).

In a manner similar to the treatment of AROs, if under-funded or over-funded pension obligations have not been reflected in earnings, it is recommended that their impact be reflected either through an entity-specific adjustment, or through a discussion of the financing policies that should explain the policy for funding pension obligations.

- iv. **Stock compensation expenses** Under GAAP, entities must reflect in compensation expense the cost of stock-based compensation. The method of calculating that expense depends on the nature of the arrangement. In some circumstances, stock-based compensation may involve significant accruals of amounts that will not be settled in cash, but may be settled by the issuance of shares in exchange. Share-linked settlements may result in the obligation being subject to significant volatility as the price of the underlying shares fluctuates.

Some managements add back stock compensation expense because they don't believe it should be considered in assessing performance. We understand that

some disagree with its accounting treatment because of its volatility. Others don't believe it captures the true cost of the arrangement. Nonetheless, stock-based compensation is an operating expense that is accounted for in accordance with GAAP. It reflects part of the entity's compensation costs and is not related to financing costs, taxes, or the consumption of capital assets. Accordingly, there does not appear to be a good argument for omitting such amounts from EBITDA. This is particularly true when comparability of measures is an objective of reporting EBITDA, for example when one entity compensates its management with cash measures while the other uses stock-based compensation.

When an entity adds back stock-based compensation in arriving at an entity-specific EBITDA, the CPRB believes that, in addition to discussing the purpose for the adjustment, there should also be a discussion of the extent to which the transaction has had a dilutive impact on the entity's equity.

#### *Segmented EBITDA measures*

Even when EBITDA is not the performance measure determined by GAAP for segment reporting, it would still be useful to disclose EBITDA by segment when EBITDA is reported for the entity as a whole. In that case, it is suggested that both the standardized and entity-specific measure be presented for each segment and that the entity-specific measure be applied consistently to each segment.

## D. CONTEXTUAL DISCLOSURES THAT COMPLEMENT EBITDA

As discussed above, EBITDA has various strengths as a performance measure. As well, used in isolation, it has limitations due to the exclusion of any measure of the costs of consuming capital assets, and the costs of finance and taxation. The CPRB believes that the communication of EBITDA information should include disclosure that complements the measure by providing investors additional information about these matters so that EBITDA can be placed in context.

#### *Recommended Practice*

**To enhance the communication of EBITDA, entities should complement Standardized EBITDA with additional disclosures about the specific circumstances of the entity's capital assets and finance strategy.**

#### Capital assets

EBITDA does not recognize any costs for the consumption or replacement of capital assets even though such costs exist in most entities that are going concerns. Accordingly, there should be some discussion of the entity's productive capacity,

including the trend in costs to maintain capacity and produce the current level of EBITDA. For more information about suggested disclosures, see the discussion about the relationship of an entity's capital expenditures to its productive capacity strategy in the Free Cash Flow section of this guidance.

### Financing strategy

The absence of the entity's financing and tax expenses in EBITDA is appropriate when comparing the operating performance of different entities' assets. In equity valuation exercises, however, it is assumed that the user needs to make an estimate of the effects of financing and income taxes to determine the valuation of equity. Making that estimate is facilitated when an entity communicates its financing strategy along with its EBITDA measures. This could include such matters as the entity's target debt to equity or leverage ratio, the degree to which it has fixed but uncapitalized commitments such as operating leases and purchase commitments, and the likelihood of compliance with covenants. Some of this information should already be provided in the MD&A table of contractual obligations and the statement of capital disclosures required by Canadian GAAP.

### Capital intensity and potential biases in EBITDA measures

EBITDA is a measure of performance that recognizes the cost of labour but does not contemplate the costs of acquiring, consuming, and disposing of an entity's capital assets, which may substitute for labour expenses. Comparisons of EBITDA measures across entities, therefore, would not reflect potential differences in the "capital intensity" of the entities' operations. This could lead to misleading or biased comparisons of EBITDA, if one entity was in fact more "capital intensive" and less "labour intensive" than a competitor/comparable enterprise. Comparatively higher EBITDA in the capital-intensive entity due to lower labour costs may well be compensated by higher capital expenditure rates. Accordingly, the CPRB believes it would be useful when discussing EBITDA to consider a discussion of the relative ratios of labour and capital (or other significant inputs, such as energy), in the communication of the significance of EBITDA for an entity. A similar potential for biased comparison that would benefit from discussion is the circumstance where one entity capitalizes and amortizes a particular cost while a competitor expenses the cost.



# III. FREE CASH FLOW

Following the general principles set out in Section I, this guidance: (i) provides a standardized definition of Free Cash Flow; (ii) encourages entity-specific Free Cash Flow disclosures; and, (iii) recommends contextual disclosures that complement Free Cash Flow.

Free Cash Flow is a measure that is becoming increasingly popular with investors. Accordingly, the CPRB encourages entities to present Free Cash Flow measures. Such information, presented in accordance with this guidance, should lead to more effective and comparable communications.

## A. USES OF FREE CASH FLOW

The cash flows of an entity can be analyzed in a variety of fashions. The GAAP cash flow statement classifies them by operating, financing, and investing categories. Other aggregations of cash flow are used by preparers and investors in analyzing the periodic amounts of cash generated and consumed by an entity. These involve combining the operating activities with some elements of the financing and investing activities in order to provide a measure of the internally generated cash flow available for debt repayment, internal growth, or distributions to shareholders.

Many entities report one such measure, Free Cash Flow, as an indicator of financial strength and performance. Free Cash Flow measures the amount of cash from operating activities net of capital expenditures (“capex”) available for activities such as repayment of debt, distributions to owners, and investments in future growth through acquisitions. The primary objective of Free Cash Flow is to assist users in projecting future cash flows for valuation purposes, but the measure may also assist in determining an entity’s ability to maintain liquidity and operations for the foreseeable future.

Given the lack of a generally accepted definition, there are many different calculations of Free Cash Flow used by preparers. The CPRB believes that more effective and efficient communication of this information would be accomplished by some degree of standardization in the definition of Free Cash Flow. Likewise, distinguishing and discussing the components of an entity-specific definition from the standardized definition would enhance the efficiency and effectiveness of the communication.

## B. BASIS FOR CALCULATING FREE CASH FLOW

Free Cash Flow is a measure of cash generated from operations

A strength of Free Cash Flow measures is that they focus on cash flows (hence the label) and thereby avoid some of the complexities of earnings measures' allocations and accruals. The measure is based on an entity's ability to generate operating cash. Accordingly, most definitions of Free Cash Flow employ cash flows from operating activities as the starting point for the calculation.

As a measure based on operating cash flows, many entities' Free Cash Flow reflects the cash provided from or used in changes in working capital, consistent with the GAAP measure cash flows from operating activities. Some entities, however, exclude such changes in working capital from their measure of Free Cash Flow because they view these changes as timing differences under management's control that obscure the underlying cash flow trends.

Free Cash Flow reflects outlays for capital expenditures

In a going concern, expenditure on capital assets is clearly one of the most significant uses of operating cash, as the entity reinvests in capital assets in order to maximize shareholder wealth. The net amount of operating cash flows and capital expenditures provides an indication of the entity's need for external financing. For a profitable yet growing firm, for example, capital expenditures may exceed cash from operations, resulting in a need for additional cash despite profitability. On the other hand, a marginally profitable entity may only require minimal spending on replacement capacity. Such a firm may have the ability to distribute cash from operations by paying down debt, or making distributions in the form of dividends or share repurchases. These are the signals, distinct from profitability, that are effectively communicated by a Free Cash Flow measure.

Free Cash Flow does not address various financing and investing activities

Free Cash Flow's strength as a measure focuses on operating cash flows. This focus is also a limitation in that it is a selective measure of an entity's cash flows. An understanding of an entity's cash flow is incomplete without insights into its other financing and investing activities.

Generally, Free Cash Flow measures do not reflect financing activities such as paying dividends and refinancing debt – implying that these are discretionary uses of the “free cash”. Some of these activities may be non-discretionary, however, for example paying debt on its maturity in the absence of rollover or refinancing provisions. If Free Cash Flow measures are to be used effectively, the user needs to be able to distinguish such activities from those that are in fact at the discretion of management.

As well, Free Cash Flow normally does not include cash expended or received on account of acquisitions or disposition of discontinued operations. M&A activity in particular may represent an alternative to capital expenditures using cash for the maintenance or growth of productive capacity.

Accordingly, Free Cash Flow should not be viewed in isolation, but rather in conjunction with contextual disclosure that discusses an entity's other financing and investing activities.

### Free Cash Flow includes financing-type activities that are characterized as operating activities

While Free Cash Flow measures do not generally include the financing activities that are presented in the cash flow statement, there are various financing-type transactions that are characterized by GAAP as operating activities and consequently included in the definition of Free Cash Flow when paid or received. These activities can either accelerate or defer the cash flow related to the transaction in question. Consider, for example, the cash flows associated with an enhancement of prior period service benefits as part of a labour agreement. A cash flow may occur shortly after the initiating transaction, or it may not occur for several years.

Other finance-like transactions that affect operating cash flows involve varying degrees of management discretion. For example, cash flows for a period may be enhanced by a securitization of receivables, which is essentially a short-term acceleration of cash flows resulting from an activity almost completely at management's discretion.

When financing-type activities exist that are characterized as operating activities under GAAP, it may be difficult to determine the nature of the source of such "free" cash without additional disclosure or analysis.

### Communication of Free Cash Flow

The communication of Free Cash Flow should emphasize its ability to indicate when a highly profitable entity is in need of finance, such as when it is in growth mode. It should also be able to indicate the opposite condition - a marginally profitable entity that has excess cash because of minimal capital expenditure requirements. Effective communication should also recognize that, in isolation, the measure has limitations. For example, it does not reflect "other" cash transactions and M&A activities.<sup>11</sup> Neither does it present a picture of discretionary cash when other claims such as debt repayment are compelling. Accordingly, other disclosures need to complement the Free Cash Flow measure so that a suite of information is presented, such as the nature and extent of other sources, and the total other uses of cash. When Free Cash Flow

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<sup>11</sup> It has been noted that entities that suspend share buy-back programs are often stockpiling cash to use in acquisitions.

is negative, the discussion should consider the sources of cash (if any) that offset the negative Free Cash Flow. When Free Cash Flow is positive, the discussion should address how that cash is being used.

## C. DEFINITION AND DISCLOSURE OF FREE CASH FLOW

Formulating a definition of Free Cash Flow that standardizes its calculation and thereby enables comparisons necessarily involves making some judgements and choices. The CPRB recommends that Standardized Free Cash Flow reflect cash flows from operating activities less capital expenditures net of proceeds of dispositions other than those related to discontinued operations, with no deduction of dividend payments unless the dividend is stipulated, and with no exclusions for changes in working capital. To facilitate its understanding, the CPRB believes that Standardized Free Cash Flow should be accompanied by a brief explanation of what the measure represents.

This definition of Free Cash Flow will not necessarily result in a measure that represents the net cash generated in the period that is available for use at management's discretion. Rather, as cash from operating activities net of capital expenditures and those dividends that are more representative of interest costs, the measure should be an indicator of the entity's capacity to generate discretionary cash from operations. Other sources of cash, for example proceeds from raising new capital or selling discontinued operations, will generally not be a continuous source of cash. The notion that Free Cash Flow is "free" may be incorrect. There may be little discretion in some of the entity's other cash transactions, for example payments required under debt agreements. In these circumstances, however, in a going concern, it would generally be expected that the debt repayment would be matched with the entity's ability to obtain new debt financing. In circumstances when management believes that a transaction not contemplated in the definition of Standardized Free Cash Flow is compulsory and does not result in a corresponding access to additional cash resources, that transaction can be highlighted in the analysis of investing and financing activities (see below) or reflected in an entity-specific measure.

### A Standardized Definition of Free Cash Flow

#### *Recommended Practice*

**A standardized definition of Free Cash Flow is:**

**Cash flows from operating activities as reported in the GAAP financial statements, including operating cash flows provided from or used in discontinued operations; less:**

- i. total capital expenditures minus proceeds from the disposition of capital assets other than those of discontinued operations, as reported in the GAAP financial statements; and
- ii. dividends, when stipulated, unless deducted in arriving at cash flows from operating activities.

The Standardized Free Cash Flow calculation should be reconciled to cash flows from operating activities for the period determined in accordance with GAAP, disclosing separately each adjustment to cash flows from operating activities, including proceeds from the disposition of capital assets. It should also be accompanied by the following explanation of what the measure represents:

Standardized Free Cash Flow represents an indication of the entity's capacity to generate discretionary cash from operations, comprising cash flows from operating activities less net capital expenditures and those dividends that are more representative of interest costs. It does not necessarily represent the cash flow in the period available for management to use at its discretion, which may be affected by other sources and non-discretionary uses of cash.

To avoid confusion, a measure of Free Cash Flow that varies from the above-noted definition should not be described as Standardized Free Cash Flow.

Cash flows from operating activities are the starting point for this definition as they are generally the major source of internally generated cash. This definition is also dictated by the recognition that Free Cash Flow is seen as a liquidity measure. Accordingly, Standardized Free Cash Flow reflects cash consumed by or provided from changes in working capital and will vary for the effects of seasonal, cyclical and non-recurring activities. Some entities may view this as a discretionary use of cash. The CPRB recommends that cash consumed by or provided from changes in working capital be included in Standardized Free Cash Flow for two reasons. First, the Free Cash Flow measure should be consistent with the term "cash" used in its label. Second, the measure should be consistent with the GAAP statement of cash flows. Entities that wish to present Free Cash Flow without the effects of changes in working capital can provide an entity-specific measure.

Total capital expenditures for the period net of proceeds from dispositions are included in the computation of Standardized Free Cash Flow as they represent the entity's re-investment of cash in continuing operations. Adjustments for capital expenditures are restricted to cash outlays in the period for tangible and intangible capital assets, including those major repairs and maintenance items that are capitalized in accordance with GAAP.

Standardized Free Cash Flow includes all cash flows from subsidiaries, whether wholly or partially owned, as reported cash flows from operating activities and capital expenditures are calculated on a consolidated basis.

Cash distributions to shareholders other than certain dividends are excluded from the calculation. Cash distributions to shareholders include share repurchases through normal course issuer bids or any other unit transaction executed in exchange for cash in the normal course of business. The Standardized Free Cash Flow calculation excludes common dividends and others that are declared at the board's discretion. When the dividend is stipulated, however, it should be reflected in the computation, if paid. In these circumstances, the dividend is more characteristic of an interest cost than a discretionary distribution. If an entity views other dividends as being essentially compulsory distributions, which may be governed by the entity's circumstances, then management can incorporate this into its entity-specific measure of Free Cash Flow.

Disclosure of Standardized Free Cash Flow on a per share basis provides useful information about the growth or diminishment of Standardized Free Cash Flow from period to period. Even though Standardized Free Cash Flow is not a residual amount attributable to shareholders, per share disclosure is useful to compare cash flow performance to share prices. As well, it is a useful measure to compare against dividends paid which are routinely reported on a per share basis. It should be noted, however, that in some jurisdictions securities regulators preclude disclosure of share- or unit-based cash flow information.

When a fully diluted cash flow per share calculation is presented, it should be based on the effect of potential issuances of shares on the Standardized Free Cash flow per unit calculation.

### Entity-specific Free Cash Flow disclosures

If entities adopt the preceding definition of Standardized Free Cash Flow, the result would be comparable from entity to entity and consistent between periods. However, entities may believe that other adjustments should be made to cash flows from operating activities in addition to those made in arriving at Standardized Free Cash Flow.

For example, there may be a cyclical or periodic nature to the pattern of cash flows generated from operating and investing activities. In certain seasonal industries, inventory is built up (consuming cash) in the summer months, and is sold (producing cash) in the winter. In other circumstances, non-capitalized major repairs and maintenance occur cyclically and result in cyclical patterns to operating cash flows, such as significant scheduled maintenance activities once every three to five years. In other industries, routine maintenance requires a multi-year cycle of capital expenditures on compressors or capacity rebuilds that may also require capacity to be taken off-line for extended periods. The relative predictability of the pattern of such cash flows can motivate management to describe Free Cash Flow not in terms of the actual historical cash patterns, but after adjusting for the cyclical or seasonal components of operating and investing activities. These cyclical patterns could be

communicated as part of the explanation of the variance in periodic Standardized Free Cash Flow. Cyclical events such as these may also be addressed by reporting an entity-specific Free Cash Flow that adjusts for such known patterns. In communicating such cyclical patterns, significant assumptions should be discussed. For example, an adjustment to eliminate the seasonal fluctuations of working capital changes may involve an assumption about future selling prices.

Similarly, management may wish to communicate the special or non-recurring nature of certain transactions that in their view should not be part of a user's reasonable expectation of the future cash flows. For example, restructuring charges are frequently described as non-recurring (note that the securities regulators provide useful guidance for defining "non-recurring" items in CSA Staff Notice 52-306). Entity-specific adjustments may also include significant commitments that an entity considers in determining the amount of cash available for discretionary activities, such as significant commitments for future capital expenditures to be funded from operations.

The term Free Cash Flow suggests that the measure should reflect cash generated in the period available for discretionary purposes. As noted, this is not necessarily the case. For example, an entity's Free Cash Flow may be restricted by an operating financial covenant. Similarly, there can be restrictions on an entity's ability to utilize cash held in a subsidiary. Entities may wish to highlight circumstances such as these through an entity-specific adjustment. Alternatively, these matters would be discussed as part of the financing strategy discussed later in this guidance.

When an entity wishes to make entity-specific adjustments for items such as these, they should be identified separately from the elements of Standardized Free Cash Flow.

### *Recommended Practice*

The CPRB recommends that when additional entity-specific adjustments are made in the computation of Free Cash Flow:

- i. these amounts should be separately disclosed after the computation of Standardized Free Cash Flow;
- ii. the adjusted amount should be reported as Adjusted Free Cash Flow;
- iii. the purpose of each adjustment should be discussed;
- iv. a reconciliation should separately disclose each adjustment between Adjusted Free Cash Flow and Standardized Free Cash Flow (for example, when an adjustment is made for working capital, each element of the adjustment, such as seasonality and growth, should be explained);
- v. for each adjustment, the corresponding item in the financial statements should be quantified; and,
- vi. the financial statement component which contains the corresponding item should be identified.

These Recommended Practices should assist investors to quickly assimilate and understand the nature, amounts, and reasons for entity-specific adjustments. This is facilitated when entity-specific adjustments are consistent from period to period, both with respect to the nature of items adjusted and their computation. As well, adjustments should be consistent within the period. For example, when an adjustment is made for non-recurring cash outflows, there should also be an adjustment for any non-recurring inflows. When a change is made to the components of the entity-specific measure, users' understanding will be enhanced if the reason for the change is explained and comparative amounts are presented in accordance with the new basis.

When entity-specific adjustments include those in respect of working capital, accompanying disclosure should identify the specific elements of working capital that have been adjusted, together with the reasons for the change. As well, there may need to be disclosure of how working capital changes are expected to impact future cash flows and the reasons for those changes.

## D. CONTEXTUAL DISCLOSURES THAT COMPLEMENT FREE CASH FLOW

As previously noted, the Free Cash Flow measure, used in isolation, has limitations. Accordingly, the CPRB believes it should be complemented by other disclosures to provide a suite of information that enables a user to interpret the measure in the entity's specific circumstances.

### *Recommended Practice*

**To enhance communication of Free Cash Flow, entities should complement Standardized Free Cash Flow with additional disclosures about the entity's specific circumstances with respect to:**

- (i) the relationship of Standardized Free Cash Flow to the entity's investing and financing activities;**
- (ii) the relationship of the entity's capital expenditures to its productive capacity strategy; and**
- (iii) financing activities that are characterized as operating activities.**

### Relationship of Standardized Free Cash Flow to investing and financing activities

In effect, Standardized Free Cash Flow is a reorganization of the GAAP Statement of Cash Flows to reflect the interaction between an entity's cash flows from operating activities and its capital expenditures. Understanding the entity's policies and actions with respect to the other sources and uses of cash provides a more complete basis

for the analysis of Standardized Free Cash Flow. These other sources and uses of cash, categorized in the cash flow statement as financing and investing activities, include cash distributions to common shareholders in the form of dividends or share repurchases, debt and equity financing, and mergers and acquisition activities.

Financing and investing activities may complement or compete with distributions to shareholders as uses for any positive amounts of Standardized Free Cash Flow. For example, outside debt financing may fund all or a portion of the capital expenditures of an entity, and hence complement the Standardized Free Cash Flow. Conversely, the repayment (rather than refinancing) of maturing debt or lines of credit may compete with dividends to shareholders as a use of Standardized Free Cash Flow.

The relationship of an entity's Standardized Free Cash Flow to its investing and financing activities may best be explained by providing an analysis of how those activities complement and compete with Standardized Free Cash Flow. In addition, disclosure of the entity's financing strategy will assist users to understand this relationship. This could include matters such as the entity's target debt to equity or leverage ratio, the degree to which it has fixed but uncanceled commitments such as operating leases and purchase commitments, and the likelihood of compliance with covenants. Some of this information should already be provided in the MD&A table of contractual obligations and the statement of capital disclosures required by Canadian GAAP.

### Relationship of the entity's capital expenditures to its productive capacity strategy

In order for an investor to make an assessment of the likelihood that an entity's Free Cash Flow will be sustained, he or she needs to understand the entity's strategy for productive capacity and how that capacity is being maintained and grown. This could be facilitated if the entity were to define how it views productive capacity, explain how the capacity has been changing, and discuss how capacity has been affected by, for example capital expenditures, acquisitions, intellectual property, and information systems. In particular, investors want to distinguish capital expenditures focused on growth from those made to maintain existing levels of productive capacity. This discussion should also address the categories of capital asset expenditures and how each asset category contributes to growth or productive capacity maintenance. More discussion about disclosure of productive capacity and productive capacity strategy is provided in the CPRB guidance *Standardized Distributable Cash In Income Trusts And Other Flow-Through Entities*.

### Financing-type activities that are characterized as operating activities

In some cases, cash flows from operations are affected by financing-type activities that are characterized as operating activities. The cash flow may occur in close proximity to the transaction or may not arise for several years. In addition, these activities are subject to various degrees of management discretion. As previously noted, securitization of accounts receivable is an example of such a short-term transaction, substantially under management's control, that can have a significant impact on a period's cash flows from operating activities.

Other transactions will not have an impact on periodic operating cash flows for several years. Examples of long-term operating items that are subject to timing differences between accrual and expenditure are asset retirement obligations, free rent arrangements, and deferred interest payments on discounted long-term obligations. These accrued items are non-cash operating transactions until funded. The funding of such amounts may be over the life of the contract, such as free rent obligations which are deferred until rent is paid. They may also be paid at the conclusion or termination of a contract, such as accrued interest on a debt instrument originally issued at a discount, which is paid at redemption.

Such operating items may have a significant effect on the entity's current and/or future Standardized Free Cash Flow. Accordingly, to be effective, the communication of Standardized Free Cash Flow should identify how such items impact current and future cash flows. The analysis should explain the extent to which such activities have consumed or provided cash in the period, and the extent to which they have deferred cash inflows and outflows to future periods, including when such deferrals are expected to affect Standardized Free Cash Flow. As well, the analysis should identify the total amounts required to fund obligations arising from these activities and the amounts expected to be paid in each of the next five years. This disclosure would be similar to that required for conventional financing transactions provided as part of the table of contractual obligations.

# APPENDIX

## SIGNIFICANT CHANGES TO FEBRUARY 2008 DRAFT GUIDANCE

The following are the more significant changes made to the earlier draft guidance as a results of comments received.

### I. GENERAL PRINCIPLES

Section C. **The Characteristics of Non-GAAP Financial Measures** has been amended by adding a paragraph acknowledging that interim reports may disclose non-GAAP financial measures on a trailing 12 month basis.

### II. EBITDA

Section C. **Definition and Disclosure of EBITDA** has been amended with respect to the exclusions from net income or net loss before discontinued operations in arriving at Standardized EBITDA. The guidance now clarifies that these amounts are those disclosed in arriving at net income or net loss in accordance with GAAP.

### III. FREE CASH FLOW

Section C. **Definition and Disclosure of Free Cash Flow** has been amended to include in the definition of Standardized Free Cash Flow proceeds from the disposition of capital assets, other than those of discontinued operations.

Section D. **Contextual Disclosures That Complement Cash Flow** has been expanded to note that investors want information to distinguish growth capital expenditures from maintenance capital expenditures.

# Improved Communication with Non-GAAP Financial Measures

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