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An alternative picture of performance

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Building confidence in non-GAAP measures

Alternative performance measures (APMs) or 'non-GAAP measures', such as EBIT, EBITDA or underlying profit, are deeply ingrained in New Zealand corporate reporting.

As a result of their growing prevalence, not just in New Zealand but globally, there is increasing scrutiny from regulators, standard setters, investors and the media into how APMs are reported and whether they really support, or undermine, corporate transparency.

APMs are here to stay

If used appropriately, APMs can provide insight into the company's business, its past performance and its prospects, and it looks like they are here to stay. GAAP profit supports confidence in APMs by providing an 'anchor' – a consistent and comparable starting point from which APMs are derived – but by supplementing GAAP measures, APMs can provide a window into how management measures and drives value, and a more complete picture of performance.

There are, however, steps that can be taken to enhance confidence in those measures so that they can be assessed in the proper context.

The appropriate determination and disclosure of APMs starts with management. Fair and balanced reporting of APMs supports transparency and builds the trust of stakeholders. However, management cannot create that confidence alone. To varying degrees, regulators and standard setters also have a role to play.

Role of regulators and standard setters

Following on from a recent statement on non-GAAP financial measures by the International Organisation of Securities Commissions (IOSCO), the Financial Markets Authority (FMA) recently published a consultation paper proposing updates to its guidance note for FMC reporting entities on the use of non-GAAP measures. Although the guidance only applies to non-GAAP measures presented outside of the financial statements, the principles of this guidance note are largely consistent with those already contained in IFRS.

"We are starting with a mind-set that APMs are valuable when properly used and are here to stay. The question then becomes to what extent, if any, should we require or permit the traditional income statement to include APMs on its face."

Gary Kaburek, member of the IASB

Apart from general principles covering the presentation of APMs, currently IFRS does not provide much guidance in the way of defining, requiring or permitting the use of non-GAAP measures. However, the IASB has recently started to explore whether IFRS should define certain APMs and whether they should be required or merely permitted.

In New Zealand, the XRB launched a survey to find out whether users find APMs useful, or are confused by the APMs commonly disclosed by companies. Look out for the results when they are published shortly.

Way forward

Mindful of the growing interest in APMs, we reviewed the reporting practices of the NZX 50. Our findings suggest that more can be done to build confidence in non-GAAP measures.

Regulators and standard setters can establish principles and enforce them. Companies can make good judgments, apply the principles, and disclose non-GAAP measures that they believe are useful to the investors. Finally, users should understand non-GAAP measures and the context in which they should be considered before making decisions.

Doing so will facilitate the balanced use of these metrics and mitigate the risk of overreliance on non-GAAP measures which on their own may paint an incomplete picture of a company.

Lyn Hunt
Partner
T: +64 9 355 8863
M: +64 21 318 547
E: lyn.c.hunt@nz.pwc.com

Alternative performance measure reporting practices in the NZX 50

Mindful of the growing interest in the use of APMs, we have set out to explore how widely APMs are used and what is being adjusted by the NZX 50 companies. Our findings can be summarised as follows:

- 92% of the NZX 50 adjust their GAAP profit numbers.
- Adjustments almost always have a favourable impact on profit.
- Companies commonly adjust for: fair value movements, asset impairment and depreciation, amortisation, interest and tax.
- Descriptions of reconciling items are often too broad to understand what they relate to.
- Companies use inconsistent approaches as to where and how reconciliations are presented.

These findings may not surprise, but they do suggest more work will need to be done by management, regulators and standard setters in creating an environment in which non-GAAP measures are useful while not being confusing.

Use of adjusted profit measures

92% of the NZX 50 disclose an adjusted profit number.

But ***2*** companies did not provide supporting information in the form of a reconciliation from the GAAP measure to the non-GAAP measure.

APM description

There were ***over 8*** alternative terms used to describe the adjusted profit figure with the three most popular being:

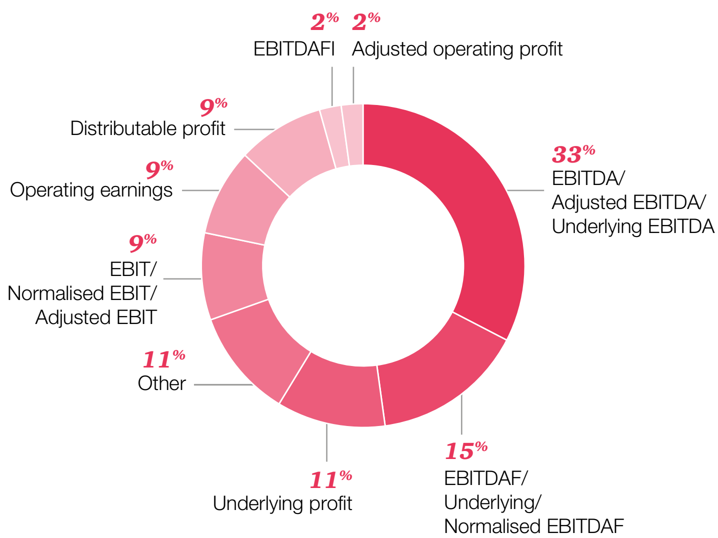
- EBITDA/Adjusted EBITDA/Underlying EBITDA
  33%
- EBITDAF/Underlying EBITDAF/Normalised EBITDAF
  15%
- Underlying profit
  11%

Such a variety of different performance measures, sometimes between competitors within industry sectors, often makes it difficult for readers to understand and compare non-GAAP financial information.

Yet, ***only 3*** companies made a statement that the non-GAAP information does not have a standardised meaning prescribed by GAAP and therefore may not be comparable to similar financial information presented by other entities.

Methodology

We performed a review of the 2016 year end reporting of the NZX 50. We focused our review on the reporting of adjusted profit measures in Annual Reports, whether companies provided a reconciliation from the GAAP measure to the APM, the types and size of adjustments that companies were making and where the APM was presented.



Prominence

Close to **33%** of the companies displayed non-GAAP financial information with more prominence outside the financial statements, for instance by only referring to the non-GAAP profit measure in the management commentary included in the 'front half' of the annual report.

$4.8 billion worth of adjustments

In aggregate for all companies with a non-GAAP measure, the GAAP figure was adjusted from roughly $8.5 billion to $13.3 billion.

Of the 46 companies that presented an adjusted profit number, ***only 11*** reported a number less than the original GAAP figure.

The type, value and number of adjustments are shown in the graph below.

Only 2 companies changed the type of adjustments from the last period to the current period and both gave an explanation as to the reason for the change.

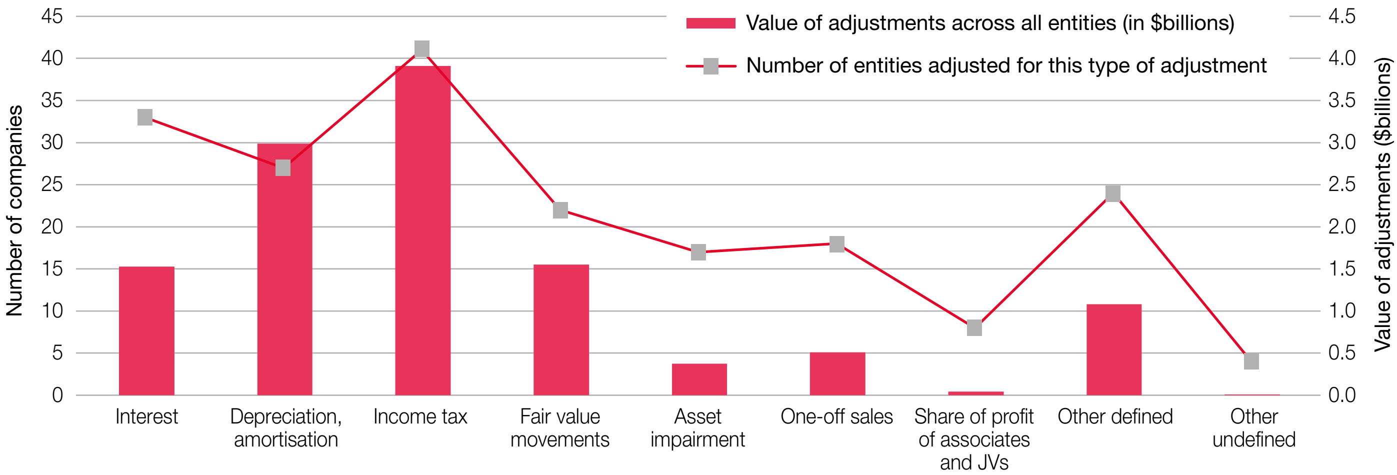
Many non-GAAP measures are similar to earnings before interest and tax (EBIT). However, entities exclude some items (e.g. infrequently reoccurring items) from their operating performance measures.

As demonstrated in the graph below the common adjustments relate to:

- depreciation, amortisation, interest and taxation
- fair value movements; and
- asset impairment.

It is also interesting to note that there are a large number of adjustments being made, but the value of adjustments represents a small proportion in comparison to the overall value. For example 37% of companies are adjusting for asset impairments and 17% of companies are adjusting for share of profits or losses of associates and joint ventures yet they represent only 7.76% and 0.89% of the total value of adjustments. The question for companies to ask is whether these adjustments are significant enough to be separately identified.

Value and number of adjustments across the NZX50



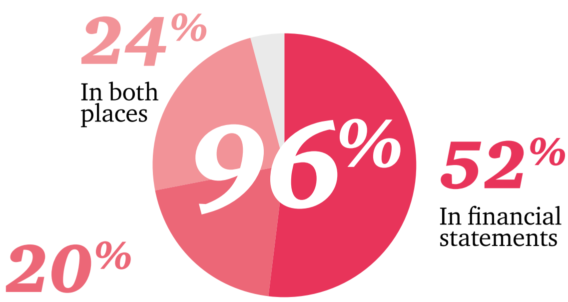
What's in 'other'?

Non-GAAP financial information is useful if it does not convey a misleading message. Nevertheless in our analysis there remains a number of companies making adjustments ($1 billion) that do not fit into the categories outlined in our graph. Included in this category are various adjustments for acquisition costs, management incentives, legal costs and deferred tax.

Almost 9% of the companies made adjustments that were undefined. It was difficult to assign the adjustment to a relevant category from reading the description that companies have given.

Reconciliation

While 96% of the companies provided a reconciliation of the APM to GAAP, including comparatives, there was no consistency in where the reconciliation was reported. Indeed in some circumstances they were reported in more than one place.



This is not a problem unless, as was the case with a few companies, there is little signposting to where the reconciliation could be found.

2 companies did not present a reconciliation at all.

Regulators and standard setters on APMs

As mentioned above, there is increasing scrutiny from international regulators, standard setters, investors and the media into how APMs are reported and whether they really support, or undermine, corporate transparency.

Regulators

Internationally, a number of regulators have issued guidance to increase discipline and transparency around performance measures.

For instance, in July 2016, the International Organisation of Securities Commissions (IOSCO) issued a *Statement on non-GAAP financial measures* to assist preparers in providing clear and useful disclosure of non-GAAP measures, and to help reduce the risk that such measures are presented in a way that could be misleading.

On the back of IOSCO's statement, in March 2017, the FMA published a Consultation Paper on *Disclosing non-GAAP financial information* to align its 2012 Guidance note: *Disclosing non-GAAP financial information* with the principles in IOSCO's statement.

The updated guidance note will set out the FMA's expectations of FMC reporting entities that report non-GAAP measures outside the financial statements.

The FMA encourages FMC reporting entities to have an internal policy, authorised by the directors, on the use and disclosure of non-GAAP financial information, which should be specific to the entity and applied consistently.

Although the FMA's updated guidance note will apply only to information presented outside of the financial statements, the below principles are largely consistent with those that already exist in IAS 1 *Presentation of financial statements.*

Principles when disclosing non-GAAP financial information:

- **Define** non-GAAP financial information in a clear and readable way and give meaningful labels.
- Adopt a **consistent** approach over time and justify any changes made.
- Not display non-GAAP financial information with more **prominence**, than GAAP measures.
- Present non-GAAP information that is **unbiased**.
- **Reconcile** non-GAAP financial information to the most directly reconcilable GAAP line item explaining material reconciling items.
- Not describe items that have occurred in the past or reasonably likely to occur in a future period as '**one-off**' or '**non-recurring**'.

Standard setters

Apart from general principles covering the presentation of APMs, IFRS does not currently contain much guidance on the use of non-GAAP measures. Acknowledging the increased prevalence of APMs, the IASB has recently started exploring whether to:

- require or permit the presentation of EBIT in the income statement;
- define EBIT to increase comparability; and
- in addition to presenting EBIT, allow entities to present a management operating performance measure.

Although the IASB's project is in its early stages, such that it's hard to predict when new requirements or guidance will be issued, it is a clear indication that the IASB has no intention of prohibiting non-GAAP measures.

In New Zealand, the XRB launched a survey: *How useful are APMs to external users of company reports?* to find out whether users find APMs useful, or are confused by the reported APM information commonly disclosed by companies. The findings of the survey will help inform future decisions about the requirements of accounting standards as well as inform discussions on policy matters, both locally and internationally.