

Monitoring of non-GAAP disclosures

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Introduction

FMA released a guidance note on Disclosing Non-GAAP Financial Information (guidance note) in September 2012. In this review we assessed the market's response to the guidance note to gain an early indication of whether disclosures around non-GAAP (generally accepted accounting principles) financial information are improving.

While there has been an improvement, there are still areas that remain a concern and we ask issuers to reconsider their future disclosures in light of the guidance note and this report.

A key part of the work that we do is ensuring investors have access to resources that help them make more informed decisions, this includes the promotion of high quality financial reporting.¹ We also perform theme-based monitoring of financial reporting by issuers.

Our review focused on the disclosure of non-GAAP profit information in market communications. This report outlines our findings and suggested areas of improvement. It is intended for issuers, their directors and preparers of financial information.

¹ FMA's Statement of Intent 2013-2016, page 13



Overview

In February 2013 we announced to the market that we would be performing a range of theme-based monitoring reviews, including a review of non-GAAP disclosures against our guidance note.

The guidance note set out our expectations on the use of financial information in corporate documents, for example, transaction documents and market communications - where that information is not presented in accordance with GAAP or is presented as an alternative to the statutory profit. It also set out our definition of non-GAAP financial information and related terms and our views on presenting non-GAAP financial information.

Our review comprised 23 listed issuers, a small cross section of a large market. While small, the sample is focused on well resourced, publicly listed issuers. This provided us with an early indication of whether issuers using non-GAAP profit information are presenting that information with disclosures that are consistent with the guidance note. The review focuses on non-GAAP profit information in market communications such as directors or management commentary and other documents accompanying financing statements, market announcements, press releases, interviews, presentations to investors and briefings to analysts.

Market Communications

We reviewed market communications for December 2012 and March 2013 half year and full year results. To assess the response of the market to the guidance note, we compared market communications post release of the guidance note to announcements made prior to its release. We looked at market communications as a whole in order to assess whether non-GAAP profit information was presented in a balanced way. The risk is that non-GAAP financial information can be misleading if it is not appropriately presented and explained.

While disclosure of financial information that does not follow our guidance note will not necessarily breach the law, in our view, following the guidance note will increase the likelihood of compliance with the regulatory requirements.²

Issuers commonly supplement their reported earnings under GAAP with non-GAAP profit information that they believe more accurately reflects their performance. In FMA's view when non-GAAP financial information is used, additional disclosures should be made so that the information is not misleading.

Reporting of GAAP profit provides a reader with financial information that is consistently calculated and comparable over time and across all issuers, regardless of industry type. It is important that these earnings announcements provide a balanced view of profit and that GAAP and non-GAAP profit are presented in a clear and balanced way. Non-GAAP financial information can be useful for some investors and other users of this information in particular circumstances.

² FMA Guidance Note: Disclosing non-GAAP financial information page 1

Significance of non-GAAP financial information

As highlighted in our guidance note³ non-GAAP financial information can provide meaningful insights into the financial condition or performance of a business. We are not seeking to prohibit the use of non-GAAP financial information in documents related to the financial result, but we consider the guidelines discussed in Section C of the guidance note will reduce the risk that such information is misleading.

In the New Zealand market, Deloitte performed a survey on the reporting of alternative profit measures in annual reports.⁴ The survey considered current practice in the 2012 annual reports of 100 companies. In summarising, Deloitte noted that “No companies fully comply with FMA’s guidance note on non-GAAP measures in their annual reports”.⁵ This is consistent with the findings of our review.

The purpose of the guidance note was to:

- Promote more meaningful communication of financial information to investors and other users of financial statements.
- Increase the likelihood that financial information is disclosed in a way that is not misleading.
- Provide greater certainty in the market about our views on disclosure of non-GAAP financial information and how we will assess such disclosures.

The guidance note also provided some specific guidelines⁶ for good disclosure of non-GAAP financial information. Considering and addressing the guidelines when presenting non-GAAP financial information will mean that disclosures as a whole will be clearer and less likely to be misleading.

The guidelines to consider are:

1. Why information is useful
2. Prominence
3. Appropriate label
4. Calculation
5. Reconciliation
6. Consistency
7. Adjustments
8. Unbiased
9. One-off items
10. Audited or reviewed


We identified two areas that are key to balanced disclosures around non-GAAP profit information; these are prominence and reconciliations. If these two key areas are not adequately addressed in market communications, the possibility of information being unclear or misleading arises. Consideration of all the

³ FMA Guidance Note: Disclosing non-GAAP financial information, page 4

⁴ Issue 10 of Deloitte’s Financial Reporting Survey Series, June 2013

⁵ The guidance note is applicable from 1 January 2013 and not applicable to the 2012 annual reports reviewed in the Deloitte survey.

⁶ FMA Guidance Note: Disclosing non-GAAP financial information, pages 8-9



guidelines when providing non-GAAP financial information will result in well balanced and transparent communication.

Summary of findings

We were pleased with the market's response to the publication of our guidance note. Our review found improvement across all of the ten guidelines for presenting non-GAAP financial information. This indicates to us that directors are considering the guidelines when presenting non-GAAP financial information and responding well to the guidance note we issued.

While overall improvements have been noted, we expect to see more improvement in disclosures. To achieve good disclosure of non-GAAP financial information, the information provided needs to be viewed as a whole. Non-GAAP financial information should not be given undue prominence, emphasis or authority, and it should be clearly explained and reconciled, calculated consistently, be unbiased and not used in an effort to negate or disguise 'bad news'.

We wrote to two issuers about their non-GAAP disclosure which we found did not comply with the key aspects of the guidelines in our guidance note. Both agreed to improve disclosures in their future communications and we will be monitoring these for consistency with the guidance note.

In the case of the 23 listed issuers, this sample generated a total GAAP profit of \$2,348 million and a non-GAAP profit of \$4,143 million; a difference of \$1,796 million. These issuers reported an additional 76 percent of profit compared to their non-GAAP profit.

Of these listed issuers, 17 of the 23 reported a non-GAAP profit greater than their GAAP profit. The difference between the two measures can be substantial, hence the importance of clear disclosure and reconciliation between the two measures.

Material findings and areas for improvement

Prominence

As indicated earlier, non-GAAP financial information should not be presented with undue prominence, emphasis or authority.

Determining prominence given to GAAP versus non-GAAP information can be subjective and therefore difficult to measure. We expect that directors and preparers will take care to exercise good judgment when determining the appropriate level of prominence given to any non-GAAP information.

In our guidance note we provided a number of examples which gave undue prominence to non-GAAP and due prominence to GAAP in order to assist directors and other preparers of information.



When we reviewed each communication against these examples, we found:

- overall prominence given to non-GAAP was greater than that given to GAAP
- instances where communications were overwhelmed by multiple non-GAAP measures with little or no emphasis on the GAAP measure.

Another useful example of giving undue prominence to non-GAAP financial information, not covered in the guidance note and commonly seen, is the presentation of non-GAAP profit information in a graph. Where graphs are presented with non-GAAP information alone there is the potential to be misleading. We expect issuers to present a balanced disclosure of non-GAAP with the equivalent GAAP disclosure if they are using a graph.

Reconciliation

A reconciliation of non-GAAP profit to the relevant GAAP profit provides transparency so the user can gauge how the non-GAAP information differs from that prepared in accordance with GAAP. There are a number of guidelines established in the guidance note to ensure that a quality reconciliation is provided.⁷ The guidance note distinguishes between a clear narrative explanation of how the non-GAAP financial information is calculated and a reconciliation between the non-GAAP and GAAP financial information; both need to be provided for clear disclosure.

During the public consultation for the guidance note, the suggestion to provide reconciliation information at least once in each document where non-GAAP financial information is disclosed was widely commented on. This has been retained in the guidance note and a range of practices have been noted in the market. After publication of our guidance note, the number of issuers in our sample who provided a reconciliation increased.

FMA found instances where issuers had provided a reconciliation, but it was not included in the market communication reviewed, resulting in the need to search for the supporting information elsewhere. We believe that the risk is that most users are unlikely to make the effort to cross reference to other sources of information. It is therefore important that users have access to readily available information to reconcile non-GAAP financial information to GAAP financial information.

There were a number of instances where issuers did not provide an adequate reconciliation and we observed the following:

- the reconciliation was omitted and no corresponding information was available to establish how the non-GAAP profit measure differed from GAAP
- the reconciliation was omitted, but we were able to establish how the non-GAAP profit measure differed from GAAP
- the non-GAAP profit measure was not reconciled to GAAP profit.

FMA expects a reconciliation to be provided in each and every document where non-GAAP measures are disclosed. We also remind issuers that when disclosing non-GAAP profit⁸ measures this should be reconciled to GAAP profit being net profit after tax.

⁷ FMA Guidance Note: Disclosing non-GAAP financial information, pages 8-9

⁸ FMA Guidance Note: Disclosing non-GAAP financial information, page 6

Other findings

Why information is useful

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.

While most issuers provided a statement as to why non-GAAP profit information was useful, only seven explained how it was used internally.

Our review found instances where multiple non-GAAP profit measures were used and not adequately explained. We do not discourage the use of non-GAAP measures, however if issuers cannot explain in a statement how such a measure is useful or is used internally, this should prompt issuers to question the use of such non-GAAP financial information in their communications.

Appropriate label

Non-GAAP financial information should be clearly labelled in a way that distinguishes it from the corresponding GAAP financial information. Most issuers appropriately labelled their non-GAAP measure.

EBITDA (Earnings Before Interest, Tax, Depreciation and Amortisation) or a variation of this, was the most commonly reported non-GAAP profit measure. Although EBITDA is a widely used term and is defined as earnings before interest, tax, depreciation and amortisation, this measure raised the most concerns.

The guidance note and our subsequent review do not specifically address financial information that is disclosed within statutory financial statements. This is because the disclosure requirements and obligations for statutory financial statements are clearly provided within the Financial Reporting Act 1993 and applicable financial reporting standards. As a result, references in this section to EBITDA relate to market announcements and not the statutory financial statements.

Our review noted several instances where EBITDA was used in the market announcement, but additional adjustments were made in arriving at the non-GAAP EBITDA profit figure. The additional items adjusted for included equity accounting, impairment of assets, revaluations, acquisitions/disposals, other gains/losses, one-off or abnormal costs. It is not appropriate to make any of these additional adjustments and still label the non-GAAP profit figure as EBITDA. Even where the EBITDA figure with its additional adjustments is explained and reconciled in the market communication, the use of an incorrect label can be misleading. For example the EBITDA figure can be quoted in media articles without reference to the additional adjustments because the term is commonly used and known.

The majority of issuers in our sample did differentiate their measures when including other adjustments to EBITDA by using terms such as normalised EBITDA, EBITDAF, EBITDAFI and EBITDAF from continuing activities.



One-off items

We still noted instances of referring to reconciling items as one-off where perhaps they were not 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’ and ‘non-recurring’.

Audited or reviewed

If aspects of the non-GAAP financial information have been extracted from audited or reviewed financial statements then a clear statement should be made to that effect. Only seven of the 23 issuers made a statement as to whether adjustments were extracted from audited or reviewed financial statements.

Conclusion

The results of our review suggest that issuers are aware of our September 2012 guidance note and are starting to apply the guidelines when presenting non-GAAP profit information in market announcements. While improvements are noted, all aspects of the guidance note are still not being addressed.

Issuers using non-GAAP profit information were not always presenting a balanced view of profit, often giving more prominence to non-GAAP profit information than GAAP profit. Issuers and preparers of information must strive to give a balanced ‘whole’ picture of their performance.

Quality disclosure around non-GAAP financial information is an important focus for FMA. We will continue to monitor disclosure of non-GAAP financial information in market announcements for compliance with our guidance note with a focus on the suggested areas for improvement set out in this report.



