Date: 9 May 2014
ESMA/2014/SMSG/015

POSITION PAPER

Alternative Performance Measures – APM

I. Background

1. In October 2005, the Committee of European Securities Regulators (CESR), ESMA's predecessor body, published a Recommendation on Alternative Performance Measures *("CESR Recommendation"* CESR/05-178b*)*. The CESR Recommendation was issued mainly in order to reinforce the objectives of Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards.

2. Given the CESR Recommendation has now been in force for more than 8 years, ESMA has decided to review it with the objective of strengthening the principles contained in it. ESMA now plans to re-issue the principles as ESMA [draft] guidelines under Article 16 of the ESMA Regulation in relation to the acts referred to in Article 1(2) of the ESMA Regulation, which include the Transparency Directive, thus ensuring that issuers and National Competent Authorities (NCAs) will make every effort to comply with them.

3. At the SMSG meeting held on 29 January 2014, Roxana Damianov, ESMA, presented the main content of the draft ESMA Consultation Paper on Alternative Performance Measures, according to a presentation shared with the meeting, and informed that the consultation paper would go for approval to the next ESMA Board meeting and thereafter be opened for consultation. The SMSG Chair noted that SMSG would consider a working group on the topic once the consultation period had opened.

4. On 13 February 2014 the final version of the ESMA Consultation Paper on APM was published, with deadline for consultation set on 14 May 2014. ESMA issued this Consultation Paper (CP) to inform market participants about the background to its decision to revise the CESR Recommendation and seek their views on such revision.

5. On 12 March 2014 a Working Group on APM was formed with a task to prepare a discussion at the next SMSG meeting on 10 April, with a view to finalize the response before the deadline of 14 May 2014.

6. At the SMSG meeting held on 10 April 2014, a Discussion Note prepared by the Working Group was presented and discussed. There was a consensus that the final report should be prepared in line with the Discussion Note.

II. Response to the ESMA Consultation Paper

7. SMSG welcomes EMSA's initiative to imply a common approach to be adopted by NCAs and issuers towards the use of APMs by issuing guidelines. The Transparency Directive does not request ESMA to issue respective guidelines. However, according to Art. 16 of the Regulation 1095/2010, ESMA shall, with a view to establishing consistent, efficient and effective supervisory practices within the ESFS, and to ensuring the common, uniform and consistent application of Union law, issue guidelines addressed to competent authorities or financial market participants.

Q1: Do you agree that the ESMA [draft] guidelines should apply to all issuers defined as a legal entity governed by private or public law, other than Member States or Member State's regional or local authorities, whose securities are admitted to trading on a regulated market, the issuer being, in the case of depository receipts representing securities, the issuer of the securities represented regardless of the financial reporting framework they use to report? If not, why?

8. The ESMA [draft] guidelines are much more extensive than those specified in the CESR Recommendation that is currently in force. The CESR Recommendation applies to financial performance figures of listed companies focusing on issuers reporting under IFRS. "Listed companies" is generally understood as companies, whose shares are listed (admitted to trading) on a regulated market. The new guidelines will be applicable not only to those issuers, whose shares are listed on a regulated market, but also to issuers of other listed securities, including bonds and depository receipts. This is a right direction.

Q2: Do you agree that the ESMA [draft] guidelines should apply to APMs included in:
a) financial statements prepared in accordance with the applicable financial reporting framework, that are made publicly available, and
b) all other issued documents containing regulated information that are made publicly available?
If not, why?

9. Yes, APMs make sense either because they more effectively reflect the way the market values specific industries - based on multiples or other indicators that are not included in financial statements - or the measures management use to assess day to day performance. In both cases they ought to be included in all the documentation published by the company. If an APM makes sense it must be consistently used, so the guidelines should apply to it in any case.

Q3: Do you believe that the ESMA [draft] guidelines should also be applicable to prospectuses and other related documents, which include APMs (except for pro-forma information, profits forecasts or other measures which have specific requirements set out in the Prospectus Directive or Prospectus Directive implementing regulation)? Please provide your reasons.

10. The current CESR Recommendation explicitly excludes information contained in prospectuses published in accordance with EU legislation on prospectus, which was subject to another CESR recommendation. We strongly believe the new guidelines should also apply to APMs published in prospectuses and related documents. This is very important and helpful for investors, as they will be able to check the consistency of information (and financial data) in prospectuses with information published later on in financial reports after the company becomes listed. There is no reason why prospectuses should be exempt from transparency requirements.

Q4: Do you believe that issuing ESMA guidelines constitute a useful tool for dealing with the issues encountered with the use of APMs? If not, why?

11. We believe the ESMA guidelines will be very useful for all market participants, however one comment is necessary. In paragraph 9 of the Consultation Paper we can read that *"the [draft] guidelines apply to NCAs and to* ***issuers****"*, but in paragraph 19 of the CP they are directed much broader, *"to NCAs and* ***financial market participants****"*, which includes not only issuers, but also several other groups of participants. We do understand this is consistent with art. 16(3) of the Regulation (EU) No 1095/2010 establishing ESMA, specifying that *"the competent authorities and financial market participants shall make every effort to comply with [ESMA] guidelines"* (*nb*. it is not cited exactly in paragraph 19, as "shall make" is replaced there with "must make"). However some inconsistency is visible here, so it should be clarified that the ESMA guidelines are directed to issuers only (who should apply them) and not to other financial market participants – they are only "users" of APMs provided by issuers.

Q5: Do you agree with the suggested scope of the term APM as used in the [draft] guidelines? If not, why?

12. Yes, we agree with the suggested scope of the term APM as used in the proposed guidelines. A broad definition what APMs are in general is necessary, with the aim of clarifying the scope of the guidelines. And within such a broad definition it should be the task of issuers only to define any specific APMs they want to use and publish.

13. However, we draw ESMA's attention on the fact that we don't exactly know what is really a non-IFRS measure. The IFRS do not really define a lot of items, but some items are customarily defined in a particular way. We can envision preparers using this argument to avoid providing any definitions.

Q6: Do you believe that issuers should disclose in an appendix to the publication a list giving definitions of all APMs used? If not, why?

14. Yes, we believe that issuers should disclose in an appendix to the "big" publication (like prospectus of annual report) a list giving definitions of all APMs used. Moreover, we encourage ESMA to require that issuers state clearly that they are adjusted measures.

15. Indeed, segment reporting under IFRS 8 allows the disclosure of non-IFRS measures inside the notes to financial statements, as long as these are defined. In practice, companies very seldom provide definitions for the items they use in the segment note. It is true that often they would use the same names for the line items as on the face of the financial statements, so the assumption is that they do not need to define them. However, the post-implementation review for IFRS 8 conducted by the IASB (final report published mid-2013) reveals that users would prefer that non-IFRS items be marked accordingly by having their name state clearly that they are adjusted measures (e.g., all names be preceded by the term "adjusted"). The IASB states it will consider this point as part of its disclosure framework work.

16. However a question arises whether all the APMs definitions should be repeated in every document or publication, as it could effect in some kind of overload of information and all the documents would have to be larger, creating additional and unnecessary cost to issuers. Therefore it seems that definitions should be fully enclosed in "big" documents only, but in other documents (like ongoing reports, press releases etc.) only an indication that the complete glossary is contained in the last annual report

and/or at the company website could be enough. Also a link could be included to the full definition (e.g. to the issuer's website).

Q7: Do you agree that issuers should disclose a reconciliation of an APM to the most relevant amount presented in the financial statements? If not, why?

17. Yes, we agree that issuers should disclose a reconciliation of an APM to the most relevant amount presented in the financial statements. Nevertheless, we draw ESMA's attention on the fact that having regulations that ask for definitions and reconciliations does not necessarily mean that disclosure transparency automatically improves. Besides the non-compliance issue, it appears that practical application may be less straightforward than we think, and having that information does not mean it is also understandable.

18. On the one hand, from a standard-setting point of view, we know that IFRS 8 requires segment figures to be reconciled to group-level totals. In practice, the segment note does not even contain reconciliations, or these are very superficial. When reconciliations are provided, reading these tables is most of the time quite hard – they seem convoluted and are very hard to follow. The post-implementation review report confirms this opinion. More precisely, investors complain that reconciliations are not properly explained and are confusing, while preparers have mixed opinions about how easy it is to provide reconciliations and how clear the reconciliation requirements are. On the other hand, from an academic perspective, and specifically related to non-GAAP measures, Zhang and Zheng (2011) find that high quality reconciliation disclosures of non-GAAP earnings to GAAP earnings reduce the mispricing of non-GAAP earnings. Therefore, according to this same paper, it seems that well-done reconciliations indeed help investors value a company.

19. Furthermore, a question may arise whether reconciliations are necessary and useful in every single case. Therefore a differentiated approach for application and presentation of APMs taking into account relevance and practicability might be applied, together with possibility of waiving the required reconciliations in cases where they would not build any added information value.

Q8: Do you agree that issuers should explain the use of APMs? If not, why?

20. Yes, we agree that issuers should explain the use of APMs.

21. However, it still remains several questions in relation to the disclosure overload issue. Doesn't a requirement for providing definitions for all non-GAAP items used in each document clutter the disclosure? If we think about firms' presentations to analysts and investors, they usually have a slide warning about the estimates behind forward-looking disclosures, but we doubt anyone ever reads this slide, it's just cluttering the presentation. Where should the definitions be? Each time the item is used and in each document? Should the audience be taken into consideration? Maybe the financial analyst, who knows the firm very well, doesn't need to be reminded every time what one item stands for, and would in fact see this as an increase in the number of pages he needs to read.

Q9: Do you agree that APMs presented outside financial statements should be displayed with less prominence, emphasis or authority than measures directly stemming from financial statements prepared in accordance with the applicable financial reporting framework? If not, why?

22. Yes, we agree that APMs presented outside financial statement should be displayed with less prominence, emphasis or authority than measures directly stemming from financial statement prepared in accordance with the applicable financial reporting framework. Whenever APMs are used to the past performance, they should always stem from financial statements prepared in accordance with the applicable financial reporting framework and should reflect audited figures.

23. However, in our opinion, paragraphs 31 and 33 on page 13 of the Consultation Paper are not very clear – what does "the context of an APM" mean? What will be considered "greater prominence"? The literature on impression management that looks at press releases considers that the bullet points following the title are more prominent than the text that follows. But how can this be judged in presentations to analysts, for example? Of course, this assumes that impression management and investors' behavioural biases play a role.

Q10: Do you agree that issuers should explain the reasons for changing the definition and/or calculation of an APM? If not, why?

24. Yes, we agree that issuers should explain the reasons for changing the definition and/or calculation of an APM.

25. Nevertheless, we wonder how will the truthfulness of those reasons be checked and we think it's useless to require this if it cannot be reliably enforced. Therefore we would consider such information more trustworthy if provided voluntarily.

Q11: Do you believe that issuers should provide comparatives and/or restatements when an APM changes? If not, why?

26. Yes, we believe that issuers should provide comparatives and/or restatements when an APM changes. And we specifically encourage ESMA to be clearer on the number of years required to restate for comparative purposes.

27. Indeed, we know that issues related to providing comparative information in segment reporting arise when companies change their segmentation. Most companies' current practice is to not disclose any restated information beyond the prior year. As a response to the post-implementation review for IFRS 8, users claim such changes make the trend-line impossible to assess and have asked for as much as five years of restated data. The IASB is considering this as part of the work on the disclosure framework but thinks that restatements for the previous five years would be too costly for the preparers to produce.

28. Otherwise, in our opinion, comparability of non-GAAP measures between companies is very hard to achieve because each manager could be adjusting the measure in different ways – eventually what we could potentially compare is still the GAAP measure that the non-GAAP measure should be reconciled to. We think it's an open question whether users want to see the company through the management's eyes or whether they want to "put it in a box." Interestingly, the post-implementation review for IFRS 8 reveals that a large proportion of users would like to see the operating segments of the company from the manager's perspective, but have the segment line-items standardized (i.e., the

standard should define the line-items to be disclosed in the segment note.) In this way, there would be at least some comparability between companies.

29. Last but not least, according to the IASB Conceptual Framework and the recent academic literature, we would like to underline that comparability refers to cross-sectional comparisons of companies (e.g., comparing two different companies), while consistency mainly refers to time-series comparisons for the same company (e.g., comparing across years). For clarity, there's also a distinction between comparability, consistency and comparative information. Providing comparative information means restating prior disclosures to provide information that is comparable with what is currently disclosed in order for users to be able to judge the trend.

Q12: Do you believe that issuers should provide explanations when they no longer use an APM? If not, why?

30. Yes, especially because in practice an issuer may decide to discard an APM when it no longer provides a positive picture of the company.

Q13: Do you agree that the [draft] guidelines will improve transparency, neutrality and comparability on financial performance measures to users? If not, please provide suggestions.

31. We fully agree with this, and the reasons are explained in the answers to all the previous questions.

Q14: Do you agree with the analysis of the cost and benefit impact of the [draft] guidelines? Please provide any evidence or data that would further inform the analysis of the likely cost and benefits impacts of the proposals.

32. It is difficult to find any special evidence or exact data, but we strongly believe the benefits will be much higher than costs. Of course there will be some additional costs for NCAs, but it seems to be necessary.

33. We all agree that the additional cost for issuers will be rather marginal (almost no cost at all), as costs may be connected with **using** some APM by issuers (on voluntary basis, if they want to use any APM), rather than with **defining** or **describing** them. It means: if the issuer uses an APM, he should understand it, so he should have his own definition of that APM. Adding that definition (and some explanation, if necessary) to the document where that APM is used, should be rather cheap. But issuers will use APMs only if they so wish, and if they think that the benefits will outweigh the related costs.

34. Another comment is that requirement to publish a description of APMs may have a negative effect on prospectuses and annual reports, as the number of pages in those documents may increase (however not so greatly), generating an additional 'cost' of reading for users. It may also create an unnecessary flood of information generated by additional (or longer) ongoing reports, not always necessary or important. However it should be taken into account that it is a decision of an issuer to use APMs, and if he wants to use them, he should explain them to the users, so users understand well what issuers are telling them.

References

- **CESR**: CESR Recommendation on Alternative Performance Measures, October 2005, Ref: CESR/05-178b

- **ESMA**: Consultation Paper. ESMA Guidelines on Alternative Performance Measures, 13 February 2014, ESMA/2014/175

- **Zhang H. & L. Zheng (2011),** The valuation impact of reconciling pro forma earnings to GAAP earnings, *Journal of Accounting and Economics*, 51, 186-202.