Non-IFRS performance measures: the good, bad and ugly

Companies have a practice of presenting additional financial information not required by International Financial Reporting Standards or generally accepted accounting principles. This may be because management consider these additional measures better represent an entity's financial performance. Commonly used non-IFRS or non-GAAP measures include operating profit and EBIT (earnings before interest and tax).

Recent trends and concerns

The use of non-IFRS or non-GAAP measures seems to be widespread.

An article published by *Forbes* in November 2016, *Is Non-GAAP Reporting Hurting Your Porfolio*, noted that the use of non-GAAP measures in United States-listed corporations is on the rise, and that the gulf between reported GAAP and non-GAAP earnings is widening. This article also noted that "by incorporating non-GAAP earnings into executive compensation plans, directors can pay their chief executive officers more than they otherwise would," and that "aggressive use of non-GAAP reporting is associated with indicators of shoddy accounting."

In November 2016, the United Kingdom's Financial Reporting Council published findings of its corporate thematic review on the use of non-IFRS measures in U.K.-listed companies. The UK FRC found that non-IFRS measures are widely used with "adjusted profits" being higher than the equivalent IFRS measure in 78 percent of cases. They also found that there is no common definition of adjusted profit.

The Institute's Standard Setting Department also found a trend in the use of non-HKFRS/IFRS measures from its 2016 limited desktop review of Hong Kong targeted industries and listed company financial statements. From its targeted outreach, the department found that Hong Kong investor analysts consider non-HKFRS/IFRS measures useful only when there is transparency of what constitutes the measure. Notwithstanding that, investor analysts do not think it would be useful to require a fixed set of line items as performance measures. Instead, they suggested providing general principles of what should constitute the measure to improve the comparability and consistency of performance measures. A reconciliation of the measure to audited IFRS information should also be required.

Views of regulators and investors

Securities regulators around the world have noted the increasing use of non-IFRS or non-GAAP measures. This led the U.S. Securities Exchange Commission staff to update its *Compliance & Disclosure Interpretations on Non-GAAP Financial Measures* in May 2016; and the European Securities and Markets Authority to issue *Guidelines on Alternative Performance Measures*, which became effective on 3 July 2016.

Key messages from the U.S. SEC interpretation and ESMA's guidelines are extracted and summarized in the table on page 47.

Concerns over non-IFRS or non-GAAP measures are also expressed within the investor analyst community. In September 2016, the CFA Institute published the paper *Investor uses, expectations, and concerns on non-GAAP financial measures*, which is based on a global survey with investor analysts. Headline conclusions from the paper include:

- Investors generally find non-GAAP measures useful and apply them for varied reasons, including as a valuation input and as an indicator of accounting quality.
- Many investors make further adjustments including reversing questionable management adjustments to get the best view of economic reality.
- Many investors judge the appropriateness of different line item adjustments or exclusions on a case-by-case basis.
- Investors are generally uncomfortable with exclusions of recurring business expenses (e.g. stock option expenses) and are comfortable with exclusions of truly one-off items (e.g. discontinued operations and one-off asset sales).
- Investors have concerns around the transparency, communication, consistency, comparability across periods and similar companies.
- There are particular concerns related to the reconciliation of non-GAAP measures to the most directly comparable GAAP/IFRS line items as well as on the inadequacy of disclosures around the adjustments made in calculating non-GAAP measures.

Developments in accounting requirements

The International Accounting Standards Board is aware of the increasing use of and concerns over non-IFRS measures. "*IFRS Standards prescribe very little in the way of formatting the income statement. We define revenue, we define profit* *or loss, but we do not define very much in between. So companies have considerable freedom in the way they present the components of income that make up profit or loss. As a result, there is little comparability above the bottom line, making it difficult for users to judge performance. Partly as a result of IFRS prescribing few subtotals in the income statement, preparers increasingly present alternative performance measures to investors, which is basically adjusted IFRS. This information is easier for users to consume, but it almost always paints a rosier picture than reality and can be highly misleading*," said IASB Chairman Hans Hoogervorst at the August 2016 Joint IFRS Conference in Nairobi.

Along this view, the IASB agreed it needs to prioritize its work in this area by examining possible changes to the structure and content of the primary financial statements. This is the IASB's "Primary Financial Statements" project. As part of the project, in December 2016, the IASB tentatively decided to explore, among other topics:

- Requiring additional subtotal(s) in the statement(s) of financial performance, i.e. EBIT and/or operating profit; and
- Providing guidance on the use of non-GAAP performance measures, including separate presentation of non-recurring, unusual or infrequently occurring items.

Institute's views

The Institute recognizes the importance of the IASB's "Primary Financial Statements" project in light of Hong Kong's position as an international financial centre. This project is one of the Institute's Standard Setting Department's priorities. Please contact us at *outreachhk@hkicpa.org.hk* if you would like to participate in the department's future outreach or consultation on this project.

Last but not least, companies are reminded to adhere to the presentation requirements of HKAS 1 *Presentation of Financial Statements*, paragraphs 85 to 85B, for any additional non-HKFRS/IFRS line items, headings or sub-totals that are presented in financial statements.

The dos and don'ts of presenting non-GAAP measures

Do	Don't
Define and **disclose** the non-GAAP measures and basis of calculation in a clear and readable way, which should be consistent over time.	Present a non-GAAP measure that excludes the normal, recurring, cash operating expenses necessary for business operations.
Indicate whether it relates to the (expected) performance of the past or future reporting period.	Inconsistently adjust charges or gains year-on-year, without disclosing the change and explaining the reasons for the inconsistency.
Reconcile it to the most directly reconcilable line item, subtotal or total presented in the financial statements.	Eliminate items identified as non-recurring, infrequent or unusual when it has previously occurred or is likely to recur within two years.
Explain the relevance and reliability of the non-GAAP measure, and any material reconciling items.	Present a non-GAAP measure using a style of presentation (e.g. bold, larger font) that emphasizes it with greater prominence over GAAP measures.
Present comparatives for the corresponding previous periods with the appropriate reconciliations.	Adjust only for non-recurring charges when there were also non-recurring gains that occurred during the same period.

Source: Key messages extracted and summarized from the U.S. SEC interpretation and ESMA's guidelines.

This article is contributed by the Institute's Standard Setting Department.