



**Alternative Performance Measures – A survey of their use together
with key recommendations**

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1. Introduction

The financial statement review remit of the Irish Auditing and Accounting Supervisory Authority ('IAASA') derives from the [Transparency \(Directive 2004/109/EC\) Regulations 2007 \(S.I. No. 277 of 2007\)](#) (as amended) ('the Regulations')¹. Under the Regulations, IAASA examines the annual and half-yearly financial reports of certain equity, debt and fund issuers with securities admitted to trading on a regulated market within the European Union.

Most equity issuers within IAASA's financial reporting review remit² choose to present alternative performance measures ('APMs')³ in their annual reports. APMs are used to analyse the performance, financial position and cash flows of a business and to highlight the key components of an issuer's results for users of financial statements.

APMs can be derived from the financial statements prepared under IFRS⁴ (the statutory financial statements) or other sources and typically use alternative methodologies to those that are required to be used under IFRS. Furthermore, some issuers report non-financial key performance measures, such as production or activity levels. For the purpose of this document, APMs are limited to measures which are derived from items reported in the financial statements.

Typically, though not exclusively, APMs are to be found in sections of the annual report outside of the financial statements, such as in the Chairman's Statement, Operating and Financial Review, Directors' Report or other similar reports. APMs are often quoted in preliminary results and other market and press announcements and attract significant attention from users.

When appropriately used, APMs can supplement the information provided by the financial statements and add quality and depth to users' understanding of the performance, financial position and cash flows of issuers. However, where APMs are improperly used they may:

- (a) inhibit users' ability to interpret the issuer's results;
- (b) present an unbalanced assessment of the performance, financial position or cash flows (e.g. focussing on the positive with insufficient reference to the bad news);
- (c) confuse the message reported by the financial statements; and
- (d) mislead users as to the performance, financial position or cash flows arising.

2. Purpose of this document

This survey focuses on the use of APMs in annual reports. The findings are based on a desk top review of 20 equity issuers with financial year ends occurring mainly during the calendar year ending December 2011. The purpose of this paper is to identify and describe the most common financial APMs presented in equity issuers' annual reports and to identify key recommendations which, if applied, should enhance users' understanding of the performance, financial position and cash flows and enable better comparability across issuers.

¹ The [Transparency \(Directive 2004/109/EC\) Regulations 2007 \(S.I. No. 277 of 2007\)](#) has subsequently been amended by the [Transparency \(Directive 2004/109/EC\) \(Amendment\) Regulations 2010 \(S.I. No. 102 of 2010\)](#), the [Transparency \(Directive 2004/109/EC\) \(Amendment\) Regulations 2012 \(S.I. No. 238 of 2012\)](#), and the [Transparency \(Directive 2004/109/EC\) \(Amendment\) \(No. 2\) Regulations 2012 \(S.I. No. 316 of 2012\)](#). Each of these Statutory Instruments is available at http://www.iaasa.ie/legislation/index.htm#Other_Relevant_Statutory_Instruments

² For the purposes of this document, reference to equity issuers is a reference to issuers applying IFRS as endorsed by the EU and falling within the scope of the EU Transparency Directive (EU Directive 2004/109/EC).

³ Also referred to as non-GAAP financial measures or key performance indicators ('KPIs')

⁴ International Financial Reporting Standards

3. Summary findings

The following are a summary of the findings of this survey:

- The most common APMs presented by the equity issuers included in the survey were:
 - (a) EBITDA and other variations of earnings;
 - (b) Operating profit/results of operating activities;
 - (c) Free cash flow;
 - (d) Net debt/gross debt;
 - (e) Adjusted earnings per share ('adjusted EPS');
 - (f) Return on capital employed; and
 - (g) Revenue growth.
- In respect of the EBITDA earnings measure, there was variation across issuers in respect of the items included or excluded from the earnings component, although there was, in most cases, no explanation as to why adjustment was considered necessary. A majority of issuers did not reconcile the IFRS earnings line item to the earnings used in the EBITDA measure. A majority of the items for which earnings were adjusted were expenditure, rather than income items.
- All of the issuers surveyed reported some form of 'operating profit' as an APM. Net debt was a popular APM, with 80% of the issuers surveyed reporting the measure. Free cash flow was a less used, although still popular, APM. With regard to the latter two APMs, it was found that the measure was often not explained and that the basis of calculation included different combinations of a range of items. Similarly, in the case of adjusted EPS, most issuers did not disclose the reasons for the adjustments.
- In respect of return on capital employed, there were a variety of interpretations regarding both the components of the profit measure and the measure of capital employed used to calculate the percentage.
- Only a minority of issuers surveyed identified the various different components of revenue growth, including volume increases, price growth, acquisition related revenue growth and the effects of currency movements.

More detail on the findings can be found in the Appendix.

4. Key recommendations

In preparing future annual reports, directors are encouraged to give further consideration to their judgements concerning the preparation and presentation of APMs given the attention these command from users. Specifically, where APMs are presented, the directors are strongly encouraged to ensure their appropriate selection, preparation and presentation and to apply the following recommendations:

- (a) explain the reason for the presentation of each APM;
- (b) provide a clear definition of each APM used;
- (c) provide an explanation of the basis for the calculation of each APM including details as to why selected APMs exclude certain items. The reasons for the adjustments should be clearly explained (i.e. how the underlying residual figure is key to understanding the performance or financial position or cash flows);

- (d) provide a reconciliation of each APM to the relevant IFRS data, where applicable;
- (e) include a comparative measure for all reported APMs;
- (f) disclose all APMs used within a single location in the annual report where possible, making it easier for users to assess the performance measures as a whole;
- (g) avoid the preparation and presentation of APMs in a manner that has the potential to detract from, or conflict with, the information provided in the financial statements; and
- (h) avoid the presentation of APMs in a manner that gives them inappropriate prominence over the IFRS measures.

5. Relevant sources of information regarding the use of APMs

The following documents provide information of relevance to the use of APMs in annual reports and readers may find them a useful source of reference in this context.

5.1 CESR Recommendation on Alternative Performance Measures

A Paper entitled *CESR Recommendation on Alternative Performance Measures*⁵ (published in October 2005) provides non-mandatory guidance on the use of APMs. It encourages issuers that provide APMs to do so in a manner that is appropriate and useful for investors' decision making and provides eight specific recommendations for their presentation. While at the time of publishing this survey, ESMA (successor to CESR) had not published an update to this Recommendation, IAASA understands that an updated Paper will be published before year end.

5.2 Content of the management report

Transparency Rule 6.1⁶ and Section 13 of the Companies (Amendment) Act, 1986 require the management report (directors' report in respect of the 1986 Act) to contain a fair review of the development, performance and financial position of the business using key performance indicators where necessary, both financial and non-financial.

5.3 IASB Practice Statement: Management Commentary (issued December 2010)⁷

The IASB Practice Statement provides a broad, non-binding framework for the presentation of management commentary that relates to financial statements and sets out the principles, qualitative characteristics and elements of management commentary that are necessary to provide users of annual reports with useful information.

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⁵ Reference CESR/05-178b and available at http://www.esma.europa.eu/system/files/05_178b.pdf

⁶ The Transparency Rules (September 2009) are issued by the Central Bank and are available via the web at <http://www.centralbank.ie/regulation/securities-markets/transparency/Documents/Transparency%20Rules.pdf>

⁷ The IASB Practice Statement: *Management Commentary* is available via the IASB website at: <http://www.ifrs.org/NR/rdonlyres/9EA9F29A-3F34-4E39-9388-989B07563D4E/0/Managementcommentarypracticestatement8December.pdf>

Appendix - Detailed findings on issuers' use of APMs

EBITDA and other variations of earnings

Earnings before Interest, Tax, Depreciation and Amortisation ('EBITDA') is a measure of the operational profitability of the business. EBITDA (and variations thereof) is a commonly understood performance measure and for this reason is favoured by many issuers.

80% of the issuers surveyed reported EBITDA or earnings linked APMs in their annual reports. In many instances 'earnings' was adjusted, often resulting in the 'earnings' measure differing significantly from the earnings amount reported in the financial statements. Furthermore, there was variation as to which items were included or excluded from the APM earnings measure, with one or more of the following items often being excluded:

- (a) exceptional items;
- (b) share based payment expense;
- (c) lease rentals;
- (d) contributions from associates and joint ventures;
- (e) non-recurring items including related tax credits;
- (f) asset impairment charges;
- (g) profits on disposals and group share of associates profit after tax;
- (h) past service gain/charges on retirement obligations;
- (i) restructuring costs; and
- (j) annualised EBITDA of companies acquired during the year.

The reported APM earnings included some, or a combination, of the following items:

- (a) discontinued operations;
- (b) share based payment compensation; and
- (c) gain/loss on the divestment of a business.

It was noted from the examination of the selected issuers' annual reports that:

- (a) the majority did not provide a reconciliation of earnings used for APM purposes to earnings reported in the financial statements;
- (b) a majority did not explain the rationale for excluding selected charges, which are outlined above, from earnings;
- (c) a number of issuers did not explain why the adjusted earnings figure was considered to be a more relevant reflection of the underlying earnings;
- (d) the majority of excluded items were expenditures rather than income; and
- (e) the significant adjustments to EBITDA reported by many equity issuers can also have a consequential effect on other earnings linked APMs (e.g. EBITDA to net debt or interest cover to EBITDA).

Operating profit/results of operating activities

Operating profit is a widely used APM and is scrutinised by many users of annual reports. It usually appears in the Income Statement and, therefore, differs from many other APMs as it is included as part of a primary statement contained in the financial statements.

While operating profit is not defined in IFRS, it is noted that IAS 1.BC56 states that entities should ensure that amounts classified as operating are representative of activities that would normally be considered to be operating. IAS 1.BC56 further states that it is misleading and would impair the comparability of financial statements if items of an operating nature were excluded from the results of operating activities.

All of the issuers surveyed reported some form of 'operating profit' as an APM. It was noted that in a number of cases, operating profit was presented before:

- (a) exceptional items (which vary from issuer to issuer); and
- (b) amortisation of intangibles.

Net debt/gross debt

80% of the issuers surveyed disclosed 'net debt', 'gross debt' or both as an APM.

'Net debt' was described by issuers as being comprised of various combinations of:

- (a) cash and cash equivalents;
- (b) liquid investments;
- (c) derivative financial assets and liabilities;
- (d) interest bearing loans and borrowings; and
- (e) in one instance, excluding net debt of an associate investment.

In a majority of the cases, issuers explained the basis for the calculation.

'Net debt to EBITDA' was a financial measure presented by 50% of issuers in the survey. However, the significance of the measure was not explained in the majority of instances.

Free cash flow

Free cash flow represents an entity's ability to generate cash after deducting the funds necessary to maintain or expand its current asset base. Its focus on cash in the current environment where access to funds is limited has resulted in this measure being the subject of heightened attention and comparison amongst issuers and across industries.

50% of the issuers surveyed presented free cash flow as an APM although most of those did not provide an explanation as to the reason for their specific definition and presentation of 'free cash flow'. 60% of issuers that reported free cash flow as an APM did not provide a description of what was included in and omitted from 'free cash flow'. It was described as 'net cash flow from operating activities' adjusted for capital expenditure and various issuer specific combinations of:

- (a) interest paid;
- (b) tax paid; and
- (c) pension deficit funding.

Adjusted earnings per share ('Adjusted EPS')

In addition to the basic and diluted EPS calculations required by IFRS, 60% of the issuers surveyed disclosed an adjusted EPS measure as an APM.

Adjusted EPS measures were entity specific and variations included EPS measures adjusted for combinations of the following:

- (a) exceptional items;
- (b) movement of fair value on derivatives;
- (c) amortisation of intangible assets including acquisition related intangibles;
- (d) after tax impact of one-off gains;
- (e) results of discontinued operations;
- (f) pension interest;
- (g) non trading items;
- (h) onerous lease provisions;
- (i) impairment charges; and
- (j) net restructuring costs.

Most issuers who disclosed 'adjusted' EPS measures did not disclose the reasons for the adjustment to EPS or the significance of the 'adjusted' EPS measures to financial performance.

Return on capital employed ('ROCE')

Return on capital employed is a measure that indicates the profitability of an issuer's business relative to the amount of capital investment, e.g. ROCE may be expressed as:

$$\frac{\text{Operating profit measure}}{\text{Capital employed measure}} \times 100 = \text{x\%}$$

40% of the issuers surveyed reported a ROCE measure as an APM. It was noted that there was a variety of interpretations regarding the determination of both the profit measure and the measure of capital employed.

The profit measure consisted of 'operating profit' adjusted for variations of:

- (a) exceptional items;
- (b) amortisation of intangibles;
- (c) share of profit of joint venture and associates;
- (d) interest; and
- (e) tax paid.

'Capital employed' measures consisted of variations of:

- (a) the sum of total equity plus net debt at year end;

- (b) the book value of equity and net debt excluding investment property and pension scheme assets/deficits;
- (c) average of opening and closing equity/capital employed; and
- (d) consolidated net assets excluding net debt and pension assets/liabilities.

Revenue growth

85% of issuers reported a measure of revenue growth. There was a noted variety in the manner that revenue growth was presented as an APM.

The level of disaggregation of the significant components of revenue growth was varied across issuers with some describing revenue growth as made up of combinations of:

- (a) underlying growth;
- (b) acquisition growth;
- (c) volume growth;
- (d) price growth; and
- (e) currency effects.

Some issuers excluded items such as disposals made during the year or other returns from investments from the revenue growth APM.