Financial Reporting Council

CORPORATE REPORTING THEMATIC REVIEW

ALTERNATIVE PERFORMANCE MEASURES (APMs)

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ALTERNATIVE PERFORMANCE MEASURES (APMs)

Key Messages

APMs

- Very widely used. Definitions and reconciliations usually given
- 35% of companies sampled had made improvements in last year
- Some good explanations for why APMs were used, but in other cases explanations either not given or cursory/boilerplate
- Narratives usually dealt with IFRS measures as well as APMs
- No common definition of adjusted profit but some commonality in items added back
- Adjusted profit higher than equivalent IFRS measure in 78% of cases
- Concern over some of the items added back, e.g. restructuring costs

Thematic review into the use of alternative performance measures (APMs)

The Financial Reporting Council (FRC) has conducted a thematic review of companies' use of APMs in their narrative reporting. The review was conducted in light of concerns expressed about the use of such measures by a number of stakeholders and also by a number of commentators. In addition, the topic has been given added relevance by the issue of the European Securities and Markets Authority's (ESMA) "Guidelines on alternative performance measures" (the Guidelines). Listed companies are required to make every effort to comply with the Guidelines which apply to all regulated information, including interim statements and annual reports, published by listed companies on or after 3 July 2016. The Guidelines do not, however, apply to financial statements prepared in accordance with IFRS.

We believe that the Guidelines largely represent a codification of what is needed for APMs to support a fair, balanced and understandable strategic report and of best practice in this area. Accordingly, to achieve continuous improvement in reporting, we would expect many companies to make changes in response to the coming into force of the Guidelines. In our reviews of reports and accounts, we will consider whether APMs disclosed in strategic reports are consistent with the Guidelines and, where there are material inconsistencies, we will write to the companies concerned. We are also taking into account any such inconsistencies when deciding whether strategic reports are fair, balanced and comprehensive as required by the Companies Act 2006. We emphasise that this is not a major change in our approach and should not lead to reports becoming less understandable, clear or concise. We have previously stated that we have challenged companies where narratives focus only on "good news" or if trend information is not sufficient to explain the effect of non-recurring items. In addition, we have considered the balance between the discussion of IFRS and non-IFRS measures, particularly where this affected trend information.

The Guidelines define an APM as "a financial measure of historical or future financial performance, financial position, or cash flows, other than a financial measure defined or specified in the applicable financial reporting framework". The definition therefore covers, for example, adjusted measures of profit, such as underlying or management basis profit. While it is acknowledged by many users that such measures can provide useful financial information in addition to that provided under International Financial Reporting Standards (IFRS), concerns have been expressed that they can also obscure important information shown in the IFRS accounts or present an unjustifiably favourable view of trends or other aspects of performance.

The study consisted of a desktop review of the interim statements of 20 listed companies, spread across the FTSE 100, FTSE 250 and smaller companies, published after the Guidelines came into force. The review aimed to establish the extent to which the statements were consistent with the Guidelines and so enable us to promote specific points which companies need to take into account in preparing their 31 December strategic reports. We also identified, by comparing the statements with the equivalent document for the previous year, what steps, if any, companies had taken to achieve greater consistency with the Guidelines. 90% of the statements in the sample voluntarily included a review report by the company's auditors.

Consistency findings

Regarding consistency with the Guidelines:

- All the companies in the study except one used APMs. Comparatives were also reported in the great majority of cases.
- With one exception, all companies provided definitions of at least the most significant APMs used, together with reconciliations to IFRS measures where appropriate, although definitions and reconciliations were sometimes not cross-referenced.
- In general, the descriptions given to APMs did not appear to be misleading and were a good indicator of what the APM was. This was less clear for some of the items excluded in arriving at adjusted measures of profit. See "Adjusted measures of profit" below.
- Explanations given as to how companies had determined that it was beneficial to disclose APMs varied significantly. All FTSE 100 and FTSE 250 companies provided at least some explanation, but this was not the case among the smaller companies. While very full explanations were provided by some companies, some other companies gave quite cursory, boilerplate explanations or assertions, for example, stating only that "these figures better reflect performance of continuing businesses"; "this reflects the way the business is managed and how the directors assess the performance of the Group"; or "adjustments to results have been presented to give a better guide to business performance".

In our view, a good explanation states why an APM is useful, helpful or more meaningful rather than asserting that this is the case and clarifies whether the APM is used internally, why it is so used, by whom and for what purpose.

Common reasons given for presenting APMs were because:

they were used by the board of directors or management

40%

they provided additional helpful or useful information

40%

or they better reflected the company's performance

35%

Two companies referred to the company's performance being obscured by some of the adjustments required by IFRS.

10%

- The Guidelines state that APMs should not be displayed with more prominence, emphasis or authority than measures directly stemming from the financial statements. For the purposes of this study, we took the view that, if an APM appeared as a line item in the IFRS income statement, then, as the measure directly stemmed from the statements, prominence was not an issue. This was the case for 9 (45%) of the companies in our sample.

  Where companies used multi-column income statements (for example, three columns labelled "underlying", "adjustments" and "IFRS"), we accepted that, as the APM and the equivalent IFRS measure were presented side by side, equal prominence was achieved.

  Where APMs appeared as line items in the income statement, we assessed whether the narrative dealt with all significant items in that statement. Only one company did not do this. We would stress that equal prominence applies to how APMs are dealt with in the narrative as well as to how they are presented.

  Where APMs did not appear as line items, all but one of the sample began by showing both APMs and IFRS amounts, then discussed trading in terms of APMs before concluding with a discussion of other items in the IFRS income statement. The remaining company discussed APMs only. We have, however, seen examples of companies putting their commentary on the IFRS amounts first and consider that this is more consistent with best practice, although we recognise that the nature of the adjustments also needs to be considered.

- In two of the 20 cases, APMs had changed compared to the previous year. In both cases, the definition of an adjusted profit measure had been amended to bring in additional adjusting items. No explanation of the change was made in one case while the explanation given in the other case was that it had been made "in order to better represent the key metrics used by the Group to monitor and describe its performance", which does not explain why the new metric was an improvement.

- Two of the companies selected were large insurance companies. Both companies used a considerable variety of APMs not seen at other companies in the sample. There are particular challenges of accounting and presentation of the income statement in the insurance industry, including the lack of an updated accounting standard, and this is likely to be the reason for industry specific APMs.

In terms of changes made to be more consistent with the Guidelines, such changes had been made by 7 companies, all from either the FTSE 100 or FTSE 250. Five of these gave either new or enhanced explanations for their use of APMs. One company reported its IFRS figures with greater prominence and also included details of adjusting items in its narrative rather than only in the IFRS accounts. The final company included a reference to an IFRS measure, profit after tax, on the first page of the statements compared to no references to any IFRS measure in the previous year.

In summary, based on the above, we would urge companies to consider whether the explanations they have given for using APMs properly reflect why they believe the additional information is useful to investors and other users of their accounts. We are also concerned, based on the limited evidence available, that companies may not appreciate the importance of explaining changes either in the APMs they use or in their definition.

Adjusted measures of profit

In addition to establishing consistency with the Guidelines, the study also gave us the opportunity to consider how the adjusted measures of profit were defined, how they were disclosed and how they differed from the corresponding IFRS measure. With the latter, we took the position that profit before interest and tax (PBIT) is an IFRS measure provided that the only differences between it and IFRS profit before tax were finance costs and income. PBIT is not, however, defined in IFRS.

18 companies in the sample (90%) used adjusted measures of profit so percentages below refer to these 18.

- A wide variety of terms were used to refer to the adjusted measure of profit. Words used included adjusted, normalised, management basis, underlying and headline as applied to operating profit, trading profit and profit before tax. Terms were sometimes qualified as being, for example, before exceptional items.
- As already noted above, in 9 cases (50%) the adjusted measure appeared as a line or column item in the income statement.
- In all cases, it was possible to find a definition for the adjusted measure. In 15 cases (83%), at least an abbreviated form of the definition was set out in the first 2-3 pages of the interim statement. In two cases, a cross-reference was given in those pages. In only one of the 18 cases would the reader have had to search for the definition. Where exceptional (or similar) items were excluded, the reader also had to find the definition of such items to understand what the company considered to be exceptional. This definition was usually to be found in the notes to the IFRS statements.

In some cases, the definition was relatively straightforward (PBIT before exceptional items, EBITDA before exceptional items and share-based payment), but, in other cases, contained a long list of excluded items. 4-5 were not uncommon and one company excluded 8 items.

The main exclusions seen were:

amortisation of intangible assets arising on acquisition

61% of the sample

restructuring costs

56%

profit or loss on disposal of investments or businesses

44%

share-based payment charges and fair value movements on non-hedge accounted derivatives

both 22%

Adjusting items which were only seen on one company in the sample included inventory holding gains (for an oil company), litigation costs, foreign exchange gains and losses and provisions for onerous leases. In our view, when a company adjusts for an item not adjusted for by other companies, fuller explanation of the reason for the adjustment should be given.

- We compared the adjusted measure with the corresponding IFRS measure. The range of differences was considerable, ranging from the APM being 70% below the IFRS equivalent to more than 200% above. However, the APM was only below the IFRS measure in four cases (22%).

- In all cases where the APM was not a line item in the income statement, a reconciliation to the IFRS equivalent was given, either in the narrative or in the notes to the IFRS statements.

While we were pleased to see that definitions and reconciliations were generally presented, we were concerned at the list of excluded items. As an observation, it is not clear to us why, for example, share-based payment charges should be excluded in a number of cases, especially as the general view shown above appears to be that they are a valid cost of the business and relieve the company of an alternative cash expense. We also continue to be concerned at the treatment of restructuring costs as in some way not being part of the continuing business, for example being described as non-recurring items. We have seen examples where restructuring costs of a roughly comparable magnitude occur every year and will question companies in such circumstances. In most cases, our concerns could be mitigated if better explanations were given as to why such items had been excluded.

It is not our intention in this report to express a view, in general, as to whether particular items should or should not be excluded from adjusted profit. We would, however, like to draw attention to the press notice issued by the FRC in December 2013 “FRC seeks consistency in the reporting of exceptional items”. That document discusses the considerations companies should have regard to in judging how to determine adjusted profit – referred to as underlying profit in the press notice. In our view, the principles underlying the press notice remain valid.

Next steps

In our reviews of 31 December 2016 reports and accounts, we will question companies where:

- Good explanations for the use of APMs and for any changes made in the APMs used, including changes in definition, are not provided.

- Good explanations of why items have been excluded from adjusted measures of profit are not provided and, in particular, where an item is excluded from adjusted profit that we have not seen others exclude.

- A description such as non-recurring is used and that description does not appear to apply in the circumstances.

- There is no discussion of either the IFRS results themselves or of the adjustments made to those results to arrive at adjusted profit.

- The IFRS results are not highlighted at an early point in the narrative.

As a result of our work, we have identified two companies, one where definitions of APMs were not clearly given and the other where there was a particularly long list of excluded items, where we will be giving advance notice of our intention to review their next annual reports and accounts.

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