www.pwc.com

Corporate performance: What do investors want to know?
Reporting adjusted performance measures

July 2014

pwc

Contents

Introduction

The rise of adjusted performance measures

This report – looking at the disclosure of adjusted performance measures (APMs) – is the first in a series[1] of PwC surveys of investment professionals aimed at maximising the effectiveness of corporate reporting. Understanding the needs and opinions of investment professionals is crucial if management teams are to prepare truly useful financial reports and accounts.

When investment professionals analyse a company, their goal is to understand the quality and sustainability of its 'underlying' or 'core' performance. They want insight into what drives profits year on year and the measures that management teams consider to be market moving. They want to understand the impact on company performance of management actions relative to general market conditions. They also seek a clear line of sight into any potential challenges.

APMs are increasingly used by companies to help provide such insights. They may not be measures defined in generally accepted accounting principles (GAAP) such as International Financial Reporting Standards (IFRS) or US GAAP, but they can play a useful role in helping management teams tell the story of their business and how it has performed. They may, for example, take account of industry-specific factors that would otherwise not be reported. When management teams identify an APM as being an underlying or core performance measure, they give investment professionals an understanding of what management considers key to understanding the company's ongoing performance potential.

As APMs have become more widespread, so their reporting has become a hot topic around the world for preparers, auditors, investors and regulators. In Europe, the European Securities and Markets Authority (ESMA) is consulting on new guidelines for APM reporting. In South Africa, the Johannesburg Stock Exchange requires companies to disclose a specifically-defined APM – headline earnings per share. The US Securities and Exchange Commission (SEC) sets out rules on how these types of measures can be disclosed. We are also seeing more discussion in the press and throughout the accounting profession about the disadvantages and benefits of APMs, including their effect on executive and director remuneration.

One important question concerns the extent to which APMs are – or should be – subject to some form of independent assurance. In many cases, APMs fall outside the scope of statutory audit or assurance requirements. In the absence of such independent review, how much confidence can the market place on the reliability of reported APMs? Our latest research finds scepticism about the reliability of APMs reported outside the financial statements.

PwC has been talking to investment professionals about their reporting needs for many years. In this survey, we interviewed 85 investment professionals from around the world to gain their insights into what is useful – and less useful – in current reporting of APMs. We aim to identify where there are opportunities for improvement and make some recommendations for management actions in the form of basic ground rules for APM reporting.

[1] Future publications will focus on investment professionals' views on integrated reporting and financial statement note disclosures.

Executive summary

Adjusted performance measures are useful but need improvement

Adjusted performance measures (APMs) are widely reported by companies alongside GAAP results. Based on interviews with investment professionals around the world, it is clear that APMs are highly valued. Nevertheless, their value could be enhanced substantially by changes in how they are reported.
Investment professionals tell us:

- A substantial majority of investment professionals find APMs useful; only 12% do not.
- For some companies, GAAP measures on their own may not always provide the best insights for understanding ‘core’ or ‘underlying’ business performance. APMs play a crucial role in company reporting: 85% of investment professionals like to see management’s view of what is ‘underlying’ or ‘core’ to the company.
- APMs can complement GAAP measures to give clarity on issues such as the impact of foreign exchange movements or merger and acquisition activity.
- Companies could improve the quality of their APM reporting: 95% of investment professionals would like management teams to provide clearer descriptions of the items they have adjusted when calculating their ‘underlying performance’ measure, as well as why they thought it appropriate to make the adjustments. The explanations that management teams give for why they have adjusted for various amounts often provide the most insightful parts of APM disclosures.
- They are sceptical about the balance management teams display in reporting APMs. This is a concern because a lack of balance in APM reporting could damage management’s credibility with investment professionals: 81% of investment professionals say that if management’s adjustments to GAAP numbers seem aggressive or unusual, their evaluation of the riskiness of management increases.
- Investment professionals 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.
- There is a case for considering assurance of APMs where not already obtained. Only 22% of investment professionals think that the measures that move markets (including APMs) are sufficiently reliable.

These findings closely mirror those of a previous PwC survey conducted in 2007, *Corporate reporting: Is it what investment professionals expect?*, in which investment professionals told us they wanted to see clear and consistent non-GAAP disclosures, reconciliations and comparative information. This consistency of view suggests that there is a lack of a perceived improvement in the quality of APM reporting over the intervening period, and this provides a compelling reason for management teams to take action now. To help investment professionals understand business performance fully, APM disclosures need to be as transparent, balanced and consistent as possible.

Ground rules for APM reporting

Based on what investment professionals have told us in this and previous research, management teams could improve their reporting by applying the following basic principles when reporting APMs:

- Be clear and consistent in definitions of measures and the adjustments made.
- Apply balance when making adjustments and only use measures that are relevant for understanding performance.
- Explain the why as well as the what: why particular APMs are relevant to understanding performance and why adjustments are made.
- Provide comparative data and restate the comparatives if definitions do change.
- Reconcile APMs to GAAP, showing adjustments clearly in a bridge chart or table.
- Give balanced prominence to GAAP and non-GAAP measures in all communications.
- Be clear about which measures are non-GAAP, and about what is and isn’t audited or subject to some other form of assurance.

Survey findings

While generally accepted accounting principles, such as IFRS or US GAAP, form the bedrock of corporate reporting, they may not always be enough. Many management teams now identify measures of business performance in addition to the GAAP net income or profit or loss figure. These APMs are seen by management as providing helpful additional information for users of financial statements – telling a clearer story of how the particular business has performed.

Frequently used measures include 'underlying earnings', 'core earnings', or other management performance measures such as 'sales per square foot', 'all in cash costs' or 'production rates'.

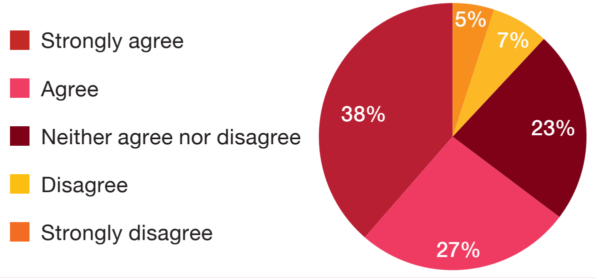
But are such measures really useful to investment professionals? And if they are, could their value be increased by changing the way they are disclosed? We asked investment professionals from around the world for their views.

Investment professionals value adjusted performance measures

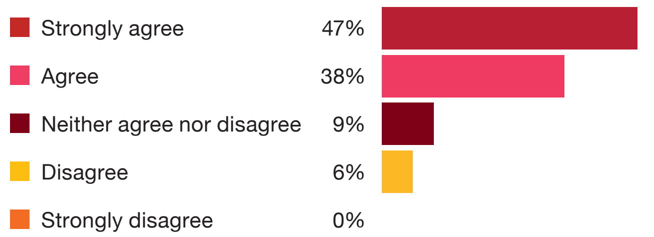
If management teams are to spend time on providing APMs, they need to know that investment professionals value them. Our latest survey confirms that they do. In general, the majority find adjusted performance measures helpful for their analysis. In fact, only 12% of those we surveyed say they do not. APMs can complement GAAP measures to give clarity on issues such as the impact of foreign exchange movements or merger and acquisition activity.

Management's view of what is 'underlying' or 'core' to the company is important to investment professionals: 85% of those we surveyed like to receive this information. Many feel it plays an important role in enabling management teams to tell their company's story as they see it, which gives investment professionals insight into the value drivers of a business.

Generally, I find adjusted performance measures helpful for my analysis



I like being able to see management's view of what is 'underlying' or 'core' to the company



Transparency of disclosures could be improved

"I like seeing what they think is core – I don't always think they are right, but it definitely gives some insight."

"I need to understand what is really driving the numbers and why management chose to present them."

"Understanding why management have made the adjustment is really the whole value of the adjusted number."

Given that some APMs are non-GAAP measures, investment professionals depend on management to explain them clearly. Many see considerable room for improvement in this area: 95% of the investment professionals we spoke to would like management teams to provide clearer descriptions of the items they have adjusted when calculating their 'underlying performance' measure, as well as why they thought it appropriate to make the adjustments.

This powerful message is consistent with the views investment professionals have shared with us over many years through discussions and research. They consider disclosure of adjustments, and reconciliation to the nearest GAAP measure, to be important – but they particularly value management's explanations of why they have done what they have done. This is where investment professionals feel they gain added insight into management's perception of the factors that are really driving the business' performance.

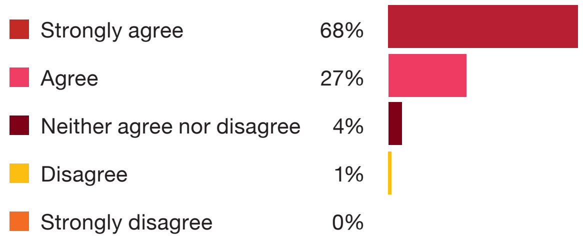
Over four out of five investment professionals (81%) feel that adjusted earnings measures should exclude unusual income as well as unusual expenses. This might reflect a desire for balance and completeness in adjustments and disclosures to support greater transparency and understanding of company performance.

Actions

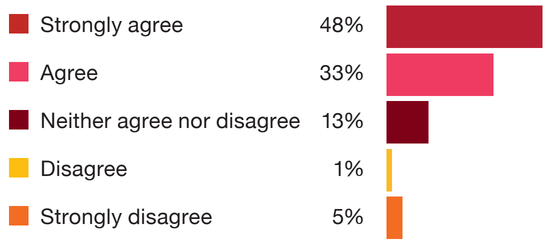
Explain the why as well as the what: explain why particular APMs are relevant to understanding performance and why adjustments are made.

Reconcile APMs to GAAP, showing adjustments clearly in a bridge chart or table.

I would like management to be clearer in its descriptions of the items it has adjusted to arrive at 'underlying performance' (or a similar measure) and why they chose to adjust for them



I think adjusted earnings measures should exclude unusual incomes as well as unusual expenses



"I just like to know what they want to highlight as items of note, but ultimately I will make my own decision about what I will include or exclude in my analysis of the company."

"The biggest challenge with using adjusted performance measures is that every company defines them differently."

"What they adjust for seems to change every year; consistency is key."

Some investment professionals, however, told us they do not think management teams should be making their own adjustments for unusual items. They would prefer to decide for themselves what adjustments should be made. What matters most to this group is that management reports business performance as clearly as possible. This means providing appropriate disaggregation on the face of the financial statements or in the notes, breaking down income and expense items clearly. Investment professionals can then review these items and make up their own minds about what is unusual or not.

One challenge for investment professionals is that individual companies tend to define APMs in their own way. In the absence of industry standards, management teams could help investment professionals by defining their APMs clearly and, if appropriate, explaining why that definition is relevant. Breaking down the components and adjustments clearly would also help investment professionals take a different approach if they wanted to.

When considering the transparency of their disclosures, management teams should also bear in mind that investment professionals might become frustrated when the measures reported are inconsistent year-on-year.

Actions

Be clear and consistent in definitions of measures and adjustments made.

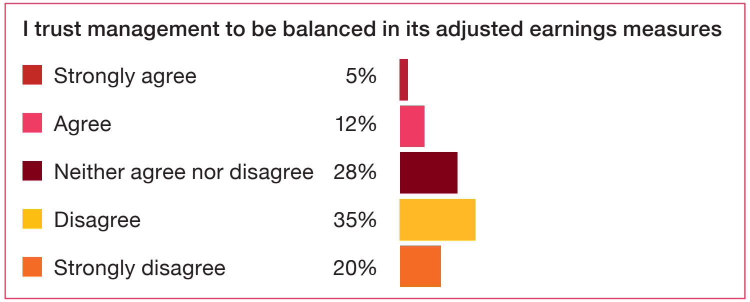
Provide comparative data and restate the comparatives if definitions do change.

Disclosures could be improved by greater balance and reliability

Many investment professionals are somewhat sceptical about the degree to which management teams are capable of applying a balanced approach to their APM adjustments and disclosures. In fact, 55% do not trust management to be balanced when presenting adjusted earnings measures. Only 17% told us they do trust management to be balanced.

The way management teams define their APMs has a real impact on how investment professionals perceive them. Over 80% of those we spoke to said that if management's adjustments to reported GAAP numbers seem aggressive or unusual, their evaluation of the riskiness of management increases. Such poor perceptions could translate into a direct financial cost for the company through an uncertainty or risk premium being priced into valuations.

When seeking to apply a balanced approach to the reporting of performance, management should consider the relative prominence given to GAAP and non-GAAP measures across all communication channels.



"You can judge management by how much they seem to be stretching the facts – but that is good to know; I want to know if they are talking nonsense."

APMs, by indicating the core or underlying performance of the business, have the power to influence markets. They therefore need to be reliable. Only 22% of investment professionals we surveyed, however, feel that the measures that move the market are sufficiently reliable.

A large number (45%) of investment professionals told us they neither agree nor disagree that the measures that move markets are sufficiently reliable. This may suggest some confusion about which measures are and are not currently assured (by the company's independent auditor, for example) or which measures are derived from assured numbers. In order to improve understanding, disclosures should clearly indicate which measures are subject to assurance.

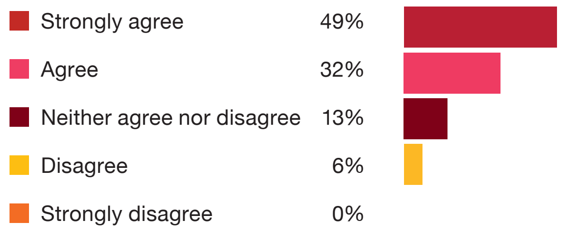
Actions

Apply balance when making adjustments and only use measures that are relevant for understanding performance.

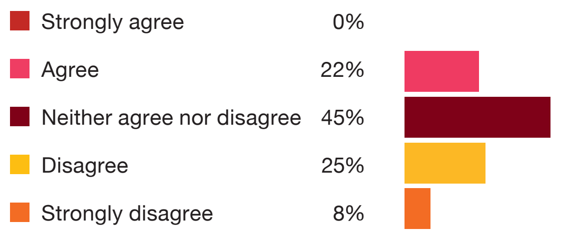
Give balanced prominence to GAAP and non-GAAP measures in all communications.

Be clear about which measures are non-GAAP, and about what is and isn't audited or subject to some other form of assurance.

If management's adjustments to reported GAAP numbers seem aggressive or unusual, my evaluation of the riskiness of management increases



In general, I believe that the measures that move markets (including industry-specific, non-GAAP or adjusted numbers) are sufficiently reliable



"My experience is that in many cases management adjust when the optics are favourable, and don't adjust when the optics are unfavourable. The impact of that is really negative for a company; it makes them look so self-serving and it damages their credibility."

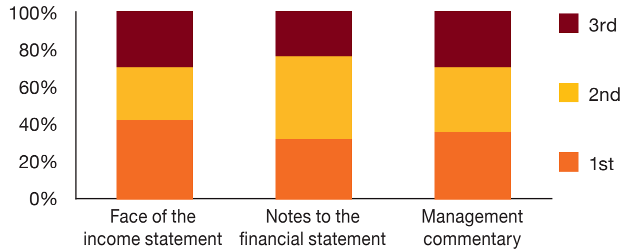
Location of APM disclosures is less important than transparency

The quality of APM disclosures is more important to investment professionals than their location in the annual or interim report.

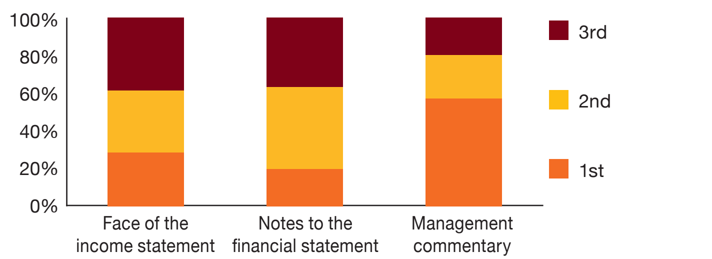
Survey respondents[2] were asked to rank in order of preference three possible locations for APM disclosures: the face of the income statement, the notes to the financial statements and the management commentary. Each location received a broadly similar number of first and second preference votes, with a slight preference for the face of the income statement as a first choice.

From a geographical perspective, investment professionals in the UK express a stronger preference for non-GAAP measures to be presented in the management commentary; survey respondents in the rest of Europe prefer them to appear in the income statement. In Asia-Pacific, there is a slight preference for including APMs in the notes to the financial statements. All other territories were aligned with the overall outcome.

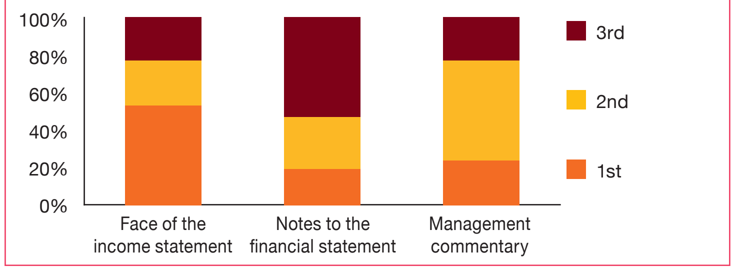
Where would you most like companies to disclose APMs?
Overall



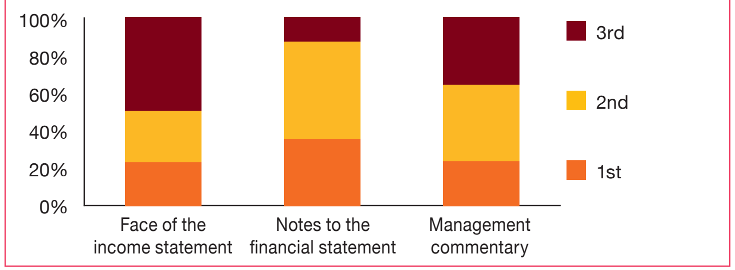
UK



Rest of Europe



Asia Pacific



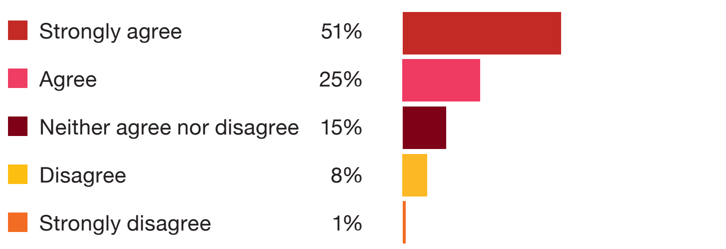
[2] Investment professionals in the US and Canada were not asked for their preferences due to the Canadian securities regulators' and the US Securities and Exchange Commission's rules on the presentation of APMs.

Management should apply 'ground rules' for good disclosure

APMs are of interest to investment professionals partly because they reveal management's view of what reflects business performance and the drivers of that performance. However, this does not mean that they want a complete disclosure 'free-for-all': three quarters of those we spoke to would gain comfort from knowing that there are some basic 'ground rules' or 'rules of engagement' for APMs included in financial reports. The strength of this finding perhaps reflects investment professionals' concerns that management teams may be tempted to apply too much positive 'spin' in their APM adjustments and disclosures.

What should these ground rules be? Our latest feedback from investment professionals is consistent with the messages we have been hearing from them for many years. Their views therefore form the basis of the action points highlighted in this report. Applied together, these could usefully form some common ground rules for reporting of APMs.

I would gain comfort by knowing that the non-GAAP measures that move markets reported by management adhere to somebasic ground rules



Ground rules for APM reporting

- Be clear and consistent in definitions of measures and adjustments made.
- Apply balance when making adjustments and only use measures that are relevant for understanding performance.
- Explain the why as well as the what: why particular APMs are relevant to understanding performance and why adjustments are made.
- Provide comparative data and restate the comparatives if definitions change.
- Reconcile APMs to GAAP, showing adjustments clearly in a bridge chart or table.
- Give balanced prominence to GAAP and non-GAAP measures in all communications.
- Be clear about which measures are non-GAAP, and about what is and isn't audited or subject to some other form of assurance.

Conclusion

Investment professionals tell us that adjusted performance measures have a valuable role to play in high-quality, useful company reporting. They bring added insight to help them to understand a company's performance story.

However, management needs to be thoughtful when reporting adjusted GAAP or non-financial information. APMs should be used only when management believes that measures derived under IFRS or other GAAP do not provide all the information relevant to understanding the company's performance during the period.

The value that investment professionals derive from APM disclosures is far more dependent on how they are made than where they are made. APM reporting must be transparent, so that investment professionals fully understand why a measure is being reported, what adjustments have been made and why management thinks those adjustments are appropriate.

Management teams should try to apply balance, bearing in mind that aggressive APM reporting can influence investment professionals' perceptions of the riskiness of management and hence their company valuations. Consistency is also key, so that investment professionals can clearly read the performance story over time through comparable data.

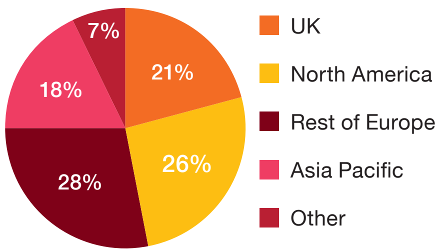
These findings closely mirror previous PwC research, suggesting that there has been little improvement in APM reporting in recent years. The sustained value that investment professionals place on it, however, should provide a compelling reason for management teams to take action now to ensure their APM disclosures are as useful as they can be.

Appendix: Survey population

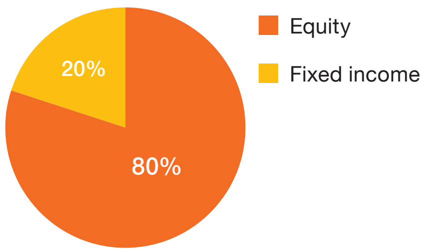
We conducted interviews with 85 investment professionals from the buy side, sell side and ratings agencies. Their roles included equity analysts, fixed income analysts, ratings agencies, portfolio managers, chief investment officers and heads of research.

Survey participants were drawn from key markets across the world. Throughout this report we have presented our findings on a global basis, unless we found significant variation by a particular user group or geography.

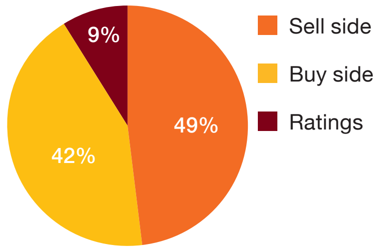
Participants by geography



Participants by specialism



Participants by type



Contacts

For further information please enquire of your usual PwC contact or the investment community engagement team:

Hilary Eastman

T: + 44 (0)207 804 1818

E: hilary.s.eastman@uk.pwc.com

Jennifer Sisson

T: + 44 (0)207 804 8644

E: jennifer.sisson@uk.pwc.com