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cutting through complexity

Bridging the GAAP

Communicating effectively through alternative performance measures

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IN THE HEADLINES

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> “Investors increasingly look to non-GAAP information for insight into the companies that they own. It’s time to work together globally to make that information more consistent, transparent and reliable. Current and proposed guidelines are a start; but more is needed.”
>
> – Mark Vaessen
> KPMG’s global IFRS network leader

Investors are demanding more than GAAP is delivering

GAAP rarely tells the whole story of a company’s performance. To bridge the gap, companies and investors communicate through key performance indicators (KPIs)[1], alongside the GAAP numbers. Disaggregation and subtotals (earnings before …), quasi-financial measures (sales per square foot, order pipeline) and operational metrics (cost per …, proven and probable reserves) have become commonplace. A few such measures are the subject of agreed, usually sector-specific, definitions; but many are not.

This topic has prompted much debate. When do KPIs enhance GAAP, aiding communication, and when do they present a confusing or overly optimistic picture? To date, regulators around the world have taken different approaches to non-GAAP information or alternative performance measures (APMs). The most recent contribution to this important subject comes from the European Securities and Markets Authority (ESMA).

Transparency and comparability are key

ESMA has issued a consultation paper on APMs[2] in public, regulatory filings. The proposals, once finalised, would apply to non-GAAP information in the 28 member states of the EU. Similar regulations already exist in other major financial markets around the world, such as Australia, Canada and the US, although important differences would remain.

The proposals acknowledge the importance of APMs and user demand for them. They don’t try to ban APMs; they don’t define specific APMs; and they don’t limit either the measures that a company presents or where they are disclosed – e.g. in the financial statements or in the management commentary. Instead, the proposals seek to enhance transparency and comparability when APMs are presented (see ‘Basic facts’).

1 Such KPIs are referred to, interchangeably, as ‘non-GAAP information’ and ‘alternative performance measures’.
2 *ESMA Guidelines on Alternative Performance Measures*.

A very broad scope

ESMA’s proposals would apply to APMs included in all issued documents that contain regulated information and are made publicly available. Such documents include financial statements, management commentary – e.g. MD&A – and certain other public disclosures[3]. ESMA is considering whether the proposals should also apply to prospectuses and related documents.

APMs are broadly defined as ‘any numerical measure of … financial performance’ (see ‘Basic facts’), including those presented in graphs and tables. If in doubt, the measure is assumed to be an APM. It appears that the proposed guidelines may apply to numerical non-financial KPIs if they are a measure of *financial* performance.

‘Comply or explain’ regime

The proposals would take a ‘comply or explain’ approach, which would be enforced by national regulators in EU member states. Some might see this as light-touch regulation; others that market participants would embrace the enhanced transparency and drive best practice more quickly than rules ever could.

Best practice may be unaffected

The effect of the proposals would vary among issuers and may depend on the extent to which they have already followed previous EU recommendations[4]. The proposals to reconcile measures to the most relevant financial statement amounts and to present any narrative analysis also on a GAAP basis may drive changes in practice.

3 Disclosures issued under the *EU Market Abuse Directive* 2003/6/EC and the *EU Transparency Directive* 2004/109/EC.
4 *Recommendation on Alternative Performance Measures*, issued in October 2005 by ESMA’s predecessor organisation, the Committee of European Securities Regulators (CESR).

Are the proposals enough?

Investors invest globally, and demand for APMs does not stop at regulatory borders; therefore ESMA's proposals will be followed with interest beyond the EU.

Many of the proposals are hard to disagree with, although the details merit attention. For example, the disclosure of APMs with *no more* prominence than GAAP measures may be a more appropriate benchmark, and the scope is unclear in respect of numerical, non-financial APMs. We also question whether all subtotals of GAAP information are properly labelled as APMs given the requirement in IFRS, for example, to present additional subtotals in some circumstances; however, transparency is the primary objective, regardless of label.

Basic facts

Under ESMA's proposed guidelines, companies would:

- present APMs with less prominence than corresponding GAAP information;
- give APMs meaningful names, and explain their context;
- define and reconcile APMs to the most relevant GAAP amount; include cross-references to, and an appendix of, definitions;
- present any narrative explanation or analysis also on a GAAP basis;
- present comparatives, disclosing APMs consistently over time; and
- change the disclosed APMs only if they provide more relevant and reliable information; then explain and reconcile any changes.

ESMA's definition of an APM

Any numerical measure of historical, current or future financial performance relating to financial position, comprehensive income or cash flows, other than one defined by GAAP. Examples include: EBIT; EBITDA; underlying profit; net debt; free cash flow; sales per square metre; pro forma financial information; and profit forecasts.

But there are also wider issues that stakeholders should work together to solve as global requirements evolve.

So, what more is needed?

- Companies should consider whether current and proposed requirements give them the level playing field that they need, in the EU and globally, and the flexibility to appropriately explain their financial performance.
- Executives and audit committees should ask whether APMs are subject to sufficiently robust systems and processes.
- Investors should consider whether the level of consistency, transparency and reliability is sufficient and, if not, what more is needed.
- Industry bodies could step up and deliver sector-specific definitions of key metrics to enhance consistency and comparability.
- Standard setters should consider how GAAP itself might change to bridge the gap to what is demanded by investors.
- Regulators working through the International Organization of Securities Commissions (IOSCO) could seek to harmonise their approaches, globally.

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Next steps

ESMA has requested comments from all stakeholders. The comment period is open until 14 May 2014.

Find out more

You can download a copy of the consultation paper from the ESMA website.

> "ESMA's proposals could enhance the transparency and comparability of information to investors in the EU. But it is surely an anomaly that some of the information most valued by investors is subject to the least scrutiny."

– David Littleford, KPMG's global IFRS presentation leader

About ESMA

ESMA is an independent EU authority that contributes to safeguarding the stability of the EU's financial system by ensuring the integrity, transparency, efficiency and orderly functioning of securities markets, as well as enhancing investor protection. It is an umbrella body for national enforcers in the 28 member states of the EU. More information about ESMA can be found at www.esma.europa.eu.

Timeline

13 February 2014:
Consultation paper released

14 May 2014:
Consultation period closes

Q4 2014:
Final guidelines published

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