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An alternative picture of performance

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Alternative Performance Measure reporting practices in the FTSE 100

Alternative Performance Measures or, APMs, are deeply integrated in UK corporate reporting and investors tell us they are useful in both the understanding of the underlying operational performance of a business and making management's monitoring of their business more transparent. *Click here to view our investor survey.*

But, despite their prevalence, there is increasing scrutiny from regulators, investors and media into how APMs are reported and whether they really support, or deceive, corporate transparency.

Mindful of the fact that the European Securities and Markets Authority (ESMA) has published updated guidelines for listed companies that will be enforceable in the UK later this year, we have set out to explore how widely APMs are used and what is being adjusted by companies. Our findings can be summarised as follows:

- 95% of the FTSE 100 adjust their GAAP profit numbers.
- Adjustments almost always have a favourable impact on profit.
- Companies commonly adjust for: acquired intangibles amortisation; asset impairment; interest, depreciation, amortisation and tax.
- Descriptions of reconciling items are often too broad to understand what they relate to.
- Inconsistent approach to where and how reconciliations are presented.

These findings may not surprise, but they do suggest more work will need to be done by companies to ensure they comply with the ESMA guidelines.

What did we find?

Use of Adjusted Profit Measures

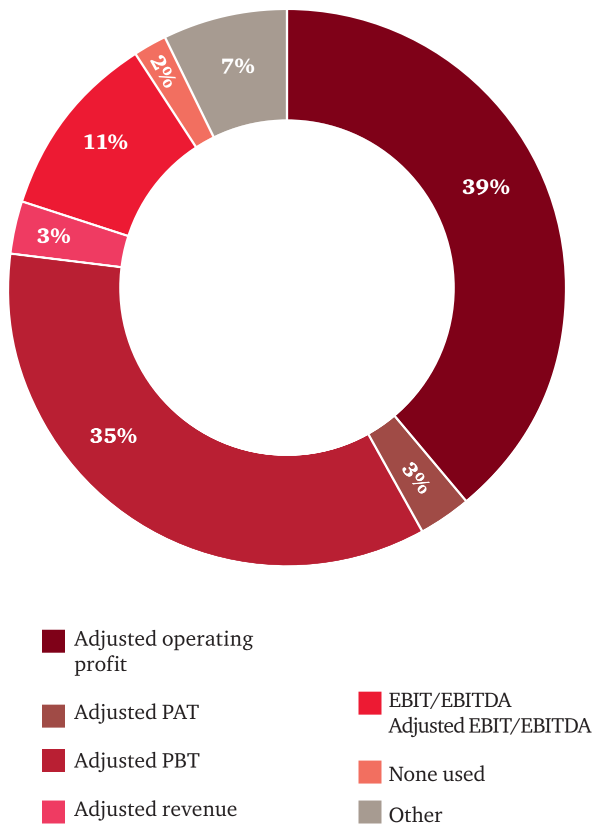
95% of the FTSE 100 disclose an adjusted profit number. But **2** companies did not provide supporting information in the form of a reconciliation from the GAAP measure to the APM.

APM description

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

- adjusted operating profit ***(39%)***,
- adjusted PBT ***(35%)***,
- EBITDA ***(11%)***.

Such a variety of approaches, sometimes between competitors/industries, often makes it difficult for readers to understand and compare APMs.



Methodology

We performed a review of all of the FTSE 100 with year-ends from 1 April 2014 to 31 March 2015.

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

£62bn worth of adjustments

A review of the total number of adjustments showed that movements in aggregate for all 100 companies with an APM went from a GAAP figure of roughly £119bn to £187bn.

Of the 95 companies that presented an adjusted profit number only **12** reported a number less than the original GAAP figure.

Placement of the reconciliation

While ***98%*** of the companies provided a reconciliation of the APM to GAAP, there was no consistency in where they were reported, and indeed in some circumstances they were reported in more than one place.

- Front half ***(45%)***.
- Face of the primary statements ***(37%)***.
- Notes to the financial statements ***(57%)***.
- Other section ***(7%)***.
- No reconciliation ***(2 companies)***.

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

What is in 'other'?

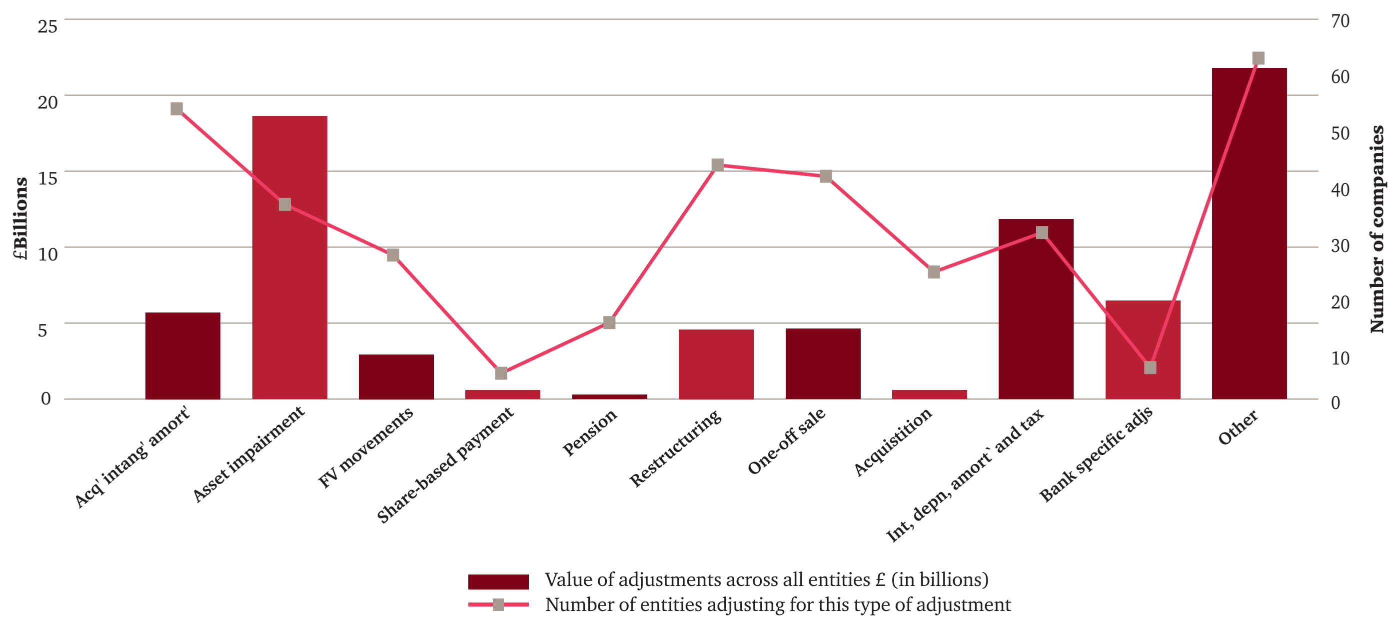
We continue to see the FRC's Corporate Reporting Review Team (CRRT) challenge companies where they believe the label used for a particular APM might convey a misleading message.

Nevertheless in our analysis there remain a number of companies making adjustments ***(£21.7bn)*** that do not fit in to the categories outlined in our graph. Included in this category are various adjustments for legal costs, inventory holdings and 'entity-specific adjustments'. But what is most telling is that ***28%*** of the adjustments remain undisclosed ***(£6.0bn)***. This is where it has been difficult to assign the adjustment to a relevant category from reading the description that companies have given.

What is being adjusted?

The graph below analyses the reconciling items by value and number.

Value and number of adjustments across the FTSE 100



As well as there being a variety of descriptions used for APMs, there are also a variety of terms that are used to describe the adjustments from GAAP numbers to APMs. As demonstrated in the graph above the common adjustments relate to:

- acquired intangibles amortisation
- asset impairment
- interest, depreciation, amortisation and taxation; and
- bank specific adjustments for those in the banking industry

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 10% of companies are adjusting for pension-related items and nearly 30% of companies are adjusting for acquisition-related costs yet they represent only 0.4% and 0.7% of the total value of adjustments. The question for companies to ask is whether these adjustments are material enough to be separately identified.

ESMA Guidelines on Alternative Performance Measures

The guidelines apply to APMs disclosed in regulated information published by issuers with securities traded on regulated markets. This will include APMs presented in the 'front half' of annual reports and interim financial reports, but exclude financial information provided in the audited financial statements of the accounts. They also apply to APMs in other regulated information published by an entity. This includes management reports disclosed to the market under the Transparency Directive and disclosures under the requirements of article 17 of the Market Abuse Regulation (for example, ad-hoc disclosures including financial earnings). The guidelines also apply to prospectuses issued under the Prospectus Directive.

An APM is "a financial measure of historical or future performances, financial position, or cash flows, other than a financial measure defined or specified in the applicable financial reporting framework."

Under the guidelines issuers are required to:

- Define APMs in a clear and readable way and give meaningful labels (impairments and restructuring charges are 'rarely … unusual or non-recurring').
- Reconcile APMs to the most directly reconcilable GAAP line item explaining material reconciling items.
- Explain the use of APMs so users understand relevance and reliability.
- Not display APMs with more prominence, emphasis or authority than GAAP measures.
- Present APMs with comparatives which also need to be reconciled.
- Define APMs consistently over time and justify any changes made.

These guidelines will be effective for all announcements from 3 July 2016 and the FRC and FSA will be responsible for enforcement in the UK.

It is helpful for companies to note that these guidelines are not new. The Committee of European Securities Regulators (CESR) (replaced by ESMA in 2011) acknowledged that non-GAAP measures can provide investors with appropriate additional information if properly used and presented. In 2005, it made recommendations similar to those summarised above from ESMA. The scope of the guidelines has been amended. CESR recommendations applied to financial performance figures of listed companies but not to prospectuses published in accordance with EU legislation. One significant change to be aware of is that the ESMA guidelines, which have higher status than the CESR recommendations, now require a reconciliation, whereas CESR recommended an explanation of differences, which could be done by means of a reconciliation.

In light of the CRRT's stance and ESMA's guidance, which states that "APMs disclosed should be given meaningful labels reflecting their content and basis of calculation in order to avoid conveying misleading messages to users", and based on our findings, we think that more work will need to be done by companies to make their reconciling items relevant, understandable and not misleading.

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Summary

Our findings show that APMs are widespread and companies use many different descriptions for them. While most companies try to explain APMs and reconcile these to GAAP measures, this reconciliation is not always easy to find. It is evident from our surveys that investors find APMs useful but would like more transparency over the information disclosed in the annual report. We expect increasing regulator scrutiny over the use and disclosure of APMs and that the ESMA Guidance will significantly impact the disclosure of APMs. While the guidance is effective for all announcements from 3 July 2016, companies should now be thinking about what they need to do to publish transparent, unbiased and comparable information on their financial performance.

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