Financial Reporting Council

CORPORATE REPORTING THEMATIC REVIEW

ALTERNATIVE PERFORMANCE MEASURES (APMs)

NOVEMBER 2017

The Financial Reporting Council (FRC) is responsible for promoting transparency and integrity in business. The FRC sets the UK Corporate Governance and Stewardship Codes and UK standards for accounting and actuarial work; monitors and takes action to promote the quality of corporate reporting; and operates independent enforcement arrangements for accountants and actuaries. As the Competent Authority for audit in the UK the FRC sets auditing and ethical standards and monitors and enforces audit quality.

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Thematic reviews supplement the FRC's monitoring work conducted by Corporate Reporting Review (CRR). CRR monitors company reports and accounts for compliance with the Companies Act 2006, including applicable accounting standards, and other reporting requirements. The aim of our reviews is to identify and share examples of good practice reporting and highlight areas where improvements can be made.

This report shares our detailed findings from the targeted review of certain aspects of companies' APM disclosures. Companies can use this review to assess and enhance their own disclosures to ensure that they provide high quality information to investors in their annual reports and accounts.

CRR's reviews are based solely on company reports and accounts and do not benefit from detailed knowledge of each company's business or an understanding of the underlying transactions entered into. They are, however, conducted by staff who have an understanding of the relevant legal and accounting framework. The FRC provides no assurance that the reports and accounts subject to review, including the examples of good practice reporting, are correct in all material respects. The FRC's role is not to verify the information provided in a company's report and accounts but to consider the quality of compliance with reporting requirements.

1 BACKGROUND

In December 2016, the FRC wrote to 20 companies informing them that CRR would review the APM disclosures in their next annual report and accounts. The purpose of the review was to encourage better disclosures of APMs and, in particular, to consider those matters which had given cause for concern in CRR's earlier review of a sample of 2016 interim reports[1]. A press notice was issued on 15 December 2016 to raise awareness of the issues to be covered by this thematic review.

We decided to carry out a second review to examine how APMs were used in the very different context of annual reports and when all companies would have had a full opportunity to consider both the European Securities and Markets Authority's (ESMA) "Guidelines on Alternative Performance Measures" (the Guidelines) themselves and the comments made in our first thematic report.

Our sample comprised eight companies from the FTSE 100, nine from the FTSE 250, two smaller listed entities and one company from the AIM market.

This review aimed to establish the extent to which the reports and accounts considered were consistent with the Guidelines. In carrying out the review, we took into consideration the findings of our 2016 review. We also identified, by comparing the reports with the equivalent document for the previous year, what steps, if any, companies had taken to achieve greater consistency with the Guidelines. In line with our objective of achieving continuous improvement in reporting, we have sought to identify examples of good practice.

Note:

ESMA has subsequently issued a series of questions and answers on various aspects of the Guidelines ("the Q&A"), the latest being published in October 2017. As most of the Q&A had not been published at 31 December 2016, we have not taken them into account in this review in determining whether or not individual reports and accounts complied with the Guidelines.

In due course, we will consider whether any change to our approach is necessary in the light of the Q&A and will issue further guidance if we believe that further modification is required. To be clear, no such modified guidance will affect our approach to reviews of December 2017 year end reports.

1 https://www.frc.org.uk/getattachment/3b030929-b2ba-4f07-85f8-00e5eb1f1403/Corporate-Reporting-Thematic-Review_APMs-v2-1.pdf

2 KEY MESSAGES

General

APMs were used by all companies in the sample.

Compliance with the Guidelines was generally good across the sample and very much improved on the previous year's annual reports (to which the Guidelines did not apply). In particular:

- Definitions were given in all cases. Labels used generally conveyed an accurate description of each APM, although we are aware, from our regular reviews, of instances where it was not always clear whether a measure used was an APM rather than an International Financial Reporting Standards (IFRS) measure.

- Explanations for the use of APMs were given in all cases, although two companies only asserted that the APMs were the "most meaningful" measures without further explanation as to why. We saw a number of good examples and also noted helpful "health warnings" being inserted by several companies. We also found far fewer explanations using either cursory or boilerplate wordings than in our previous review.

- Reconciliations were given by all companies but not necessarily for all APMs used; the most frequently omitted being for ratios such as return on capital and cash conversion. Reconciliation disclosures can be lengthy where a company uses several APMs and we saw a number of good approaches to presenting these in a clear and concise way.

- Most of the reports in the sample gave, taken as a whole, equal prominence to APMs and IFRS measures. Equal prominence was, however, more of an issue in sections such as the chairman's statement or chief executive's review than it was with the presentation of highlights or in financial reviews or equivalents.

Our main concern arising from the review is the use of the term "non-recurring" and the use of similar terms such as "unusual", "infrequent" and "one-off" in connection with items such as restructuring costs and impairment charges. For larger companies in particular, there will be few occasions when there is only one event in a period of years which drives such charges. We accept that there will be some such cases where more than one year is affected, for example, a very substantial restructuring that is part of a single plan with a defined cost. However, we recommend that, in general, companies remove such descriptions as "non-recurring" from their definitions of APMs and select more accurate labels. A number of examples are given in sections 4 and 5.

In considering the quality of explanations for the use of APMs, we noted that 85% of the companies in the sample stated that APMs were used by management in evaluating performance but only 40% referred to their use in determining management and executive remuneration. However, our review did not involve reviewing remuneration committee reports to assess the extent that disclosed APMs were used in determining management remuneration.

All but one of the companies in the sample had made at least minor changes to the presentation of APMs in the year, with some changes being extensive. The most common improvements were to explanations for the use of APMs followed by a better balance between APMs and IFRS measures and presenting clearer reconciliations.

Adjusted measures of profit

The great majority of the companies in the sample used either “adjusted” or “underlying” as the principal description for their adjusted measure of profit (85% of the sample). The adjusted measure appeared as a line item in the income statement for 65% of the sample.

As with the earlier review, there was significant commonality in items excluded from the corresponding IFRS measure in arriving at the adjusted measure. Amortisation of acquired intangibles, at least some restructuring charges and profit or loss on disposal of investments or business were near universal adjustments. However, we noted that share-based payments were only added back in three cases.

We saw relatively few explanations as to why individual items were added back with the exception of amortisation of acquired intangibles and restructuring costs.

For restructuring costs, companies often linked the costs in the year to identified programmes or initiatives that were discussed elsewhere in the report and accounts.

In all but three cases, the adjusted measure of profit was higher than the IFRS equivalent.

3 THE REQUIREMENTS OF THE ESMA GUIDELINES

This thematic review, together with the earlier review in 2016, has been conducted in the light of concerns expressed about the use of APMs by a number of stakeholders and commentators. The topic was given added relevance by the issue of 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 on or after 3 July 2016. The Guidelines therefore applied for the first time to the annual reports and accounts of the companies included in the sample.

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 adjusted profit. While many users acknowledge that such measures can provide useful financial information in addition to those provided under 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 Guidelines do not apply to APMs disclosed in financial statements prepared in accordance with IFRS. Therefore, in terms of annual reports and accounts, their main impact is on the narrative reporting in such documents, mainly strategic reports but also highlights pages and chairman or chief executive statements. This is the case whether or not these have been formally included in the strategic report required by the Companies Act 2006 (the Companies Act).

We believe that the Guidelines largely represent a codification of what is required of APMs to support a fair, balanced and comprehensive strategic report and of best practice reporting in this area. Accordingly, we expected many companies to review, assess and alter their disclosures in response to the coming into force of the

Guidelines. In our regular reviews of reports and accounts, we consider whether APMs disclosed in strategic reports are consistent with the Guidelines. Where there are material inconsistencies, we write to the companies concerned and ask for further explanation. We take account of such inconsistencies when deciding whether strategic reports meet the requirements of the Companies Act.

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. We have also considered the balance between the discussion of IFRS and non-IFRS measures, particularly where this affected trend information.

This practice is not a major change in our approach and should not lead to reports becoming less understandable, clear or concise.

4 PRINCIPAL FINDINGS – GENERAL

4.1 Definitions and labels

The FRC expects companies to provide definitions of all APMs used and to use labels which accurately describe the APM to which they are applied.

All the companies in the sample provided definitions of the APMs used, although, in three cases, not all APMs used were defined. The missing APMs were cash conversion, return on invested capital and organic revenue growth.

The definitions were usually generally easy to find, with two exceptions. In one case, no cross-references were given. In the other case, the reader was required to go first to the glossary at the end of the report and accounts which then referred back to the notes to the accounts for details. In our view, definitions should be clearly cross-referenced and complete in themselves.

The labels given to APMs generally reflected their content and basis of calculation. However, one company referred to its alternative measure of profit as “reported”, which is potentially misleading. A reader would have been likely to assume that “reported” referred to the IFRS results.

From our regular reviews, we are aware of instances where APMs have been given labels such as “operating profit” and it has not been made clear that the item concerned is an adjusted rather than an IFRS measure, or has only been made clear once at the beginning of the strategic report. We have also seen labels such as “non-operating” used where some of the items appearing under that label appear to be part of normal operating activities.

In terms of positioning, definitions were located either in the strategic report, usually as part of the financial review or similar section (60%), in the notes to the accounts (10%) or at the end of the report and accounts, that is outside the audited financials (30%), sometimes in a glossary.

One particularly helpful format we observed in a number of reports tied together the definition of the APM with its purpose and, on occasion, a comment on performance in the year. For example:

- **“Underlying Trading Profit (UTP)**

Definition

Trading Profit is defined as IFRS Operating Profit adjusted for (i) amortisation and impairment of intangibles arising on acquisition and (ii) exceptional items. Consistent with IFRS, it includes Serco’s share of profit after interest and tax of its joint ventures. Underlying Trading Profit excludes Contract and Balance Sheet Review adjustments (principally Onerous Contract Provision (OCP) releases or charges), the beneficial treatment of depreciation and amortisation of assets held for sale, and other material one-time items as set out in the Finance Review. Trading Profit measures include discontinued operations for consistency with previous guidance.

Relevance to strategy

The level of absolute UTP and the relationship of UTP with revenue – i.e. the margin we earn on what our customers pay us – is at the heart of our 'profitable and sustainable' business objective, as well as being an output of 'winning good business' and 'executing brilliantly'. We describe on page 13 that the delivery of strategic success, after the completion of further transformation in the coming year, has potential to deliver revenue growth of 5–7% and trading margins of 5–6%.

Performance

A materially better outcome than expected at the start of the year, driven largely by non-repeating factors such as the successful resolution of a number of commercial issues. The £14m decline was a reduction of £4m excluding the £19m effect of discontinued operations that reflect the disposal of the private sector offshore BPO business at the end of 2015 and excluding the £9m net currency benefit. The underlying margin was flat at 2.7%."

Serco Group plc, Annual report and accounts 2016

4.2 Non-recurring and similar terms

The FRC expects companies to justify clearly the use of such terms as non-recurring.

The Guidelines state that companies "should not mislabel items as non-recurring, infrequent or unusual. For example, items that affected past periods and will affect future periods will rarely be considered as non-recurring, infrequent or unusual (such as restructuring costs or impairment losses)".

This issue most frequently occurs in connection with restructuring and reorganisation costs as discussed in section 5.3. However, the majority of companies in the sample used one of the terms set out in the previous paragraph or a similar term.

Eight companies used the term "non-recurring" while three referred to "one-off" items. Similar labels were used for items excluded because of their inconsistent profile or that did not form part of recurring activities. Items were also excluded because of their volatility, for example, fluctuations due to changes in exchange rates and commodity prices. However, nine companies did not use any variant of non-recurring.

While restructuring costs were the most common item covered by such terms, impairments, strategy implementation costs and corporate transaction costs were also so described.

We recommend that companies use terms that could not be read as implying, for example, that a company is unlikely to recognise a further impairment charge on any asset for a considerable period.

4.3 Explanations for the use of APMs

The FRC expects companies to set out clear explanations of why they have used APMs.

In our earlier review, we noted that explanations given as to how companies had determined that it was beneficial to disclose APMs varied significantly. All FTSE 350 companies provided at least some explanation but this was not the case amongst smaller companies. We were also concerned that some of the explanations given were cursory and boilerplate, for example, stating only that "these figures better reflect the performance of the business". 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, by whom and for what purpose.

In the present review, all but one of the companies explained their use of APMs. However, two companies still only asserted the usefulness of their APMs, one stating that they were the "most meaningful" measures while the other stated that they were the "most meaningful" and "most appropriate". The company that did not give an overall explanation did, however, give explanations for individual adjustments. Overall, few of the explanations could be described as either cursory or boilerplate.

On the reasons given:

- Several companies referred to ensuring comparability either between years or between reported segments or both. Some mentioned comparability without clarifying what was being compared.
- A number referred to removing distortions or volatility, for example, from exceptional events or from commodity price fluctuations.
- There were a number of references to enhanced clarity, transparency and/ or consistency, usually in respect of underlying performance.
- One property company, which used industry standard measures, cited comparability with its peer group.
- Two companies referred to measures used as being common in their industry.

85% of the sample stated that the APMs disclosed were used by management in evaluating performance but only 40% referred to their use in determining management remuneration, which is of concern given the interest of investors and other stakeholders in that subject. However, it should be noted that our review did not involve reviewing remuneration committee reports to assess the extent, if at all, that disclosed APMs were used in determining management remuneration.

The following extracts are examples of some of the better explanations for the use of APMs, albeit subject to the above discussion on non-recurring and similar items:

- *"The Group uses APMs to improve the comparability of information between reporting periods and business units, either by adjusting for uncontrollable or one-off factors which impact upon IFRS measures or, by aggregating measures, to aid the user of the Annual Report in understanding the activity taking place across the Group's portfolio…*

"APMs are used by the Board and management for planning and reporting. A subset is also used by management in setting director and management remuneration. The measures are also used in discussions with the investment analyst community and credit rating agencies."

Anglo American plc, Annual report and accounts 2016

- *"The Strategic Report includes both statutory and adjusted measures, the latter of which, in management's view, reflects the underlying performance of the business and provides a more meaningful comparison of how the business is managed and measured on a day-to-day basis.*

  Our APMs and KPIs are aligned to our strategy and together are used to measure the performance of our business and form the basis of the performance measures for remuneration.

  Adjusted results exclude certain items because if included, these items could distort the understanding of our performance for the year and the comparability between periods."

ITV plc, Annual report and accounts 2016

- *" The Directors believe that these APMs assist in providing additional useful information on the underlying trends, performance and position of the Group.*

  APMs are also used to enhance the comparability of information between reporting periods and geographical units (such as like-for-like sales), by adjusting for non-recurring or uncontrollable factors which affect IFRS measures, to aid the user in understanding the Group's performance.

  Consequently, APMs are used by the Directors and management for performance analysis, planning, reporting and incentive-setting purposes and have remained consistent with prior year."

Tesco PLC, Annual report and accounts 2017

45% of the sample included a "health warning" of some kind. Most reminded the reader that APMs are not IFRS measures and were not intended as a substitute for those measures. Further, the APMs used might not be the same as those used by other companies. We consider that such warnings are helpful in alerting readers to the limitations of APMs but, as they will inevitably tend to be boilerplate, believe that they should be kept concise.

- *" In reporting financial information, the Group presents alternative performance measures, "APMs", which are not defined or specified under the requirements of IFRS.*

  The Group believes that these APMs, which are not considered to be a substitute for or superior to IFRS measures, provide stakeholders with additional helpful information on the performance of the business."

Marks and Spencer Group plc, Annual report and accounts 2017

4.4 Reconciliations

The FRC expects reconciliations to amounts appearing in the financial statements to be presented for each APM disclosed.

The Guidelines require a reconciliation to be given for each APM to the most directly reconcilable line item, subtotal or total in the financial statements, separately identifying and explaining the material reconciling items.

12 of the sample (60%) omitted to reconcile at least one APM. The most common omissions were return on capital and similar ratios, free cash flow and cash conversion. Two of these are ratios but, for these, we would expect the numerator and denominator to be stated and, if necessary, reconciled to items in the financial statements as shown in the following example.

- ***"Return on invested capital***

  Return on invested capital (ROIC) is calculated as adjusted operating profit less operating cash tax paid expressed as a percentage of average invested capital. Invested capital includes the original unamortised goodwill and intangibles. Average values for total invested capital are calculated as the average monthly balance for the year. ROIC is included as a non-GAAP measure as it is used by management and investors to track investment returns and by management to help inform capital allocation decisions within the business.

All figures in £ millions	*2016*
Adjusted operating profit	*635*
Operating tax paid	*(63)*
Return	*572*
Average goodwill and other intangibles	*9,468*
Average net operating assets	*1,996*
Average invested capital	*11,464*
Return on invested capital	*5.0%"*

Pearson plc, Annual report and accounts 2016

A number of companies presented figures at constant exchange rates which are APMs and, therefore, require reconciliations. For example:

"Alternative performance measure	*2016*	*2015*
Statutory revenue	*1,110.0*	*1,018.1*
Adjust for acquisitions/disposals and internal transfers, where applicable	*(12.5)*	*(13.0)*
Impact of foreign exchange movements	*-*	*70.3*
Underlying revenue	*1,097.5*	*1,075.4"*

Berendsen plc, Annual report and accounts 2016

We appreciate that reconciliations can occupy considerable space and disrupt the flow of reports and accounts. Companies should try to present them as clearly and concisely as possible. This is especially the case for companies that use several APMs. We noted three possible approaches in our sample.

- A reconciliation in each relevant note. The advantages of this approach are that presentation here tends to be concise and does not detract from the overall presentation of the accounts. The downside is that users have to search for the reconciliations in the accounts when the relevant APM definitions are often located elsewhere, for example, in the strategic report. Both of these disadvantages can be mitigated by good cross-referencing.
- Collecting all the reconciliations in one place. This is usually in the financial review, or similar section, of the strategic report or under "other information" at the back of the accounts. In this approach, the definitions and reconciliation are often provided together. Arguably, positioning is better at the end of the report and accounts rather than spoiling the flow of the strategic report unless, for example, commentary on performance in the year is also included.
- Including all income statement-related APMs in a single tabular reconciliation.

Reconciliation of 2016 statutory results to performance measures

	2016 statutory results	*Build to Last restructuring costs*	*Intangible amortisation*	*Provision increases/ (releases)*	*Gains on disposal*	*Results of ES*	*Results of Rail Germany*	*Other*	*2016 performance measures*
	£m	***£m***	***£m***	***£m***	***£m***	***£m***	***£m***	***£m***	***£m***
Group revenue (statutory)	***6,923***	-	-	-	-	*(3)*	*(138)*	-	***6,782***
Group operating profit/(loss)	***(41)***	*14*	*9*	*31*	*(8)*	*6*	*(1)*	*2*	***12***

Extract Balfour Beatty, Annual report and accounts 2016

4.5 Prominence

The FRC expects APMs to be disclosed with no greater prominence than measures directly stemming from the financial statements.

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 the earlier exercise, 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.

For the present exercise, we have taken the opportunity to refine our expectations regarding prominence. We are now taking the position that prominence is not an issue if the APM appears in the IFRS column of a multi-column income statement. If the APM does not fulfil that criterion, then we would expect a corresponding measure which does fulfil the criterion to be presented alongside, with equal prominence. For 13 (65%) of the companies in our sample, either the APM presented appeared in the IFRS column or a corresponding measure that did was shown with at least equal prominence.

Where APMs appeared as line items in the income statement, we assessed whether the narrative in the strategic report dealt with all significant items in that statement. This was the case for all the reports in the sample with one possible exception. Here, the narrative appeared in the financial statements themselves so that it was not clear whether or not this narrative formed part of the strategic report.

Where APMs did not appear as line items, all of the sample began by showing both APMs and IFRS amounts. Trading was then usually discussed in terms of APMs before concluding with a discussion of other items in the IFRS income statement. However, two of the seven companies did not discuss all significant reconciling items between the APMs presented and the corresponding IFRS amounts. An issue was also noted with those parts of the narrative which did not focus solely on financial measures, for example, the chairman’s statement or chief executive’s review. We would emphasise that equal prominence applies each time an APM is presented.

In summary, most of the reports in the sample gave equal prominence to APMs and IFRS measures but this was more of an issue in some parts of the report and accounts than others.

4.6 Other observations

Comparatives

The FRC expects that the definitions and bases of calculation of APMs should be consistent over time. Readers of the accounts should be informed of any changes and told why they result in reliable and more relevant information.

All companies in the sample provided comparatives for each APM and provided reconciliations for those comparatives as required by the Guidelines, at least where reconciliations were provided for the current year amounts.

No company in the sample had changed any definitions of their APMs, so that compliance with the Guidelines regarding such changes could not be considered.

However, we did see some changes in labels. Changes in label, that is the term used to describe the APM, are not addressed in the Guidelines. However, we believe that it is consistent with their spirit, as well as being helpful for users, that companies identify and explain such changes.

Other

We also looked at references to APMs in other areas of the report and accounts. 55% of the sample referred to APMs in their audit committee reports, while 20% of the audit reports did so. An accounting policy was given by 20% of the sample.

Issues regarding APMs were cited as a significant judgement or estimate in 40% of cases. These generally related to the determination of which items to exclude from the adjusted measure of profit, for example:

- *"Management exercises judgement in determining the adjustments to apply to IFRS measurements in order to derive APMs which provide additional useful information on the underlying trends, performance and position of the Group.*

  This assessment covers the nature of the item, cause of occurrence and the scale of impact of that item on reported performance."

Tesco PLC, Annual report and accounts 2017

4.7 Improvements in year

All but one of the companies in the sample had made at least minor changes to their selection, presentation or explanation of APMs from the previous year. The most common change seen was in the level of explanation given for the use of APMs.

One company that changed relatively little had already achieved quite good compliance with the Guidelines in its 2015 annual report and therefore little further change was necessary in order to comply. In this context, it should be remembered that the Guidelines were published in 2015 so that companies could adopt them early. In addition, the Guidelines codified existing best practice.

The most common improvement was new or more meaningful explanations (80% of the sample), followed by changes giving a more even balance between APMs and IFRS measures (50%) and either new or clearer reconciliations (40%).

5 PRINCIPAL FINDINGS – ADJUSTED MEASURES OF PROFIT

As in the 2016 review, we considered how adjusted measures of profit were defined, how they were disclosed and how they differed from the corresponding IFRS measure.

5.1 Measures used

All companies in the sample used an adjusted measure of profit.

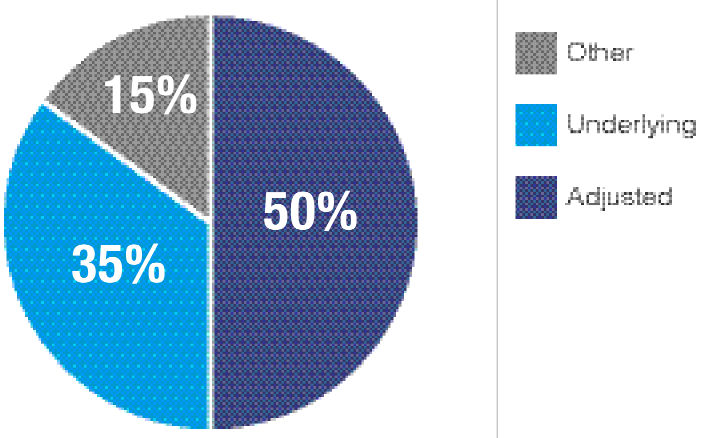
As we found in our previous review, a variety of terms were used to refer to the adjusted measure of profit. The great majority of companies used some variation of either adjusted (10 companies – 50%) or underlying (seven companies – 35%). Of the remaining three:

- One, a property company, used an industry specific measure.
- One referred to operating profit.
- One used the term “reported”, which was a cause for concern, given the potential for misunderstanding.

The proportion of accounts where the adjusted measure appeared as a line item in the income statement was rather higher than we found in the last study, being 65% compared to 50%. A measure was taken to be a line item provided it appeared on the face of the income statement but not necessarily in the column showing the results as determined under IFRS.

For 16 of the accounts in the sample (80%), the adjusted measure was either defined in the first 2-3 pages of the report or a cross-reference provided to where the definition might be found. Where the definition excluded exceptional or similar items, that definition would also usually have had to be consulted to obtain a complete picture of the adjusted measure.

Adjusted measure of profit – terms used



In all cases, at least one item was excluded in arriving at the adjusted measure. In all but three cases, at least five items were excluded, while nine companies excluded more than six. The most common exclusions were:

	Number	%
Amortisation of acquired intangibles	*16*	*80*
Restructuring charges	*17*	*85*
Fair value movements on non-hedge accounted derivatives	*7*	*35*
Profit or loss on disposal of investments or businesses	*16*	*80*
Impairment charges	*11*	*55*
Major pension items, e.g. gains arising on curtailments	*6*	*30*
Acquisition and integration costs	*8*	*40*

This list is longer than in the previous thematic review, possibly because items such as impairment charges may be more likely to be recorded in full year accounts rather than at the interim stage. Share-based payments has come off the list as only three companies in the sample adjusted for this item. We welcome this finding given the observation we made in the last review that it was not clear to us why share-based payment charges should be excluded as they appear to be a valid cost of the business and relieve companies of an alternative cash expense.

Worthy of note amongst other exclusions, and in line with findings on our regular reviews, are adjustments to contingent consideration and significant costs associated with major legal actions.

In all but three cases (15%), the adjusted measure of profit was higher than the IFRS equivalent. The range of differences was considerable, from 72% below the IFRS equivalent to more than 300% above.

5.2 Explanations

The FRC expects companies to explain why individual items have been excluded from the adjusted measure of profit.

We examined the accounts in the sample to identify whether reasons were given for specific exclusions over and above the reasons given for the use of APMs discussed above. Explanations for excluding restructuring costs are examined in the next section.

Eight companies in the sample advanced explanations supporting the exclusion of amortisation of acquired intangibles. While we did not find any of the explanations persuasive, we note the prevalence of this particular adjustment and the widely expressed view that users themselves habitually disregard this cost. We observe, however, that the original expenditure which is being amortised contributed to the profits now being generated by the enlarged business. It appears to us, therefore, that there is a significant lack of symmetry in its exclusion. As a consequence, the quality of explanation here is particularly important.

The following two examples illustrate some of the issues which arise in this area.

- We have challenged companies where the acquired intangibles are of a type which the company purchased itself in the normal course of business, for example, software licences. In such cases, we have seen companies exclude either all software amortisation or just the amortisation of the software acquired in business combinations from the adjusted measure of profit. Either approach appears to unduly benefit the adjusted measure by removing a necessary and ongoing cost of doing business.
- In one case, a pharmaceutical company developed some products itself while acquiring others through its purchase of other companies. In the first instance, some 90% of research and development costs were required to be expensed as incurred while, in the second, the company was required to capitalise the value of the acquired products. The company argued that it should exclude amortisation of the acquired products to properly compare the performance of the products in its portfolio. Whilst we accepted the company's presentation, we did so only on the basis that the company gave an undertaking to disclose a full explanation of its approach in its next report and accounts.

5.3 Restructuring costs

The FRC expects companies to explain why, and to what extent, restructuring costs have been excluded from the adjusted measure of profit.

We examined the quality of the explanations for restructuring costs in view of a number of factors:

- As already noted above, the Guidelines state that items should not be mislabelled as "non-recurring, infrequent or unusual. For example items that affected past periods and will affect future periods will rarely be considered as non-recurring, infrequent or unusual (such as restructuring costs or impairment losses)".
- The degree of judgement which often appears to be involved.
- The practice of distinguishing those costs that should be stripped out of the adjusted measure of profit and those that should be left in as they form part of the underlying trading of the business.

17 of the companies in the sample adjusted for at least some restructuring costs. 12 of the 17 companies (71%) included some variation on non-recurring, unusual or infrequent in their definitions or explanations for restructuring costs. Two companies justified this by only adjusting for major, multi-year restructuring programmes with a known budget. Others distinguished between types of restructuring costs, for example such costs:

- "relate to the restructuring of the Group's portfolio which are incremental to normal operations"
- "are as a result of a number of significant restructuring projects across the Group"
- "are excluded from adjusted operating profit where they represent fundamental changes in individual operations around the Group"
- "arise from Group-wide initiatives to reduce the ongoing cost base and improve efficiency in the business"
- "arose in relation to the restructuring programme resulting from the Strategy Review"
- arose from initiatives which "are substantial in scope and impact and do not form part of recurring operational or management activities that the directors would consider part of our underlying performance".

As already noted in section 4.2, there will often be an issue where common activities such as restructuring are identified as non-recurring or similar. This is much less the case where the restructuring concerned is identified as a major, well-defined business transformation with set borders, possibly spreading across more than one year. Where this is the case, we would expect such a programme to be referenced in each year affected. From our regular reviews, we know that this is not always the case.

The position is more questionable where there is a succession of such programmes such that there is a restructuring charge to be adjusted for in all, or almost all, years.

Where exclusions are not based on an identification as non-recurring, there is still a question as to whether the excluded costs are genuinely not part of the underlying business. Here, the quality of explanation presented by the company is key.

6 NEXT STEPS

This report sets out the findings from CRR's thematic review of APMs. Overall, we were very pleased to see the level of improvements made by most of the companies in our sample. However, we will continue to question companies where:

- Definitions are not given for all APMs used.
- A term such as non-recurring is used and that description does not appear to apply in the circumstances.
- Good explanations for the use of APMs are not provided.
- A reconciliation to amounts appearing in the financial statements for each APM is not disclosed.
- APMs are displayed with greater prominence than measures directly stemming from the financial statements.
- 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 section of the report and accounts.
- No explanation is given for changes made in the APMs used. Changes may include changes to which APMs are presented, in how APMs are defined and in the label applied to each APM.
- Explanations are not presented of why items have been excluded from adjusted profit. The quality of explanation is particularly important when this item is not usually adjusted for by the company's peers.
- Items are excluded on the basis that removing them better reflects the underlying performance of the business and it is unclear why this is the case; for example, share based payments.

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