Issue 12
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Deloitte Financial Reporting Survey Series

Underlying profit 2013

First year under new FMA guidance

The use of financial measures other than those required by accounting standards, (referred to as non-GAAP measures) is common practice in annual reports, with 90% of the companies in our survey providing **251 non-GAAP measures**.

Common examples of measures used range from those that are readily understood and consistently applied, such as earnings before interest, tax, depreciation and amortisation (EBITDA), to those where more subjectivity is introduced, such as "underlying profit", "adjusted EBITDA", "operating profit" or "normalised earnings". Used appropriately, such measures can provide an insight into the metrics that management uses to run the business. Used poorly, they can be confusing and misleading for readers.

As a result, this practice has been an area of focus for regulators internationally and in New Zealand, with the Financial Markets Authority (FMA) issuing guidance in September 2012 titled *Disclosing Non-GAAP Financial Information*. The guidance note became applicable for issuers from 1 January 2013 so this year our survey considered how companies had implemented the ten principles in the guidance note for this first full year of application.

At a glance:

Practices around reporting non-GAAP measures have improved slightly in respect of annual reports when compared to previous surveys, as noted below.

1 WHY MEASURE IS USEFUL	34% of measures provide some explanation as to their use (PY:33%)
2 PROMINENCE	5 companies (PY:11) emphasised underlying profit with no discussion on statutory profit
3 APPROPRIATE LABEL	25% of measures (PY:31%) used confusing labels, e.g. EBITDA which excluded more than interest, tax, dep'n / amortisation
4 EXPLAIN THE CALCULATION	A narrative explanation of the measure was provided for 67% of measures (PY:63%)
5 RECONCILE TO PROFIT AFTER TAX	81% of measures (PY:79%) were reconciled to a subtotal on the income statement (not always profit after tax)
6 CONSISTENT APPROACH	82% of the measures are the same as those used in the prior year, although adjusting items may have differed
7 COMPARATIVES	Comparatives are provided where reconciliations were given
8 ENSURE UNBIASED	81% of measures provided better results than the GAAP profit after tax (PY:85%)
9 ONE OFF OR NON-RECURRING ITEMS	17% of measures (PY:15%) made a reference to "one-off" or "non-recurring" items
10 EXPLAIN IF AUDITED OR REVIEWED	8 companies (PY:3) noted whether the measures provided were taken from audited or reviewed financial statements

In this publication

This year's survey considers current practice in one form of investor communication, being the 2013 annual reports of 100 companies, in order to:

- identify the areas where improvement may be needed, and
- provide examples of existing practice to aid companies in implementing the guidance.

As an aid for issuers, we also include some questions directors should consider when reporting underlying profit, and an illustrative example, as provided in our previous survey document.

Note – while examples have been provided, companies should look to develop their own policy around the use of non-GAAP measures and ensure that their disclosures are relevant to the nature of their business and the needs of their stakeholders. Boilerplate disclosures should be avoided.

What we found – Non-GAAP measures in practice

90 companies discuss their earnings in 251 different ways. This is consistent with the previous year results where 253 measures were provided by 90 companies in 2012 annual reports.

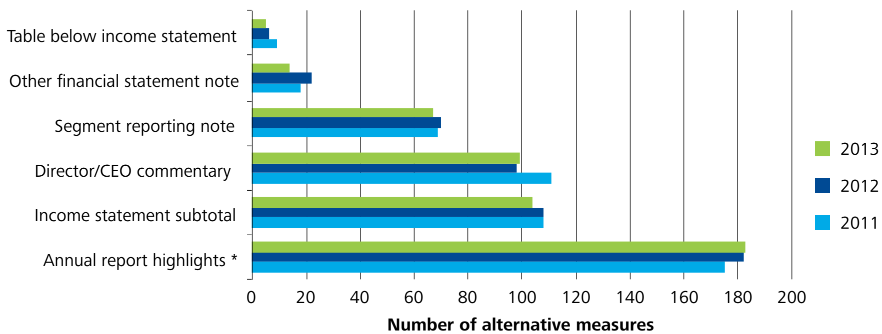
Non-GAAP financial information is defined by the FMA in its guidance note on *Disclosing Non-GAAP Financial Information* as "*financial information that is presented* *other than in accordance with all relevant GAAP*". Underlying profit is the presentation of an entity's earnings or profitability that is not the profit after tax currently determined in accordance with New Zealand equivalents to International Financial Reporting Standards (NZ IFRS) by the companies in our sample.

Some measures are presented in the financial statements, typically as sub totals, making use of the lack of guidance in NZ IFRS. The FMA notes that "*while additional line items or sub-totals included in an entity's income statement can comply with GAAP, if the same line items or sub-totals are included in documents other than financial statements and are presented as an alternative to the GAAP profit, then for the purposes of this guidance note they are considered to be non-GAAP profit information.*"

Companies continued to provide alternative profit measures in a variety of places throughout 2013 annual reports, often with multiple references. The most common places for discussion as noted in Figure 1 were in the annual report, either in the Director or CEO commentary or as financial highlights (such as in a five-year summary or CFO report), and in many instances both. It was also common to include a subtotal on the face on the income statement.

27% of measures were shown in the segment reporting note (PY: 28%). We note that the FMA's guidance expects that non-GAAP profit information disclosure will not differ from the segment reporting disclosures. "*If non-GAAP profit information is disclosed and it differs from the segment reporting disclosures in the financial statements, an explanation should be included justifying this difference. No explanation is required if the differences comprise only normal inter-segment eliminations or corporate expense allocations.*" One company added a comment to explain why its non-GAAP measure differed to the segment result to implement this guidance.

Figure 1: Where do companies discuss non-GAAP profit measures?



* Highlights includes five-year summaries, financial commentary and statistics provided in the annual report

The FMA's ten principles for presenting non-GAAP information

The FMA's guidance note sets out ten principles to reduce the risk that non-GAAP financial information is misleading – our comments on the reporting practices of our survey population are provided in line with these principles.

The guidance applied from 1 January 2013 so was effective for the annual reports in our survey.

To assess the response of the market to the guidance provided, the FMA reviewed the market communications of 23 listed issuers for December 2012 and March 2013 reporting dates. The results of this review were summarised in the report titled *Monitoring of Non-GAAP Disclosures*, issued in September 2013. This report provides a few additional examples for ensuring the guidance note is met, which we comment on further in this publication.

Principle 1: Outline why the information is useful

28% of alternative profit measures included a discussion on why the measure was provided. Another 6% of measures were included in the segment reporting note. The remaining 66% did not have an explanation compared to 67% in the prior year survey.

The FMA's monitoring report issued in September 2013 noted that "*a statement should be included by issuers disclosing why the directors believe that presenting the non-GAAP financial measure is useful information for investors, **and** to explain how the non-GAAP financial information is used internally.*" Both components are not always present.

Examples of existing practice include:

- *"Management believes that these measures provide useful information as they are used internally to evaluate performance of business units, to analyse trends in cash-based expenses, to establish operational goals and allocate resources."*
- *"EBITDA (i.e. Earnings before Interest, Taxation, Depreciation and Amortisation),… is a non-GAAP earnings figure that equity analysts tend to focus on for comparable company performance analysis, because that number removes distortions caused by the differences in asset ages, depreciation policies, and debt : equity structures."*
- *"Net operating income is an alternative performance measure which adjusts net profit after tax for a number of non-cash items as detailed in the reconciliation above. [Entity's] dividend policy is based upon net operating income. This alternative performance measure is provided to assist investors in assessing [Entity's] performance for the year."*

- *"Management believes that these measures provide useful information as they provide valuable insight on the underlying performance of the business. They are used internally to evaluate the underlying performance of business units and to analyse trends."* Normalised measures are used by this entity. Normalisation adjustments are defined as *"transactions that are unusual by nature or size so that they materially reduce the ability of users of the financial results to understand the ongoing performance of the Group or operating segment to which they relate. Unusual transactions by nature are the result of a specific event or set of circumstances that are outside the control of the business, or relate to the major acquisitions or disposals of an asset/group of assets or business. Unusual transactions by size are those that are unusually large in a particular accounting period that is not expected to repeat regularly to the same extent in future periods."*

Principle 2: Consider prominence

Five companies in the sample emphasised underlying profit in the annual report with no discussion on statutory profit compared with 11 companies in the prior year.

The FMA's guidance note sets out examples of what could be considered prominence, compared to examples that would be acceptable.

✓	giving prominence to the GAAP profit figure on the first page of a document and analysing components of the non-GAAP profit figure by division or segment on subsequent pages of the document	✗	commentary relates only to non-GAAP profit information, with little or no analysis of the reconciling items
✓	the non-GAAP and the GAAP figures are both included in the headline of an announcement	✗	the GAAP profit figure is shown only in a footnote to the non-GAAP profit information
✓	the non-GAAP figure is in the headline of an announcement and the GAAP figure is at the fore-front of the accompanying commentary	✗	changing the emphasis given to GAAP and non-GAAP profit information from period to period
✓	a summary is provided of the reconciling items between the non-GAAP profit figure and the GAAP profit figure on the first page of the market announcement with a cross reference to a more detailed reconciliation at the end of the document	✗	the GAAP profit figure and associated reconciliation is not presented at least once in every document containing non-GAAP profit information

In addition, the FMA's monitoring report issued in September 2013 noted that there is the potential for non-GAAP information to be misleading when it is presented in a graph without including the equivalent GAAP measure. Issuers should therefore consider including the GAAP measure in any graphs currently used to report the non-GAAP information.

Principle 3: Ensure an appropriate label is used

A wide range of terms are used to describe these alternative earnings figures such as 'underlying earnings', 'normalised profit', 'trading profit', 'EBITDA', 'EBITDAF', 'EBITA', 'operating profit' 'distributable profit' and more. The FMA's guidance states that labelling a measure inaccurately is an example of a misleading disclosure with the following example provided "*it is not appropriate to label a measure as EBITDA if it excludes items which are not interest, tax, and depreciation or amortisation amounts*".

25% of measures used labels that could cause confusion, which is a decline on the prior year result at 31%. For example:

- EBITDA – where it excludes items other than interest, tax and depreciation or amortisation. Common exclusions include profits from associates (equity accounting), restructuring costs, impairments and acquisitions or disposals of assets.
- EBIT – where it excludes items other than interest and tax.
- Operating profit – where it excludes items that would normally be regarded as operating activities. The Basis for Conclusions to NZ IAS 1: *Presentation of Financial Statements* (paragraph 56) notes that "*it would be inappropriate to exclude items clearly related to operations (such as inventory write-downs and restructuring and relocation expenses) because they occur irregularly or infrequently or are unusual in amount. Similarly, it would be inappropriate to exclude items on the grounds that they do not involve cash flows, such as depreciation and amortisation expenses.*"

Principle 4: Explain the calculation

A narrative explanation of the measure was provided for 67% of measures (PY: 63%).

Examples include:

- EBITDAFI - Earnings before interest, taxation, depreciation, fair value adjustments and investments in associates
- Profit before depreciation, amortisation, impairment and tax
- Profit before tax and equity accounted income.

Principle 5: Provide a reconciliation

81% of the alternative profit measures were reconciled to GAAP profit, either through presentation as a subtotal on the income statement, or through provision of a separate table or discussion of adjustments made in the annual report (PY 79%). Reconciliations are typically made to a line item on the income statement such as profit before tax, profit after tax or EBIT (earnings before interest and tax). The FMA's September 2013 monitoring report notes that "*when disclosing non-GAAP profit measures this should be reconciled to GAAP profit being net profit after tax*".

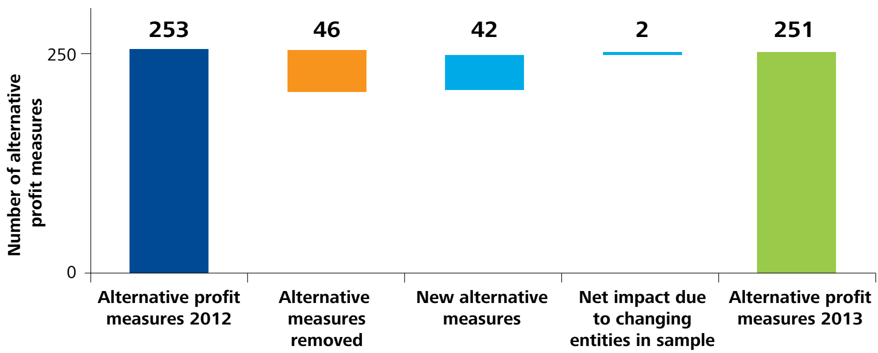
An illustrative example of a reconciliation is provided on page 11. The FMA's Guidance Note also includes an example of a market announcement which includes a reconciliation between the GAAP profit and non-GAAP profit measure which is available at: **http://www.fma.govt.nz/laws-we-enforce/policy/closed-consultations/guidance-note-disclosing-non-gaap-financial-information/**

Principle 6: Apply a consistent approach period to period

82% of measures provided were also used in the prior year indicating a consistent approach from one year to the next. A reconciliation from the 2012 total number of measures to the 2013 total number of measures is provided in Figure 2. The FMA guidance asks for Directors to develop an internal policy on an issuer's use of non-GAAP measures. The use of a policy and clarification around the purpose of the measure and how it is calculated (principles 1 and 4) should ensure consistency.

The FMA guidance also notes that providing multiple non-GAAP profit measures in the same reporting period may cause confusion. 44% of companies in our sample provided three or more alternative profit measures in their 2013 annual reports compared to 49% in 2012 annual reports. The maximum number of alternative profit measures provided was nine, given by two companies.

Figure 2: Reconciliation of alternative profit measures provided in 2012 annual reports to those provided in 2013 annual reports



Principle 7: Adjustments consistent with comparatives

Figure 3 shows the nature of the main adjustments made by companies to arrive at underlying profit. Consistent with our prior year survey, the most common adjustments are to show a figure before tax and interest. Fair value adjustments, impairments and acquisitions and disposals (asset or business gains/losses), and equity accounted earnings continue to feature highly. Depreciation/ amortisation are also common exclusions as companies look to remove items that were 'unrealised' (effectively non-cash) from reported profit. There was an increase in "other" adjustments – typically to remove specific expense items.

Principle 8: Ensure the measure is unbiased

81% of alternative profit measures provide better results than GAAP profit (2012: 85%) as shown in Figure 4. As the alternative profit measures are generally established to remove certain 'one-off' items or 'non-cash' items such as depreciation or amortisation, this is to be expected.

There is no further guidance on when disclosure might be biased. Directors will need to exercise judgement in determining whether a measure is unbiased. A clear policy will enable management to capture the appropriate adjustments and be consistent year on year. For example, if bad debt expenses are excluded, reversals of bad debts should also be excluded.

Figure 3: What are the adjustments made to the GAAP measure to obtain the non-GAAP measure?

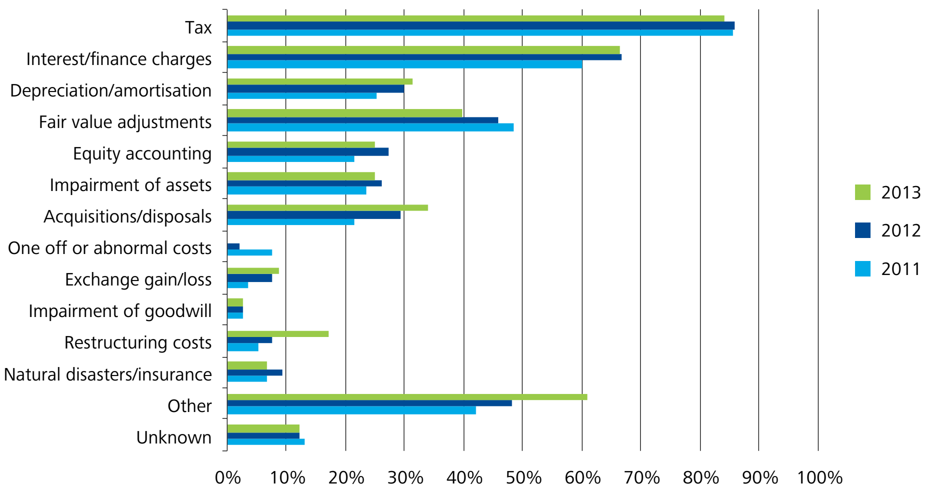
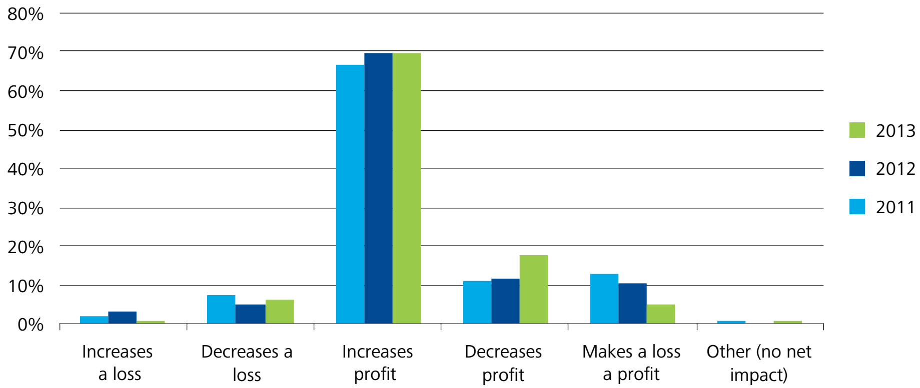


Figure 4: How does underlying profit compare to statutory profit?



Principle 9: Take care referring to one-off items

The FMA guidance notes that it would be potentially misleading to describe "*items such as impairment losses and restructuring costs as 'non-recurring' or 'unusual' when they are generally of a recurring nature in many businesses and can usually occur over a life of a business (albeit they may only arise in some years)*".

17% of alternative profit measures in 2013 annual reports referred to 'one-off' or 'non-recurring' items, an increase from 15% in 2012 annual reports.

Principle 10: Explain if audited or reviewed

If aspects of non-GAAP financial information have been extracted from audited or reviewed financial statements then a clear statement should be made to that effect. Only eight companies made this statement for some or all of their measures, an increase from the three companies that made this disclosure in the prior year.

For example, one company included a footnote in their reconciliation of the non-GAAP measure to the GAAP profit, for each adjusting item that had been extracted from the audited financial statements. This is appropriate if the adjusting item is separately identifiable in the audited financial statements.

Conclusion

The FMA's guidance note does not prohibit Directors from providing additional information on an entity's financial results in order to better explain aspects of the entity's financial performance. However, there are now principles to follow in how this additional information is presented. The results of this survey, compared to the FMA's ten principles above, indicate that some further improvement is required. We have set out some questions overleaf to aid in this consideration and an illustrative disclosure.

Questions Directors should ask

- Have the directors authorised an internal policy that sets out why alternative profit measures provide useful information for investors? Does the policy contemplate the guidance issued by the FMA? Does it address the consistency, completeness and accuracy of any adjustments made to the statutory measures?
- Where an alternative profit measure has been used (such as EBITDA), is this an appropriate way to measure performance and in narrative reporting is it clear which measure is being talked about and why?
- Are the adjustments consistent with other industry players? If not, why?
- Should the board obtain assurance on underlying profit? If yes, from whom?
- Is the alternative profit measure used to determine executive remuneration measures? Are the adjustments made from statutory profit to underlying profit appropriate?
- Has the FMA's guidance on *Disclosing Non-GAAP Financial Information* been applied:
  - Is there a statement disclosing the reasons directors believe that presentation of the alternative profit measure provides useful information to investors? Is the statement clear, understandable and specific to the measure, the entity, the nature of the business and industry, and manner in which the measure is internally assessed and applied to decisions?
  - Is GAAP profit disclosed more prominently than the underlying profit?
  - Is underlying profit labelled appropriately? Does it accurately describe the measure and not cause confusion with GAAP information?
  - Is there a clear narrative explanation as to how underlying profit is calculated?
  - Is there a reconciliation explaining the calculation of underlying profit and how it relates to the GAAP profit?
  - Is the approach to determining underlying profit consistent with the prior period? If there has been a change in approach, is there an explanation about the nature of the change, reasons for the change and financial impact of the change?
  - For each adjustment to GAAP profit, have corresponding items been adjusted in any comparative information?
  - Is the measure unbiased and not used to avoid presenting 'bad news' to the market?
  - Are any items referred to as 'one-off' or 'non-recurring'? Is this appropriate in light of the FMA comments on this?
  - If underlying profit has been taken from audited or reviewed financial statements is there a clear statement to that effect?
- As underlying profit often shows how the board and management view the business, is it consistent with the segment note in the financial statements (which is based on internal reporting)? If not, is there an explanation justifying the difference? No explanation is required if differences are only normal inter-segment eliminations or corporate expense allocations.
- If there is more than one alternative profit measure, could this cause confusion for investors?
- Where is the appropriate placement for this information?

Appendix Illustrative disclosure

The following example is illustrative only. The purpose of the underlying profit figure and particular adjustments to be included when determining underlying profit will vary between companies. Where this disclosure is provided in an annual report (such as in Chairman or CEO commentary) it should not receive greater prominence than commentary on statutory results.

The group uses underlying profit to comment on its financial performance. The Directors consider that underlying profit provides valuable insight to investors because it is the measure used internally by the group to evaluate performance, to establish strategic goals and to allocate resources. In most years it is based on EBITDA (earnings before interest, tax, depreciation and amortisation). However, the effects of exceptional events that are not part of the usual business activity of the group are also excluded when internally evaluating performance. The only exceptional event that has impacted the group in the past two years relates to the earthquake in City A. Costs incurred and recoveries from insurers have been adjusted as outlined below.

Underlying profit is a non-GAAP financial measure and is not prepared in accordance with NZ IFRS. Underlying profit is not a uniformly defined term and accordingly may not be comparable with measures used by other companies. Non-GAAP measures should not be viewed in isolation, nor considered as a substitute for measures reported in accordance with NZ IFRS.

All of the adjustments shown have been taken from the audited financial statements.

The following table shows the adjustments made to statutory profit in order to derive underlying profit.

	Group	
	20X1 NZ$'000	20X0 NZ$'000
Net profit after taxation	34,697	15,753
Add back: Taxation expense	9,851	4,235
Add back: Net interest expense	5,034	6,023
Add back: Depreciation	12,587	15,794
Add back: Amortisation	1,592	1,556
EBITDA	63,761	43,361
Effect of significant events:		
Add back: Impairment of property (1)	-	12,150
Less: Insurance recovery (1)	(15,000)	-
Add back: Debt issue costs (2)	-	1,070
Underlying profit	48,761	56,581

Notes:
(1) In 20X0, the group had to write off a property due to damage sustained during the earthquake. The insurance recovery for this property was not recorded until this year, when negotiations with the group's insurer were concluded.
(2) In 20X0, the group considered doing a debt issue to raise funds for a potential asset purchase. The asset purchase and debt issue did not go ahead as a result of the earthquake so these costs were expensed as part of net profit after taxation.

The Financial Reporting Survey Series

Our Financial Reporting Survey Series has been following the financial reporting practices of 100 New Zealand companies since 2009. The companies in our sample are primarily derived from listed and other large New Zealand companies with publicly available financial information. While our aim is to follow the same companies to identify trends, we had to replace several companies in the sample due to financial statements no longer being publicly available.

This publication is an update of issue 10 which considered underlying profit disclosures in the 2012 annual reports.

Other issues in the series are available at **www.deloitte.com/nz/financialreportingsurvey**

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