CFA Society United Kingdom

JULY 2015

NON-IFRS EARNINGS AND ALTERNATIVE PERFORMANCE MEASURES: ENSURING A LEVEL PLAYING FIELD

A report prepared by the Financial Reporting and Analysis Committee of the CFA Society of the UK

EXECUTIVE SUMMARY

The reporting of alternative performance measures (APMs) continues to be in the spotlight, with the European Securities and Markets Authority (ESMA), the International Organisation of Securities Commissions (IOSCO), the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) contributing to the debate. They are all aiming to improve consistency, transparency, clarity and usefulness of APMs because they are so widely used by the investment community.

CFA Society of the UK (CFA UK), as a group of regular users of alternative performance information, feel it's important to contribute to this debate and provide companies with our thoughts on how they can report their APMs in the most effective way. We also want our members to understand the benefits and potential pitfalls of relying on the APM information reported today.

APMs are widely used by companies as management seek to tell the story of their performance, adjusting International Financial Reporting Standards (IFRS) or Generally Accepted Accounting Principles (GAAP) information to show what they believe is more in line with underlying performance. This paper examines current practice in that area. CFA UK understands that not all businesses are the same, and companies need to be able to tell their story in a way that works for them and, overall, we believe that non-IFRS earnings and other APMs are useful for investors.

Given the need for company-specific information in APMs, we don't think standard setters can usefully prescribe which adjustments are allowed. This risks introducing a third set of performance information – companies would present IFRS earnings, a form of "prescribed APMs" and a form of "management's APMs". Even in this scenario, we think it is likely that many analysts will still produce their own adjusted measures as they evaluate a company's performance. However, we believe that if the standard setters could define some commonly used income statement subtotals, such as earnings before interest, taxes, depreciation and amortisation (EBITDA) and earnings before interest and taxes (EBIT), there would be less of a need for adjustments. CFA bodies in different parts of the world are regularly consulted by standard-setters and CFA UK looks forward to contributing to the IASB's discussion on APMs in particular and financial statement presentation more broadly. In the meantime, we think there is a lot companies can do on a voluntary basis to increase the usefulness of the APMs they report.

CFA UK represents more than 10,000 investment professionals working across the financial sector including asset managers, buy-side analysts, sell-side analysts and credit rating analysts, among others. For advocacy purposes in the field of financial reporting, these members are represented by the Financial Reporting and Analysis Committee.

CONTENTS

4 INTRODUCTION

Management-derived adjusted earnings measures provide useful insight

Clarity, balance and consistency of adjustments is key

APMs impact many aspects of investment analysis

Guidance on APMs is needed

6 COMPANY REPORTING OF APMs TODAY

Comparison of IFRS and non-IFRS earnings reported by FTSE companies

Are non-IFRS earnings misleading?

Regulator guidelines on APMs

10 COMMONLY REPORTED PERFORMANCE MEASURES

Operating Profit

EBITDA

Free Cash Flow

Other key performance indicators (KPIs)

11 KEY ADJUSTMENTS REPORTED BY COMPANIES

Stock-based Compensation

Restructuring Charges and Legal Costs

Impairments of Acquired Intangible Assets

Amortisation of Intangible Assets

16 APM GUIDELINES AROUND THE WORLD

IIMR Definition of Headline Earnings

Johannesburg Stock Exchange rules

Australian Securities and Investments Commission rules

US Securities and Exchange Commission rules

18 CONCLUSION

020 7648 6200

info@cfauk.org

www.cfauk.org

Follow us:

@cfauk

INTRODUCTION

Although IFRS financial information is critical to an investor's understanding of the performance and financial position of a business, sometimes companies feel that the accounting standards do not always produce accounts that reflect the underlying economic reality or the company's ongoing performance. Management often reports APMs as an attempt to remove what they see to be distortions and more clearly articulate the long-term story of their performance. Management teams are aware that investors often use historical results to forecast future performance. APMs can be used to guide investors to focus on the recurring, operational items that drive performance as they make their forecasts.

The reasons for making adjustments to arrive at APMs broadly fall into three categories:

1) To remove the effect of one-off, unusual or non-recurring items
2) To remove volatility associated with economic events outside of management's control
3) To remove the effect of accounting treatment that they feel does not reflect the company's performance during the period.

These non-IFRS measures of earnings are often referred to as "core" or "adjusted" earnings measures.

MANAGEMENT-DERIVED ADJUSTED EARNINGS MEASURES PROVIDE USEFUL INSIGHT

Our survey of 292 CFA UK members in April 2015[1] showed that around two thirds of respondents thought it useful to have both IFRS and non-IFRS measures in financial reports. This is consistent with findings from a July 2014 PwC survey[2] of 85 investors that showed that the majority (65%) of those polled found adjusted performance measures helpful for their analysis (only 12% did not). Similarly, our survey of CFA UK members showed that 61% of respondents routinely use the non-IFRS measures presented by management.

However, the definitions of non-IFRS measures vary across companies and sectors. Some might argue that APMs merely provide additional information that complements IFRS measures, and leaving the method of deriving APMs up to each company facilitates a "through the eyes of management approach", which is generally valued by the investment community. Cynics might even argue that APMs constructed by company management at their full discretion shed light on the extent to which management is willing to mislead them through financial reporting. Adjusted earnings per share (EPS) is, after all, often a key performance target in the remuneration packages of senior executives. As such, some degree of harmonisation would facilitate the interpretation of non-IFRS measures and enhance their comparability. At the same time, care needs to be taken to ensure that a harmonised framework is not overly rigid and does not detract from the presentation of the business as management sees it (rather than wishes it to be seen).

Some companies already provide a detailed reconciliation between IFRS and non-IFRS earnings, thus providing additional information compared with the IFRS earnings alone. A reconciliation makes the adjustments clearly visible to the analyst, who can then decide what to add back. The PwC survey referred to earlier found that 95% of investment professionals would like management to give clearer descriptions of the adjustments they make so that they can better understand the rationale for such adjustments. In addition, consistency of the definition of non-IFRS earnings over time is crucial to ensure comparisons with prior periods are appropriate.

CLARITY, BALANCE AND CONSISTENCY OF ADJUSTMENTS IS KEY

Some items are intermittent and are, therefore, difficult for analysts to forecast with any accuracy, hence the rationale for removing them from non-IFRS earnings (this is item 1 in the list of adjustment categories on the left). These types of items are sometimes also referred to as "lumpy". They may or may not be "one-offs" – critics correctly point out that charges falling into this category often recur. However, the regularity or frequency of an item may not be an appropriate criterion to decide whether the item should be included in or excluded from "core" or "underlying" earnings. In fact, earnings related to the underlying business can

[1]CFA UK annual survey on Financial Reporting and Analysis, 2015
[2]Corporate performance: What do investors want to know? Reporting adjusted performance measures

be lumpy and may effectively constitute "one-offs"; the pharmaceutical industry's "windfall" profits during the swine flu pandemic in 2009 being a prime example. However, when they arise as a direct result of the underlying business they should not be stripped out to obtain "smoothed" or normalised earnings, in our view.

To some extent, non-IFRS earnings try to approximate cash earnings by removing non-cash charges such as amortisation and impairment of intangibles. Removing amortisation, for example, enhances comparability between companies by removing the inherent subjectivity of estimating an asset's useful life; however, it also removes the costs associated with obtaining intellectual property. The add-back of stock-based compensation expense, which is particularly common amongst technology firms, is even more controversial – the remuneration of employees is a core business expense and the only viable alternative to the allocation of shares or other equity-linked instruments could have been additional cash payments. We discuss these types of adjustments in further detail later in this paper.

APMs IMPACT MANY ASPECTS OF INVESTMENT ANALYSIS

It is important that investors and analysts understand the benefits and potential pitfalls of current APM reporting. Analysts and investors performing fundamental valuation work such as discounted cash flow (DCF) analyses using APMs, rather than full IFRS numbers, as a starting point should, therefore, bear the items below in mind.

» Potential positive bias: Because companies remove a variety of charges that are in fact recurring, APMs are likely systematically to overstate their earnings potential.

» Impact on balance sheet and ratios: APMs are generally used to provide an alternative view of the income statement. But companies do not systematically adjust their balance sheets to reflect the adjustments made to arrive at that alternative view of the income statement. Consequently, any measure of return on assets that is based on APMs is bound to be a hybrid that may be difficult to interpret at best and meaningless at worst. For example, return on invested capital (ROIC) based on non-IFRS operating profits is likely to be overstated, as amortisation of intangibles is typically added back to obtain non-IFRS operating profit, while the IFRS intangibles book value is of course net of amortisation.

» Impact on the investment screening process: From a practical viewpoint, investors often lack the time to explore each company's approach to the construction of APMs in detail. Given this, they will often employ screening processes (e.g. using information provided by data service providers) to identify potentially suitable investments, which are subsequently analysed in-depth. For this approach to be effective, the metrics used as a starting point by the data service providers, including APMs, need to be of high quality. Without that, screens could wrongly identify the securities of companies with an aggressive approach to APM reporting as the potentially most attractive investments. Clarity and balance in APM reporting would, therefore, facilitate the investment selection screening process.

GUIDANCE ON APMs IS NEEDED

Various organisations are working on developing a framework that will provide more rigour in APM reporting. In light of the above considerations, we see a need for this work to progress, and for investors to play a significant role in ensuring that the resulting guidelines or requirements would provide comparability of APM-based profit measures across companies and sectors. In our experience in analysing accounts, we find that companies themselves tend to strive for comparability with their peers and occasionally adjust the definition of their own metrics following benchmarking exercises.

The PwC survey referred to earlier found that 76% of investors polled would find it helpful to know that companies were applying some basic "ground rules" or "rules of engagement" to their APM reporting. This would give them greater comfort in the relevance and reliability of the data they use in their own performance analysis. This paper provides the views of CFA UK members to help companies do better before any new rules come into place.

COMPANY REPORTING OF APMs TODAY

COMPARISON OF IFRS AND NON-IFRS EARNINGS REPORTED BY FTSE COMPANIES

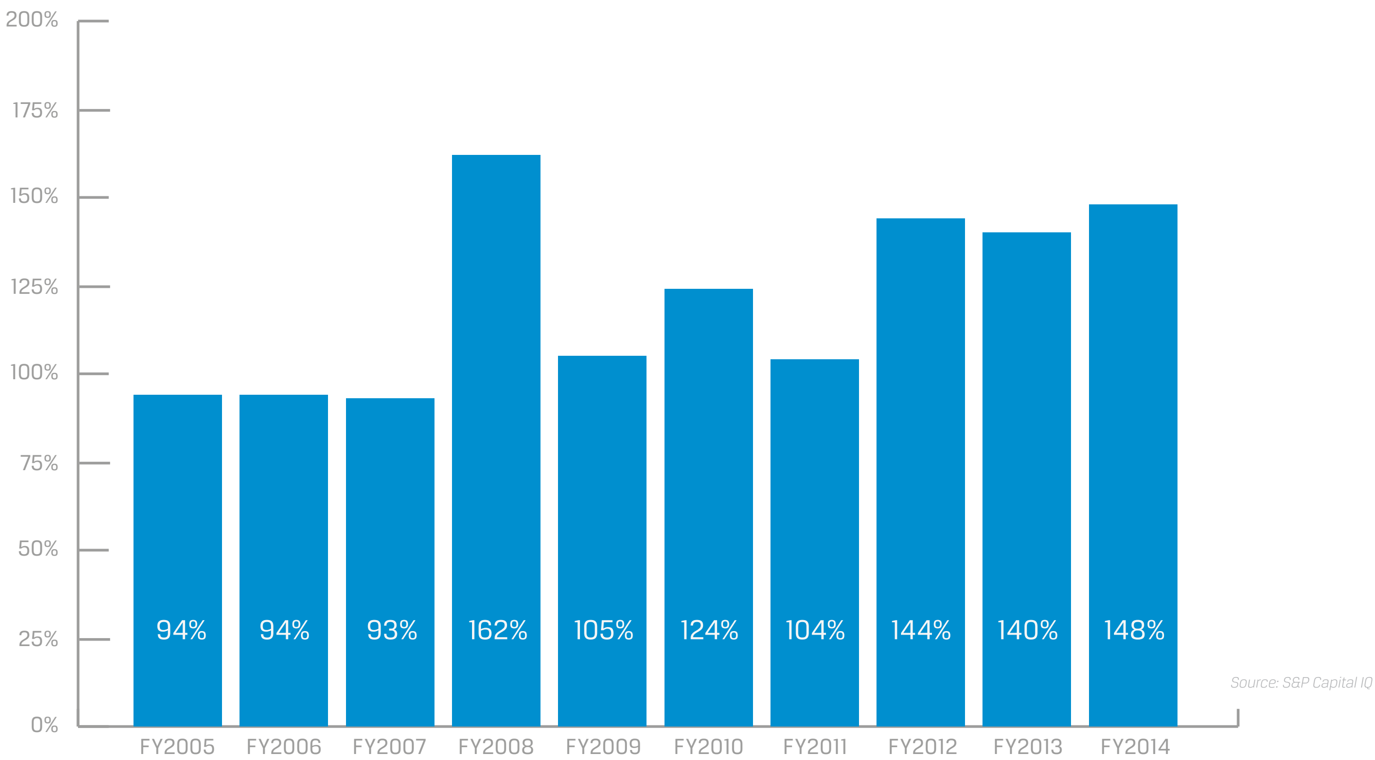
As users of company accounts, we have noticed an increasing trend in adjusted (non-IFRS) net income or earnings as compared with IFRS net income over the past several years. That anecdotal observation is evidenced by a comparison of IFRS net income and non-IFRS net income for the FTSE 100 constituents (as of 1 May 2015) for the last 10 fiscal years, as shown in the chart below. The data is taken from S&P Capital IQ.

In total, over the ten year period FY2005 to FY2014 the aggregate adjusted net income of the FTSE constituents (excluding Vodafone and Royal Mail[3]) has been 17% higher than the IFRS figure. Note there is a high variability in the IFRS/non-IFRS gap across different companies and from year to year for each company. As the chart shows, the aggregate gap between company-adjusted net income and the statutory figure has generally increased over this period, particularly in the last three years. The uptick in FY2008 was driven mainly by RBS, which reported a statutory net loss of £23.7bn but an adjusted net loss of £7.5bn.

While most FTSE companies had an aggregate adjusted net income for the FY2005-FY2014 period that was higher than the IFRS figure, there were notable exceptions in the property and utility sectors. Property companies (e.g. Hammerson and Land Securities) typically exclude net revaluation gains on their property portfolio from their underlying earnings. Similarly, utility companies (e.g. United Utilities and National Grid) exclude derivative gains and the tax credits that have arisen from the declining UK corporate tax rate over this period. Admiral Group plc is the only company in the FTSE 100 that has only reported IFRS net income and has not given any form of adjusted or normalised net income over the last 10 years.

We note a recent study by S&P[4] of 82 non-financial companies in the FTSE 100 showed that 79% of companies reported adjusted operating profit that was greater than IFRS operating profit for fiscal 2012/2013. This was up from 72% of companies in 2011/2012.

COMPANY ADJUSTED NET INCOME AS A % OF IFRS NET INCOME



[3] We have excluded Vodafone from the sample because its windfall profit from the sale of its stake in Verizon Wireless in FY2014 distorts the year on year trend in FY2014. For the ten year period ending FY2014 Vodafone's IFRS net income (including its Verizon gain) was actually 1% higher than its adjusted net income (as reported by management). However, excluding the £48.1bn gain on the disposal and £17.5bn deferred tax asset recognition in FY2014, Vodafone's overall IFRS net income from FY2005-FY2014 would have been 30% lower than Vodafone's adjusted net income, as reported by the company. We have also excluded Royal Mail from the sample given its short life as a public company. Royal Mail's reported net income of £1.3bn in FY2014 included a positive £1.4bn pension plan amendment.

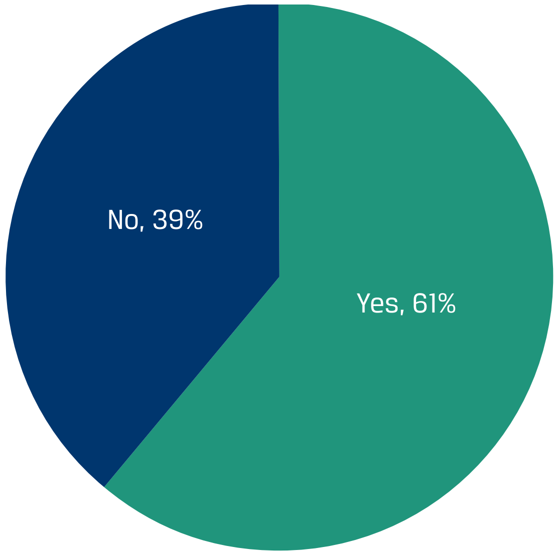
[4] "Why Inconsistent Reporting Of Exceptional Items Can Cloud Underlying Profitability At Nonfinancial FTSE 100 Companies", February 2014

ARE NON-IFRS EARNINGS MISLEADING?

The question then is: does it matter that non-IFRS numbers differ from (and are generally higher than) statutory IFRS numbers? Many, including standard setters and regulators, think it does. They are concerned that non-IFRS disclosures are misleading and that companies are fooling investors by focusing their reporting on them. As Steven Young writes[5]: "Behavioural psychology theory suggests that cognitive biases may cause investors to be misled by non-GAAP disclosures particularly when there is a material impact on the direction of the performance signal such as when adjustments transform a GAAP loss into a non-GAAP profit". Empirical evidence would suggest that retail investors are more likely to be fooled by earnings adjustments than institutional investors. But even amongst the professional investor community there is a tendency to focus heavily on adjusted earnings, even when the adjustments may seem misleading, simply because these are the numbers that consensus forecasts are based on and against which companies are measured on a quarterly basis.

Our April 2015 survey[6] investigated our members' concerns regarding financial reporting and accounting. Specifically, we asked if members routinely use the adjusted numbers reported by management in their analysis. Just over 60% of respondents said they did use management's adjusted figures while 39% said they did not. In the comment box several respondents noted they made their own adjustments to IFRS earnings but that the management version of adjusted earnings was useful for a "quick glance on reporting". Others noted that they were comfortable with management provided adjusted numbers, "so long as the adjustments are disclosed". However, many respondents were not comfortable with management providing adjusted figures "because they tend to be inconsistent over time and across companies". Several respondents noted a preference for cash flow analysis over earnings to get around the issue of adjusted earnings manipulation. However, some respondents noted that even cash flow statements are subject to manipulation, as are company-specific definitions such as free cash flow.

THE MAJORITY OF COMPANIES USE IFRS ADJUSTED NUMBERS (E.G. UNDERLYING EARNINGS) TO COMMUNICATE ELEMENTS OF THEIR PERFORMANCE. DO YOU ROUTINELY USE THE ADJUSTED NUMBERS REPORTED BY MANAGEMENT IN YOUR ANALYSIS?

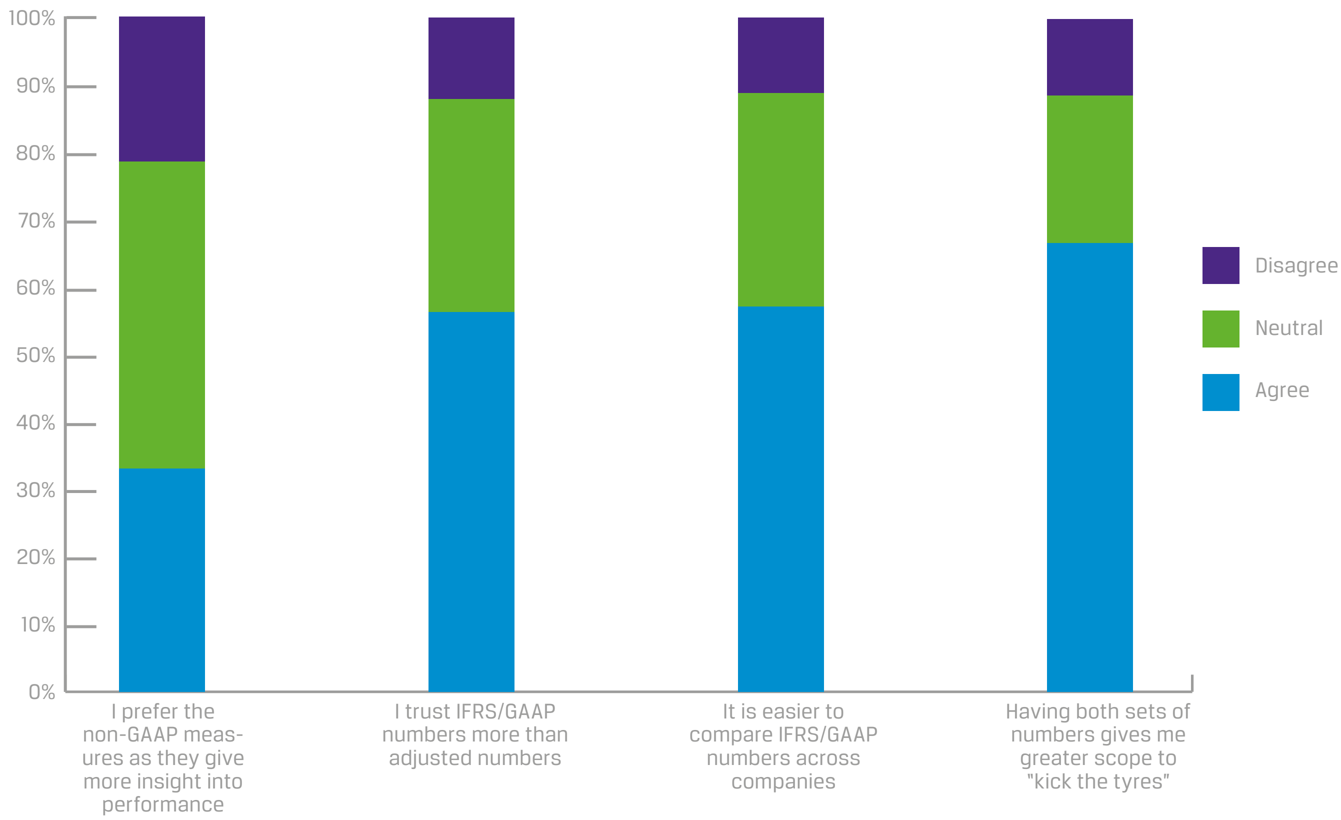


Source: April 2015 survey of CFA UK members

Around 60% of our survey respondents said that they trusted IFRS numbers more than the non-IFRS numbers. One respondent noted: "Management have an incentive to make their accounts obscure, release as little information as possible, and select the most favourable light in which to portray their company. This makes rules absolutely vital". However, others noted that even if the non-IFRS figures were subject to manipulation, "seeing what management does to the accounts through adjustments, e.g. what they term a one off event, is useful to see how transparent and honest they are".

[5] *"The drivers, consequences and policy implications of non-GAAP earnings reporting", Accounting and Business Research, 2014*
[6] *CFA UK annual survey on Financial Reporting and Analysis, 2015*

TO WHAT EXTENT DO YOU AGREE WITH THE FOLLOWING STATEMENTS



Source: April 2015 survey of CFA UK members

One area where current regulations fall short of transparency is that APM to statutory profit reconciliations focus on items that have been excluded, typically expenses. As Steven Young writes: "While included transitory items (typically gains) are equally important they are not covered by reconciliation requirements. Curtis et al (2011[7]) found that approximately 42% of US firms in their sample failed to report transitory gains transparently at the earnings announcement, leading to mispricing that is only resolved after firms publish their 10-Q/K filings that provide more structured information on transitory items. Choi et al (2007[8]) also report evidence of UK firms strategically retaining nonrecurring gains in non-GAAP earnings. Transparent disclosure of transitory items included in non-GAAP earnings is arguably as important as information on non-GAAP exclusions."

Moreover, currently there is only limited assurance provided by auditors on APMs that form part of an earnings announcement or results publication.

Investors hope and expect that auditors will be active in challenging discrepancies between what they understand through the audit and the other disclosures that companies make. Clearer linkage and reconciliation between APMs and IFRS reported numbers would give auditors stronger grounds to challenge the veracity of reported APMs. This could add to their quality control role and providing a check on potential bias in adjusted earnings measures, reinforcing investor confidence.

REGULATOR GUIDELINES ON APMs

Even the organisation that sets IFRS has joined the debate about adjustments being made to the numbers derived from their rules. In a March 2015 speech[9] Hans Hoogervorst, chairman of the IASB, said: "Alternative performance measures can provide useful additional information to investors. The IASB has no ambition to stamp out the use of non-GAAP measures. However, IFRS numbers should serve as the primary performance measures by which companies describe their financial position and performance. Alternative

[7] Curtis, a., MvVay, S., and Whipple, B., 2011. Non-GAAP earnings: informative or opportunistic? An analysis of transitory gains.
[8] Choi, Y-S., Lin, S., Walker, M., and Young, S., 2007. Disagreement over the persistence of earnings components: evidence on the properties of management-specific adjustments to GAAP earnings.
[9] Mind the Gap (Between non-GAAP and GAAP), 31 March 2015

performance measures must not be misleading and should not be given so much prominence in financial statements that they over-shadow the IFRS numbers." The IASB is currently looking at whether to define commonly-reported metrics such as EBIT and EBITDA to help provide some consistency in the reporting of these numbers.

The FASB, who set US GAAP, is undertaking a research project on "financial performance reporting" that will look to find ways to improve the relevance of information presented in the performance (income) statement for public and private companies. Specifically, the research is developing a framework for defining operating activities and distinguishing between recurring and infrequent items.

As regulatory bodies IOSCO and ESMA have recently proposed guidelines regarding the presentation of APMs. Later in this paper we discuss APM reporting rules in the United States, Australia, and South Africa.

IOSCO's proposed statement on non-GAAP financial measures (September 2014) would require issuers to:

» Label the measures clearly as non-IFRS

» Define the non-IFRS financial measure and provide a clear explanation of the basis of calculation

» Provide a clear reconciliation from non-IFRS to IFRS measures

» Provide comparative non-IFRS data from prior periods, on the same basis

» Explain the reason for presenting the non-IFRS measure

» State that the measure may not be comparable with similar measures presented by other companies

» Not use non-IFRS measures to avoid presenting adverse information

» Not make non-IFRS measures more prominent than their IFRS equivalents.

Similarly, ESMA's proposed guidelines on alternative performance measures (February 2014) would require issuers to:

» Define the APMs used as well as the basis of calculation

» Give a reconciliation of the APM to the most relevant amount presented in the financial statements

» Explain why an issuer believes the presentation of APMs provides useful information to users regarding the financial position, cash-flows and results of the operations

» Provide comparatives for the corresponding previous periods

» Ensure that the definition and calculation of an APM is consistent over time.

Neither of these guidelines provides a prescriptive list of what adjustments are acceptable and unacceptable. Although we don't think that regulators or standard setters should prescribe which adjustments are allowed, we do think it is important that investors and analysts are aware of the types of adjustments that are commonly made, and why. The next section describes the most commonly reported adjustments.

COMMONLY REPORTED PERFORMANCE MEASURES

OPERATING PROFIT

Most companies outside the financial services sector report operating profit as a separate line item in their income statements. There is a widespread understanding that operating profit is simply EBIT. As such, it may come as a surprise to many practising analysts and investors that there is no IFRS definition of operating profit, nor are there any guidelines on what can be included in or excluded from EBIT.

We would welcome a definition of operating profit by the IASB as it is a key metric used to assess profit margins, debt-servicing capacity and enterprise value.

EBITDA

Moving further up the income statement we note the popularity of EBITDA as a performance measurement. Ironically, it is particularly popular in the telecom sector despite capital expenditure being a generally high and steadily recurring feature of their business models. Companies often report adjusted EBITDA figures that strip out items they believe are non-recurring or non-cash.

EBITDA is a "quick and dirty" proxy for free cash flow although it ignores changes in working capital, cash taxes, cash interest costs, and is often adjusted to exclude other cash costs such as restructuring.

FREE CASH FLOW

Given many investors' scepticism over the income statement and manipulation of non-IFRS earnings they often focus on free cash flow (FCF) generation. FCF is often loosely defined as cash flow from operating activities less capital expenditures (capex). Note, however, that cash flow from operating activities can often contain one-time positive items such as tax refunds. Free cash flow can also be manipulated in the short term by delaying payments to suppliers. It is important to pay attention to the components of FCF. For example, the existence of finance leases, which effectively take operating costs (the rent expense on PP&E) and transform them into finance costs (which appear lower down the cash flow statement under financing), effectively excludes this cash rental cost.[10] FCF also excludes the impact of stock compensation on equity value, which we will discuss below, although it will include the tax deductibility benefit of options and share grants.

OTHER KEY PERFORMANCE INDICATORS (KPIs)

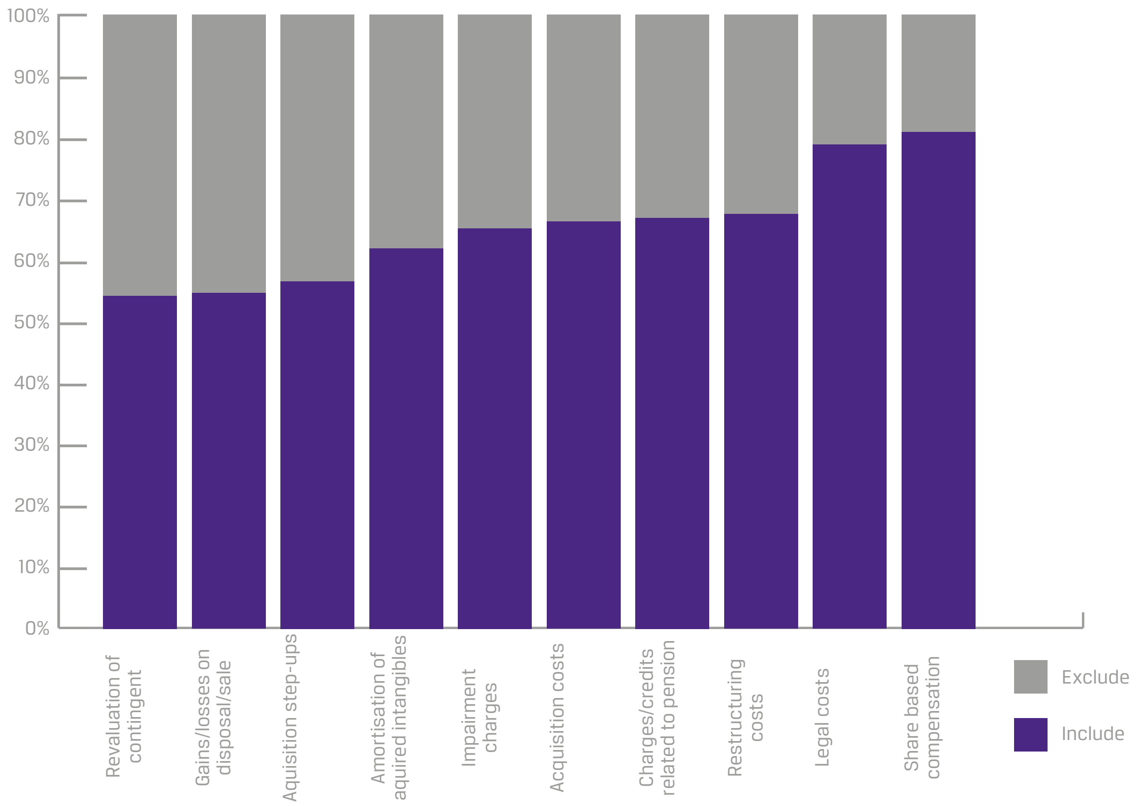
Companies often report figures that do not form part of their financial statements but are key performance indicators. Examples include same-store sales, organic or underlying revenue growth, order book, pipeline data, etc. Although these measures are not the focus of this paper, the same principles apply. The reliability of this data is very important to investors. Companies should be transparent about the extent to which there is any assurance from third parties at least over the constituent parts. If the KPI is derived from statutory IFRS numbers, companies should make it easy for the reader to see how the KPI is derived from or related to those numbers (e.g. by providing a reconciliation).

[10] The IASB and FASB currently have a project on leases which would result in most operating leases being accounted for as finance leases because of concerns that many leases are in fact a form of financing.

KEY ADJUSTMENTS REPORTED BY COMPANIES

In our April 2015 survey we asked our members which items they thought were appropriate to exclude from IFRS figures to arrive at a measure of underlying earnings. As the chart below shows, respondents were not generally keen on excluding any of the items listed in the chart below to arrive at an adjusted measure of underlying earnings. The most popular choice for exclusion was "revaluation of contingent consideration" with 46% in favour of excluding it. The least popular choice was stock-based compensation, which only 20% thought should be excluded from underlying earnings.

WHICH OF THESE ITEMS DO YOU BELIEVE IT IS APPROPRIATE TO EXCLUDE FROM IFRS FIGURES TO ARRIVE AT A MEASURE OF UNDERLYING EARNINGS?



Source: April 2015 survey of CFA UK members

Several participants commented that the crucial factors with adjusted earnings measures were the transparency and consistency of the adjustments. One respondent noted: "as long as it is clearly disclosed I don't mind as I can make own adjustments".

Anecdotally, the most common material adjustments that companies make to their non-IFRS earnings metrics are stock-based compensation, restructuring charges, legal costs, asset impairments and amortisation of intangibles. In this section we discuss each of these topics in turn.

STOCK-BASED COMPENSATION

Historically, stock or share-based compensation (SBC), such as employee stock options, was not considered an expense for accounting purposes though it was deductible for income tax purposes. As the use of SBC started to increase in the 1980s, academics and some investors began to lobby the accounting standard-setting bodies to recognise its cost in the income statement. Warren Buffet wrote in his 1992 Chairman's letter to Berkshire Hathaway shareholders: "If options aren't a form of compensation, what are they? If compensation isn't an expense, what is it? And if expenses should not go into the calculation of earnings, where in the world should they go?"

Despite the apparent logic of the argument to expense SBC, there was fierce counter lobbying by many companies, particularly in the technology sector. Eventually, however, the IASB required companies to include a stock-based compensation expense in their accounts from 2005 and the FASB followed suit a year later.

Consequently, many companies started excluding SBC in their adjusted earnings measures. Anecdotally, some investors and sell-side analysts accept this because it is not a cash expense. Some argue that the Black-Scholes method for valuing options exaggerates the real cost to shareholders. However, stock-based compensation is still considered a "real" cost for income tax purposes.

But many investors, analysts and others are not convinced that SBC should be excluded (as also evidenced by our survey results). As Jack Ciesielski, CPA, CFA writes[11]: "It's an outlay of the firm's own currency, and giving that currency to managers takes it away from shareholders. … As for the option valuation model argument, it's true that option-pricing models in use are not designed for long-term options. It's also true that the value of option compensation is not zero, and a poor estimate is better than being exactly wrong. Furthermore, most stock compensation is denominated in restricted stock these days, with little being issued in the way of options. Those who ignore stock compensation expense may not distinguish between option and restricted stock compensation."

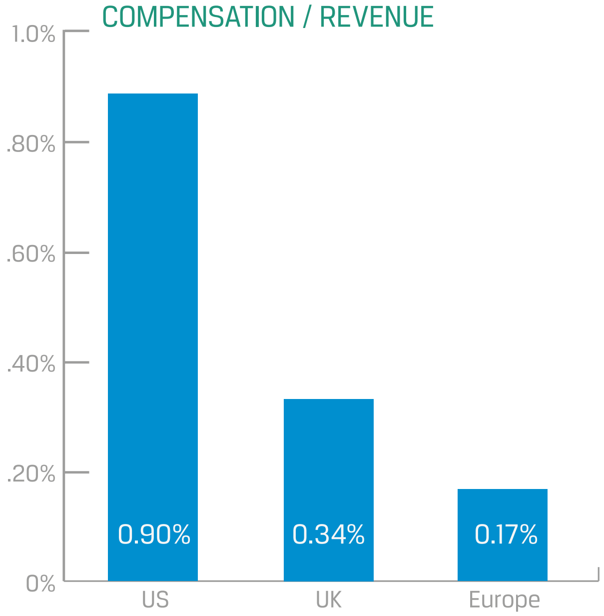
Similarly, as Aswath Damodaran, Professor of Finance at the Stern School of Business at New York University (NYU), writes[12]: "The stock-based compensation may not represent cash but … only because the company has used a barter system to evade the cash flow effect. Put differently, if the company had issued the options and restricted stock (that it was planning to give employees) to the market and then used the cash proceeds to pay employees, we would have treated it as a cash expense. … There are no free lunches and if a company chooses to pay $5 million to an employee that will affect the value of my equity, no matter what form that payment is in (cash, restricted stock, options or goods)."

Likewise, Brian Lund, CFA of ClearBridge Investments, writes[13]: "The only explanation that makes sense of this ostrich-like approach is that they think others overlook it too, and that they can sell the stock in the future to someone [else] who doesn't understand the cost of SBC. As fiduciaries and long-term, valuation-driven owners of stocks, we cannot afford to join in this folly."

The practice of paying a large proportion of management and employee compensation in the form of stock-based payments is most prevalent in the US, but it is also widespread in Europe. The chart at the top of page 13 shows the ratio of total stock-based compensation to revenue in FY2014 for the 100 largest listed companies, by market capitalisation, in the US, UK and Europe. The ratio of 0.90% in the US compares with 0.34% in the UK and 0.17% in Europe.

[11] *"The Analyst's Accounting Observer" (October 2013)*
[12] *"Stock-based Employee Compensation: Value and Pricing Effects" (February 2014)*
[13] *"The Valuation Process Challenge of Stock-Based Compensation" (September 2014)*

FY2014 STOCK-BASED COMPENSATION / REVENUE



Source: S&P Capital IQ. Top 100 companies by market cap as of end May 2015.

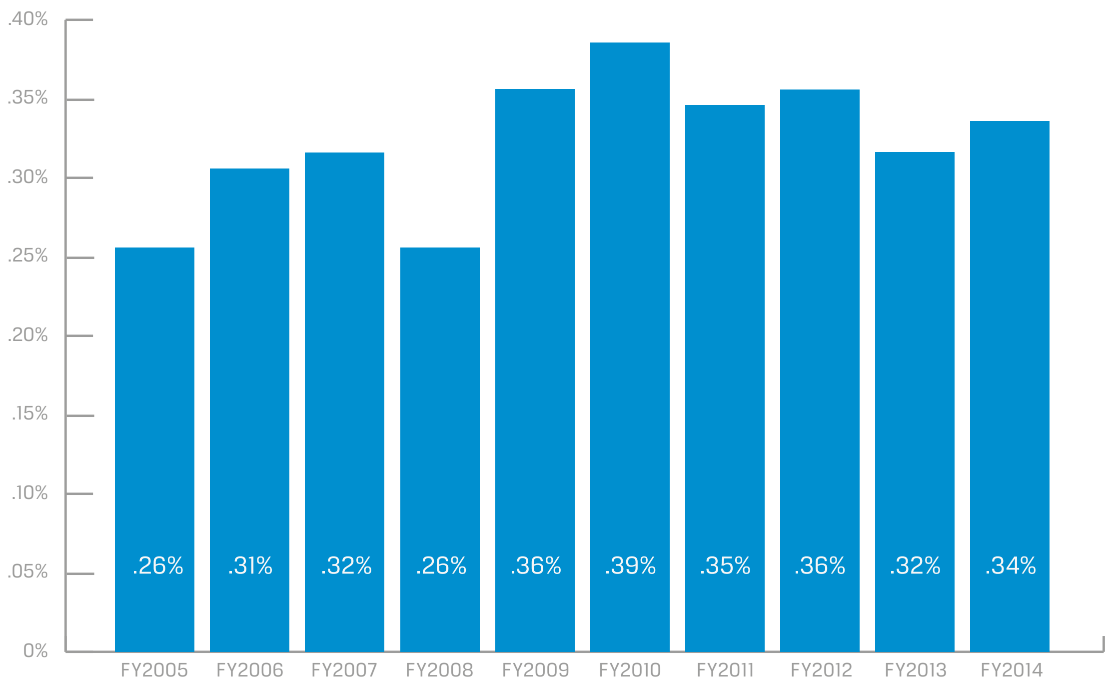
Below we show how the ratio of aggregate stock-based compensation to revenue has changed over the last 10 years for the FTSE 100 (using the composition at 1 May 2015). Overall there is a trend upwards, albeit with a peak in FY2010 and a reduction in subsequent periods.

Within the FTSE 100 the use of SBC is skewed towards a few companies such as ARM Holdings (8.6% of revenue in FY2014), Aberdeen Asset Management (5.8%), Schroders (3.1%), Barclays (3.1%), Admiral (2.6%) and Lloyds (2.2%). FY2014 was not an anomaly for these companies; their average SBC/sales over the last ten years was at a similar level. However, of these companies only ARM Holdings excludes SBC in its adjusted earnings measure.

RESTRUCTURING CHARGES AND LEGAL COSTS

While in some cases it can be useful to look at earnings excluding restructuring and legal costs, particularly if they are "lumpy", is it true to say these are non-recurring? Surely they are a feature of corporate life. Better alternatives to ignoring them would be either to include them and accept the real-life volatility, or to smooth the effect by capitalising these items and then amortising them, as we do with other lumpy expenses such as capital expenditure. Severance costs and lawyers' fees are certainly not non-cash items.

UK STOCK-BASED COMPENSATION / REVENUE



Source: S&P Capital IQ

In its proposed statement on non-GAAP financial measures, IOSCO says: "In presenting non-GAAP measures, issuers sometimes seek to adjust for items that have affected past periods and which are reasonably likely also to affect future ones (such as restructuring costs or impairment losses). Such items should not be described as non-recurring, infrequent or unusual."

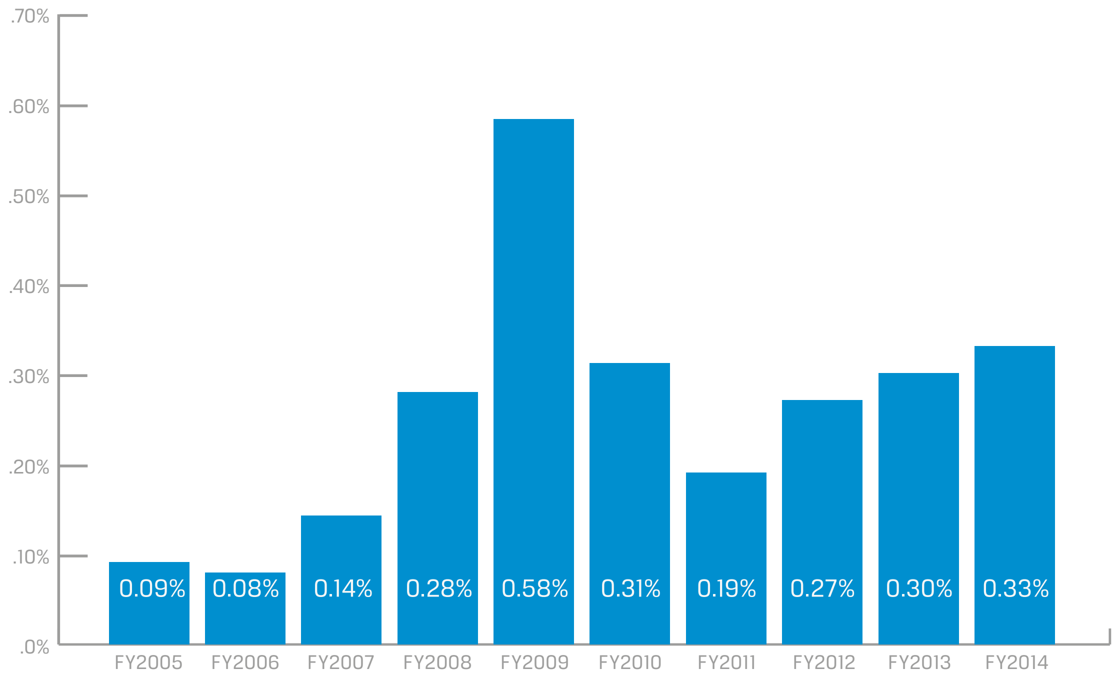
Below we show the ratio between aggregate restructuring costs for the FTSE 100 and aggregate revenue from FY2005 to FY2014. The ratio has generally increased over time albeit with a peak in FY2009 (due to BHP Billiton) followed by two years of decline, with more recent years being on an increasing trend.

IMPAIRMENTS OF ACQUIRED INTANGIBLE ASSETS

Impairments of acquired intangible assets usually reflect a weaker outlook for an acquired business than was expected at the time of the acquisition, and are often considered to be non-recurring or at least unusual. As such, companies often strip these charges out of non-IFRS earnings. This seems appropriate, but it does not mean that investors should simply ignore the impairments, even if they are taken well after it has become clear to the "market" that a particular acquisition is not faring well. The impairment charges are a useful way of holding management accountable for its acquisitions, though this breaks down when management teams change and responsibility for prior acquisitions evaporates.

Often the largest intangible asset recognised in an acquisition is goodwill. As such, the impairment of acquired intangibles usually reflects a reduction in the carrying value of goodwill. However, other acquired intangibles, such as customer lists or intellectual property, can also be impaired as well as being subject to periodic amortisation.

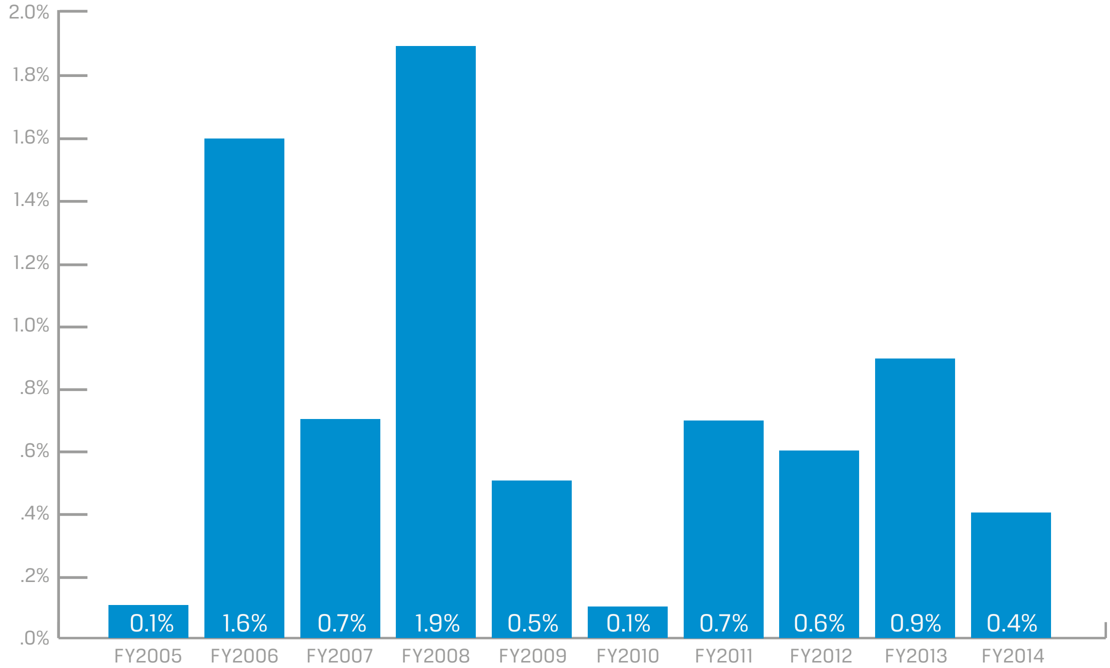
FTSE 100 RESTRUCTURING CHARGES / REVENUE



Source: S&P Capital IQ

Below we show the aggregate impairment of goodwill relative to revenue for FTSE 100 constituents (as of 1 May 2015) over the last ten years. There is no discernible trend; the write-downs appear to be cyclical and company specific (e.g. Vodafone in FY2006, and RBS and HSBC in FY2008).

FTSE 100 GOODWILL WRITEDOWNS / REVENUE



Source: S&P Capital IQ

AMORTISATION OF INTANGIBLE ASSETS

Until goodwill amortisation was abolished under IFRS, most investors ignored the charge and most companies reported earnings before goodwill amortisation. In a similar vein, many investors today ignore the amortisation from certain acquired intangible assets, such as brands, and most companies exclude these charges in their adjusted earnings measures. However, investors should be careful not to ignore all amortisation charges simply because they are non-cash. Depreciation is non-cash too but we often use it as a proxy for capex on PP&E. Similarly, the amortisation of intangibles such as licences with a finite life (e.g. a mobile spectrum) or the amortisation of capitalised development expenses are real costs with real cash outflows (often recurring). In the pharmaceuticals sector, the amortisation of acquired intellectual property can be a significant non-IFRS adjustment, as can the impairments of such assets.

APM GUIDELINES AROUND THE WORLD

IIMR DEFINITION OF HEADLINE EARNINGS

The Institute of Investment Management and Research (IIMR), a forerunner of CFA UK, developed a "headline" earnings formula in 1992. The aim was to provide an underlying or recurring EPS number in the wake of the new UK accounting standard, FRS 3 Reporting financial performance. FRS 3 effectively outlawed extraordinary items. If any were to arise, the standard required them to be included in the earnings figure used to calculate earnings per share.

The original IIMR formula for headline earnings made a distinction between changes in balance sheet values and the operating earnings of a business. For example, changes in the value of long-term debt or the value of property were excluded from the headline earnings figure, whereas sales and salaries were included.

JOHANNESBURG STOCK EXCHANGE RULES

In 2000 the Johannesburg Stock Exchange (JSE) introduced a requirement for companies to disclose "headline earnings" according to the IIMR's formula. In 2009 this was updated[14] to take account of the switch to IFRS. The 2009 requirements exclude from headline earnings all changes in fair value except those changes in fair value of items in the current position of the company (for example, changes in the value of inventories).

Although South Africa adopted a headline earnings measure in order to make earnings more comparable across companies, some investors have expressed dissatisfaction with the measure because of some of the items included, which they would seek to strip out to arrive at an adjusted measure. For example:

» Certain "re-measurements", such as the release of provisions taken in prior periods and the recognition of deferred tax assets, are included in the headline earnings figure.

» Black Economic Empowerment (BEE) expenses are included in the headline earnings figures.

As such, many South African companies today report three earnings figures: IFRS, headline (per the JSE definition) and adjusted (under management's own definition).

Although the JSE's definition of headline earnings could be re-written to better reflect the adjustments investors believe are missing, this case study indicates a potential downfall in an overly prescriptive definition of APMs. A broader set of principles is perhaps more pragmatic given regular changes in accounting standards and the legal and tax environments in which companies operate.

AUSTRALIAN SECURITIES AND INVESTMENTS COMMISSION RULES

The reporting of non-IFRS information in Australia is regulated by an Australian Securities and Investments Commission Guidance Release (RG 230). This document offers guidelines for presenting non-IFRS financial information, which are summarised in the table on page 17.

[14]The detailed rules can be found here: https://www.jse.co.za/content/JSECircularItems/Circular_2_2013_Headline_Earnings.pdf

Guideline	Explanation
Prominence	IFRS financial information should be presented with equal or greater prominence, emphasis or authority compared to the corresponding non-IFRS financial information.
Labelling	Non-IFRS financial information should be clearly labelled in a way that distinguishes it from the corresponding IFRS financial information.
Calculation	A clear explanation should be provided about how the non-IFRS financial information is calculated.
Reconciliation	A reconciliation between the non-IFRS and IFRS financial information should be provided, separately itemising and explaining each significant adjustment. Where reconciling items are components of IFRS financial information, they should be capable of being reconciled to the financial report. Where a reconciling item cannot be extracted directly from the financial report, the reconciliation should show how the figure is calculated. Where comparative non-IFRS financial information is presented for a previous period, a reconciliation to the corresponding IFRS financial information should be provided for that previous period.
Justification	A non-boilerplate statement should be included disclosing the reasons why directors believe that presentation of the non-IFRS financial information is useful for investors to understand the entity's financial condition and results of operations.
Consistency	If there has been a change in approach from the previous period, an explanation about the nature of the change, the reasons for the change, and the financial impact of the change should be provided.
Comparability	For each adjustment made to IFRS financial information, corresponding items should be adjusted in any comparative information.
Impartiality	Non-IFRS financial information should be unbiased and not used to avoid presenting "bad news".
One-off items	Items that have occurred in the past or are likely to occur in a future period should not be described as "one-off" or "non-recurring".
Oversight	A clear statement should be made about whether the non-IFRS financial information has been audited or reviewed by an auditor.

US SECURITIES AND EXCHANGE COMMISSION RULES

In January 2003, the SEC issued final rules entitled "Conditions for Use of Non-GAAP Financial Measures" (FRR 65). The rules are based on three disclosure "models", the use of which depends on where the non-GAAP measure appears. The most widely applicable, and most flexible, model is referred to as Regulation G. This regulation requires that the non-GAAP measure is not misleading and is accompanied by the GAAP figure together with a reconciliation.

For quarterly and annual earnings releases furnished to the SEC, the GAAP measures must be shown with equal or greater prominence than the non-GAAP measures and management must explain why the non-GAAP measure provides useful information to investors.
In addition to the above requirements, for annual or quarterly information that is filed with the SEC (10Q, 10K):

» Non-GAAP liquidity measures (other than EBIT and EBITDA) must not exclude charges or liabilities that require cash settlement

» Non-GAAP financial measures must not exclude items identified as non-recurring if a similar charge/gain occurred within the prior two years or is likely to recur in the next 2

» Non-GAAP financial measures must not be shown on the face of the financial statements, in the notes or in any pro forma statements

» Non-GAAP financial measures should not be given titles or descriptions that are the same, or confusingly similar to, titles or descriptions used for GAAP financial measures.

CONCLUSION

Financial statements prepared according to IFRS remain the primary tool used by analysts and investors in assessing a company's financial performance. At the same time, the investment community widely uses APMs, many of which are derived from IFRS information. Although APMs offer useful incremental information because they allow management to tell the story about the company's performance, we believe this benefit would be enhanced significantly if companies understood better what the investment community needed from their APM reporting. Such an understanding may help them adhere to guidelines that would increase their transparency and clarity, facilitating their interpretation.

Given the need for company-specific information in APMs, we don't think regulation can usefully prescribe which adjustments to IFRS should be allowed. Whether a specific adjustment is considered desirable by companies and investors ultimately depends on the message the former are seeking to display and the information the latter wish to glean. We think there is a lot companies can do on a voluntary basis to increase the usefulness of the APMs they report. Building on what ESMA, IOSCO and others have done, we put forward the following suggestions for reporting higher quality APMs:

» Clearly state what the corresponding IFRS figure is.

» Do not place non-IFRS measures more prominently in company announcements than the corresponding IFRS measure.

» Show a clear reconciliation of non-IFRS measures with IFRS measures. The reconciliation ideally should be done on a line-by-line basis.

» Explain how and why the non-IFRS measure is more relevant to the company's circumstances than the IFRS measure.

» Explain the rationale for each adjustment made to arrive at the non-IFRS measure.

» Apply the same principles to credits as debits when considering whether these should be stripped out of adjusted earnings measures (i.e. don't be biased).

» Apply adjustments consistently across different time periods, restating prior years if necessary. If there are any changes to methodology these should be explained.

» Explain whether the non-IFRS measures are subject to any assurance from independent third parties, such as auditors. Clearly identify non-IFRS measures as unaudited if this is the case.

» Explain deviations from common practice, especially with regards to sector peers.

Although we think the application of guidelines is an important first step to allaying suspicion on the part of the investment community, we would welcome a formal process that would further improve the quality, trustworthiness and understandability of non-IFRS earnings. To this end, we suggest that standard setters and regulators that oversee corporate reporting engage with both preparers and users of APMs to understand the challenges with reporting and using them. In an ideal world, companies and investors could reach agreement on guidance for their use that endorses the current push for transparency. We believe that guidance derived in this manner would benefit preparers by facilitating the construction of APMs that investors consider meaningful, and would benefit investors by enhancing the usefulness of the reported information.

We anticipate that a key focus of the debate will be the extent to which guidance should include specific recommendations as to which items (gains and losses) may be removed from statutory IFRS measures to arrive at APMs. The risk of an overly restrictive approach is that the non-IFRS measures might not fully reflect the business as seen through the eyes of management, while a laissez-faire approach that would allow each company to cherry-pick the items it considers worth removing is inherently liable to abuse and, therefore, risks undermining trust. Whilst the CFA UK member survey on corporate reporting revealed diversity of opinion as to what items should be stripped out of IFRS numbers, some adjustments are clearly less popular than others.

CFA UK looks forward to contributing to the ongoing discussions on APMs. We think an active dialogue between companies, investors, regulators and standard setters is necessary to understand their respective needs and design guidelines that best serve their mutual purpose.

CFA Society
United Kingdom

CFA Society of the UK
4th Floor, Minster House
42 Mincing Lane
London EC3R 7AE

info@cfauk.org

www.cfauk.org