# Deloitte.

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# Underlying profit 2012

The practice of reporting alternative profit measures such as 'EBITDA', 'EBITDAF', 'normalised profit' or 'underlying profit' has received significant scrutiny in New Zealand over the past couple of years culminating in the Financial Markets Authority (FMA) issuing guidance in September 2012.

The guidance note became applicable from 1 January 2013 and covers the provision of non-GAAP financial information in investor communications other than financial statements (such as directors' or management commentary and other documents accompanying financial statements, market announcements, press releases, interviews, presentations to investors and briefings to analysts), and in transaction documents (such as prospectuses, investment statements, advertisements, meeting notices etc.).
The guidance was issued by the FMA to assist issuers in ensuring that their communications with investors and other stakeholders are transparent and not misleading, and to promote more meaningful communication of financial information to investors and other users.

As this guidance was not applicable for 2012 annual reports there was little change in the results of our survey compared to prior years. Of the 100 companies surveyed, we identified 90 companies providing in total 253 alternative profit measures (2011: 89 companies provided 250 measures).

The additional company compared to the prior year was the result of changes to the survey sample (two companies needed to be replaced as they no longer had publicly available financial information).

This year's survey considers current practice in one form of investor communication, being the 2012 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 the questions directors should consider when reporting underlying profit, and an illustrative example, as provided in our previous survey document.

## At a glance

No companies fully comply with the FMA guidance note on non-GAAP measures in their annual reports. Although some companies come close, many will need to change their reporting in 2013 and beyond. Detail of how each of the FMA's principles are applied in practice follows in this report. In summary:

**253** alternative profit measures were identified – up 1% on the prior year

**81%** of measures are reconciled to the GAAP profit

**33%** of measures provide some explanation for readers as to their purpose

**63%** provide a clear narrative explanation of how the measure is calculated

**45%** use an appropriate label. 31% do not use an appropriate label, and it is not clear whether the label is appropriate for the remainder of measures (24%)

**15%** make reference to on-recurring or one-off items which is inconsistent with FMA guidance

**3** companies note whether their measures are audited or reviewed

## What we found – Non-GAAP measures in practice

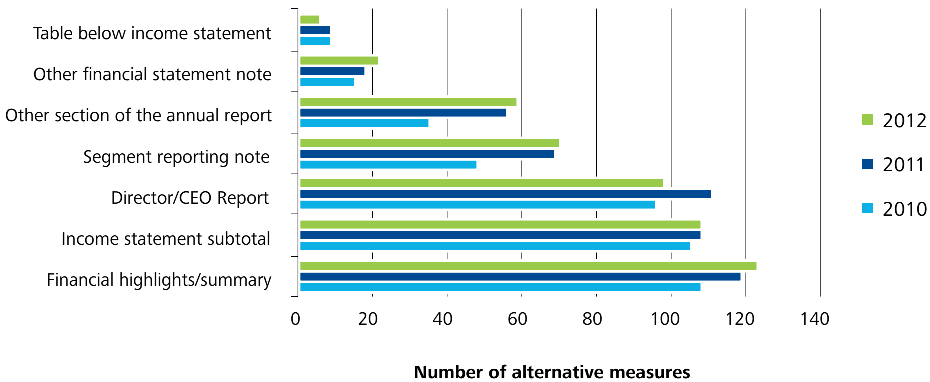
Deloitte has continued to track the same sample of 100 companies (subject to two changes due to financial information not being publicly available) in order to determine the extent of reporting non-GAAP underlying earnings or profit measures (referred to as underlying profit or alternative profit measures) in 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 currently determined in accordance with New Zealand equivalents to International Financial Reporting Standards (NZ IFRS) by the companies in our sample. The FMA also 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."*

**90 companies provided 253 alternative profit measures. This is a small increase from the 250 measures provided by 89 companies in 2011 annual reports.**

Companies continued to provide alternative profit measures in a variety of places throughout 2012 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 in a table of financial highlights (such as a five-year summary), and in many instances both. It was also common to include a subtotal on the face of the

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



income statement. In 2011 nine measures were provided in a separate table below the income statement. This dropped to only six measures in 2012. While the FMA's guidance does not address non-GAAP measures included in financial statements, we note that the Australian Securities and Investments Commission (ASIC) prohibits such information on the face of the income statement which may have influenced this change in treatment.

28% of measures were shown in the segment reporting note. We note that the FMA's guidance note 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."* This would therefore be a new disclosure for many companies.

## 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. As the FMA's guidance did not apply until 1 January 2013, little change was expected in 2012 annual reports compared to our previous surveys and the results reflect this expectation. We continue to consider practice in this area against the FMA requirements in order to assist companies to meet the FMA's guidance in 2013 and beyond. To meet this end, we have also provided some examples of current practice as a starting point. These are examples only, companies should look to develop their own policy, relevant to the nature of their business and the needs of their stakeholders. Boilerplate disclosures should be avoided.

An illustrative example is also included on page 11, and we note that the FMA's guidance note when it was issued included an example of a market announcement which is available at:

**http://www.fma.govt.nz/laws-we-enforce/policy/closed-consultations/guidance-note-disclosing-non-gaap-financial-information/**

## Principle 1: Outline why the information is useful

14% of alternative profit measures included a discussion on why the measure was provided. Another 19% of measures were included in the segment reporting note. The remaining 67% did not have an explanation compared to 68% in the prior year survey.

Examples 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."*

*"The earnings figure that equity analysts tend to focus on for comparative purposes is EBITDA (i.e. Operating Profit before Financing costs, tax, depreciation and amortisations), because that number removes distortions caused by differences in asset age and depreciation policies, and by different debt equity funding 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."*

### Principle 2: Consider prominence

11 companies in the sample emphasised underlying profit in the annual report with little or no discussion on statutory profit compared with 27 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 |

## 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".* We note that this will be a change for some companies.

We identified 79 measures (31%) which could cause confusion. 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 55) 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 63% of measures.

Examples include:

- EBITDAFI – Earnings before interest, taxation, depreciation, fair value adjustments and investments in associates
- Profit before depreciation, amortisation, impairment and tax

## Principle 5: Provide a reconciliation

79% 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. This is a slight decline on the prior year where 81% of the alternative profit measures were reconciled.

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

While the total number of measures is consistent with the prior year, we identified 53 alternative profit measures included in 2012 annual reports that were not discussed in 2011 annual reports. More than half were changes in annual report commentary. It is possible that these measures are only new in respect of items being included that did not exist in the prior year. However as different labels are used and comparatives were not always provided, particularly in annual report commentary, it is not possible to determine whether a consistent approach has been followed. 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 improve consistency.

The FMA guidance also notes that providing multiple non-GAAP profit measures in the same reporting period may cause confusion. 49% of companies in our sample provided three or more alternative profit measures in their 2012 annual reports compared to 50% in 2011 annual reports. Other than one company which provided ten different measures, the maximum number of measures provided was six.

## Principle 7: Adjustments consistent with comparatives

Figure 2 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.

We identified 10 measures where the comparatives presented had been restated. Some restatements were due to changes in accounting policy or discontinued operations and others due to a change in approach to what was included/excluded from the non-GAAP measure.

## Principle 8: Ensure the measure is unbiased

85% of alternative profit measures provide better results than GAAP profit (2011: 85%) as shown in Figure 3. 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 2: What are the adjustments made to the GAAP measure to obtain the non-GAAP measure?**

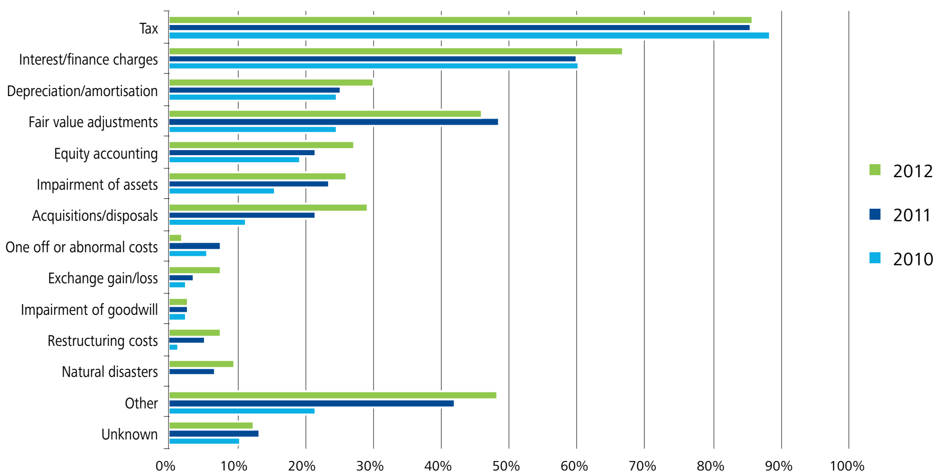
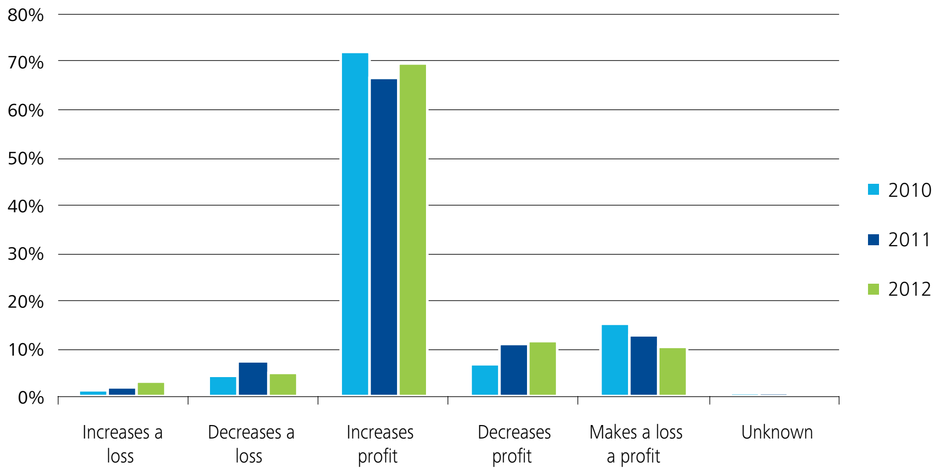


**Figure 3: How does underlying profit compare to statutory profit?**




## 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)".*

15% of alternative profit measures in 2012 annual reports referred to 'one-off' or 'non-recurring' items, a decline from 18% in 2011 annual reports.

## Principle 10: Explain if audited or reviewed

This will be a change to current practice for those measures taken from the financial statements. In 2011 annual reports only one company noted whether its measures were taken from audited or reviewed financial statements. In 2012 annual reports, three companies made this disclosure for some or all of their measures.

## 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 a change in approach and disclosure will be required. As there are areas of judgement required, early consideration is recommended. 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 (currently draft) 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 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 company uses underlying profit to comment on its financial performance. Underlying profit is the measure used internally 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 company are also excluded when internally evaluating performance. The only exceptional event that has impacted the company 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** | | **Company** | |
|---|---|---|---|---|
| | 20X1 | 20X0 | 20X1 | 20X0 |
| | NZ$'000 | NZ$'000 | NZ$'000 | NZ$'000 |
| Net profit before taxation | 44,548 | 19,988 | 35,069 | 5,823 |
| Add back: Net interest expense | 5,034 | 6,023 | 2,933 | 1,653 |
| Add back: Depreciation | 12,587 | 15,794 | 48 | 45 |
| Add back: Amortisation | 1,592 | 1,556 | - | - |
| EBITDA | 63,761 | 43,361 | 38,050 | 7,521 |
| Effect of significant events: | | | | |
| Add back: Impairment of property (1) | - | 12,150 | - | 12,150 |
| Less: Insurance recovery (1) | (15,000) | - | (15,000) | - |
| Add back: Debt issue costs (2) | - | 1,070 | - | 1,070 |
| Underlying profit | 48,761 | 56,581 | 23,050 | 20,741 |

Notes:
(1) In 20X0, the company 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 company's insurer were concluded.
(2) In 20X0, the company 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 before taxation.

## The Financial Reporting Survey Series

The survey series has been following the annual reporting practices of a sample of New Zealand companies since 2009. More information on the sample can be found in issue 9. All issues in the series are available at:

**www.deloitte.com/nz/financialreportingsurvey**

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