



Understanding performance – underlying profit



The reporting by entities of alternative profit measures such as 'EBITDA', 'EBITDAF', 'normalised profit' or 'underlying profit' has continued at similar levels since our prior year survey with 89 out of 100 companies in the sample providing 250 alternative earnings or profit measures. This compares to 87 companies providing 214 measures in their 2010 annual reports based on largely the same sample (refer to page 16 for details of the companies surveyed).

In line with developments in Australia this is a topic that has caught the attention of New Zealand's new regulator, the Financial Markets Authority (FMA). The FMA has issued a draft guidance note on "*Disclosing non-*

GAAP financial information" in May 2012. This draft guidance note covers the provision of financial information by issuers that is not prepared in accordance with New Zealand generally accepted accounting practice (NZ GAAP) in investor communications other than financial statements, and in transaction documents (such as prospectuses, investment statements, advertisements, meeting notices etc). Elaine Campbell, FMA Head of Compliance Monitoring, noted that alternative performance measures "*can provide useful information to investors, but they also have the potential to be misleading if used to mask bad news*"¹. The draft guidance is intended to assist issuers in ensuring that their communications with investors and

¹FMA media release: FMA consultation on disclosure of non-GAAP financial information. 22 May 2012. Available at www.fma.govt.nz

other stakeholders are transparent and not misleading.

The draft guidance note is largely consistent with guidance issued by the Australian Securities Investment Commission (ASIC) in December 2011 on *"Disclosing non-IFRS financial information"* with one notable exception. ASIC prohibits the presentation of non-IFRS financial information in financial statements with limited exceptions. The FMA draft guidance does not cover financial statements except to note that *"non-GAAP financial information should not be provided except as is permitted or provided for under GAAP or the Financial Reporting Act and GAAP information should be given*

prominence. For example, on the face of an income statement the IFRS reported profit or loss should always be the bottom line and given primary prominence and emphasis".

However, we note that the FMA is asking for feedback on whether excluding financial statements from the scope of their guidance note is appropriate. We think that it is.

This year's survey considers current practice in annual reports against the ten principles for presenting non-GAAP financial information in investor communications in order to provide an indication of where practice will need to change to align with the FMA guidance if it is issued as proposed. In summary:

Principle	How do the results compare?
Outline why the information is useful	Only 32% of measures provided this information (either directly or due to being part of the entity's segment reporting disclosures).
Consider prominence	27 companies clearly emphasise their underlying profit figure/s to the exclusion of their statutory measure.
Ensure an appropriate label is used	Some labels are not used clearly. For example EBITDA may be the label but the measure excludes items other than just interest, tax, depreciation and amortisation.
Explain the calculation	59% of measures had a narrative explanation of the calculation.
Provide a reconciliation	81% of non-GAAP measures are currently reconciled to a GAAP measure.
Apply a consistent approach period to period	We identified 62 new measures and 27 measures in the 2010 report that were not continued in the 2011 annual report. Further, the FMA notes that providing multiple non-GAAP profit measures in the same reporting period may cause confusion. 50% of entities in our sample provided three or more alternative profit measures with nine different measures provided by one entity.



Principle	How do the results compare?
Adjustments - corresponding items should be adjusted in comparatives	The comparatives for 20 measures were restated for consistency with the current year measure.
Ensure the measure is unbiased	As most measures remove expense items, judgement will be needed to determine whether they are biased.
Take care referring to one-off items	18% of measures referred to 'one-off' or 'non-recurring' items
Explain if audited or reviewed	One company noted that its measures, presented outside of the financial statements, were taken from audited financial statements.

The FMA is asking for feedback by 29 June 2012 and aims to issue a final guidance note in August 2012. The guidance will be used by the FMA in its review of non-GAAP measures for documents published on or after January 2013. The draft guidance note also includes guidance for reporting non-GAAP measures in transaction documents (pro forma financial information) which is not considered in this publication.

We note that the International Accounting Standards Board (IASB) has recently been consulting on its future agenda for standards development. Patrick Finnegan, a member of the IASB, reported that there was one project that stood out as a high priority and that is around performance presentation and in particular the definition of "other comprehensive income" (OCI). He notes that *"it is becoming increasingly challenging to*



understand performance given the expansion of the use of fair values mixed with the use of historical costs, particularly when the focus is on a single statistic – profit or loss”².

He considers that more thorough analysis and better decisions can be made by investors if there is more than one clear performance measure – for example, if the reporting format provided a better understanding of changes in net assets compared to reported profit or loss (which would cover recurring, or operating, or controllable items). This would go some way to removing the need for many of the adjustments made by entities in determining underlying profit, but would be several years away if added to the IASB’s agenda to allow time for development and consultation.

In the interim, we recommend that entities consider whether the proposed guidance would require a change to their current reporting practices, and whether they should respond to the FMA’s request for views on the proposed guidance note by 29 June 2012.

To assist, this publication considers the practice of reporting underlying profit measures for a sample of one hundred 2011 annual reports against the FMA’s proposed guidelines, compares the requirements to those in Australia, outlines what directors should consider when reporting underlying profit, and provides an illustrative disclosure example.



²Patrick Finnegan: Performance Reporting: Back to the Future. 31 January 2012. Available at: <http://www.ifrs.org/Investor-resources/2012+perspectives/>

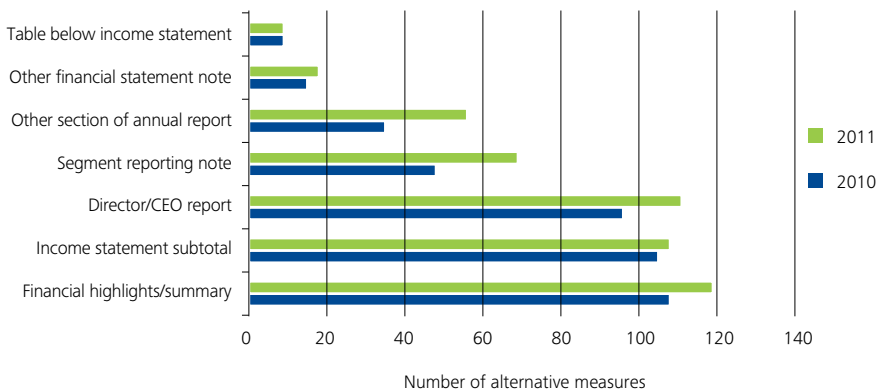
What we found – Non-GAAP measures in practice

Deloitte analysed the 2011 published annual reports of 100 companies (refer to page 16 for details of the companies surveyed) in order to determine the extent of reporting non-GAAP underlying earnings or profit measures (referred to as underlying profit or alternative profit measures). Non-GAAP financial information is defined by the FMA 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 by the companies in our sample.

89 companies provided 250 alternative profit measures. This is an increase from the 214 measures provided by 87 companies in 2010 annual reports.

Companies provide alternative profit measures in a variety of places, often with multiple references throughout the annual report. 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 income statement.

Figure 1: Where do companies discuss underlying profit?



Only 23% of measures were also shown in the segment reporting note. While not all companies in our sample are required to disclose segment information this suggests that some companies have chosen to present their results to investors in a different way to how the business is reported internally as set out in the segment reporting note. The FMA's draft 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.

Current practice compared to the FMA's ten principles for presenting non-GAAP information

The FMA's draft guidance note on *Disclosing non-GAAP financial information* sets out ten principles to reduce the risk that non-GAAP financial information is misleading. It is largely consistent with guidance issued by ASIC, although is not as restrictive as the Australian guidance. A comparison is included on page 12.

We have considered current practice against these requirements below. This gives an indication of where practice will need to change if the FMA guidance is issued as proposed.

Principle 1: Outline why the information is useful

A statement should be included disclosing the reasons directors believe that presentation of the non-GAAP financial measure provides useful information to investors regarding the financial condition and results of operations. This statement should be clear and understandable and specific to the non-GAAP financial information used, the entity, the nature of the business and industry, and the manner in which the non-GAAP financial information is assessed and applied to decisions.

9% of alternative profit measures included a discussion on why the measure was provided. For example: *"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."*



Another 23% of measures were included in the segment reporting note. The remaining 68% did not have an explanation.

The draft guidance note says that *“this information should be clearly labelled and provided at least once in each document that non-GAAP financial information is disclosed. Where non-GAAP financial information is presented, clear reference should be made to where in the document this information is located”*.

Principle 2: Consider prominence

Non-GAAP financial information should not be presented with undue prominence, emphasis or authority. When preparing and presenting financial information directors should exercise judgement when determining the appropriate level of prominence that is given to any non-GAAP financial information.

27 companies in the sample emphasised underlying profit in the annual report with little or no discussion on statutory profit compared with 32 companies in the prior year.

Additional guidance provided by the FMA on what prominence means:

✓ 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

Non-GAAP financial information should be clearly labelled in a way that distinguishes it from the corresponding GAAP financial information. Any term used to describe the information should be appropriate having regard to the nature of the information. The term or label should not cause confusion with GAAP information and should accurately describe the measure.

A wide range of terms are used to describe these alternative earnings figures such as 'underlying earnings', 'EBITA', 'EBITDA', 'EBITDAF', 'distributable profit', 'net earnings/profit before abnormal/unusual items' and more. The FMA's draft 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. EBITDA was the term used for 32 measures (excluding Adjusted EBITDA, Trading EBITDA and similar variations) but 75% of these measures excluded other items such as profits from associates (equity accounting), restructuring costs, impairments and acquisitions or disposals of assets. We also note that EBIT was the term used for 28 measures but 29% of them excluded items other than just interest and tax.

Principle 4: Explain the calculation

A clear narrative explanation should be provided as to how the non-GAAP financial information is calculated. This explanation should be supported by a more fulsome internal policy, authorised by the directors, that contemplates this guidance and specifically addresses the consistency, completeness and accuracy of any adjustments made to reported GAAP measures.

59% of measures had a narrative explanation of the calculation, although this is not always explained the first time the measure was shown. The draft guidance note says that *"this information should be clearly labelled and provided at least once in each document that non-GAAP financial information is disclosed. Where non-GAAP financial information is presented, clear reference should be made to where in the document this information is located"*.

An example of the narrative explanation provided by an entity in the sample was: *"..calculates EBITDA by adding back depreciation, amortisation, finance expense, share of associates' (profits)/losses and taxation expense to net earnings less finance income"*.



Principle 5: Provide a reconciliation

A reconciliation between the non-GAAP and GAAP financial information should be provided, separately itemising and explaining each significant adjustment. Where reconciling items are components of GAAP information, they should be capable of being agreed to the financial statements. Where a reconciling item cannot be extracted directly from the financial statements, the reconciliation should show how the number is calculated. Where comparative non-GAAP financial information is presented for a previous period, a reconciliation to the corresponding GAAP financial information should be provided for the previous period.

81% of the alternative profit measures were reconciled to statutory 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 an increase on the prior year where only 75% of the alternative profit measures were reconciled.

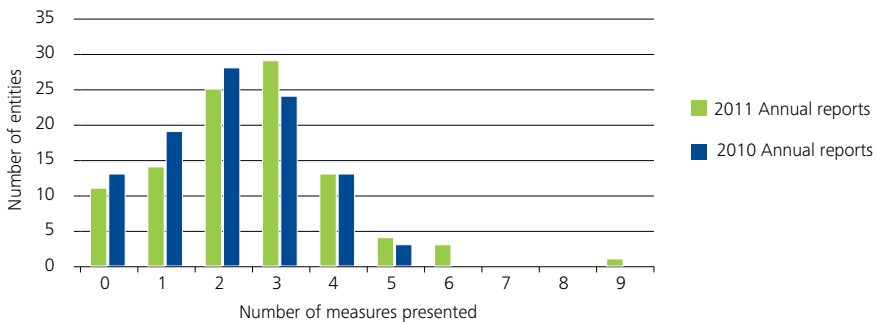
Principle 6: Apply a consistent approach period to period

A consistent approach should be adopted from period to period. If there has been a change in approach from the previous period, an explanation about the nature of the change, the reasons for the change, and the financial impact of the change should be provided.

There were 27 alternative profit measures included in 2010 annual reports that were not discussed in 2011 annual reports. Some of these measures were only included in the 2010 annual report to remove the impact of a 'one-off' tax expense created by the May 2010 tax law change removing the ability to claim depreciation deductions on long life buildings. We also identified 62 new measures not included in the prior year financial statements to deal with matters such as the Christchurch earthquake and other items considered to be 'one-off'.

The FMA also notes that providing multiple non-GAAP profit measures in the same reporting period may cause confusion. As shown in Figure 2 overleaf, 50% of companies in our sample provided three or more alternative profit measures in their 2011 annual reports compared to only 40% in 2010 annual reports with a total of nine different profit measures in one entity's annual report. New measures appear to be introduced when an entity has what they consider to be a 'one-off' event. In the prior year the main cause of this 'one-off' measure was to deal with the tax law change referred to above. In the current year new measures were created to deal with a wide range of 'one-off' events such as the Christchurch earthquake, business acquisitions and impairments.

Figure 2: Number of alternative profit measures shown per entity



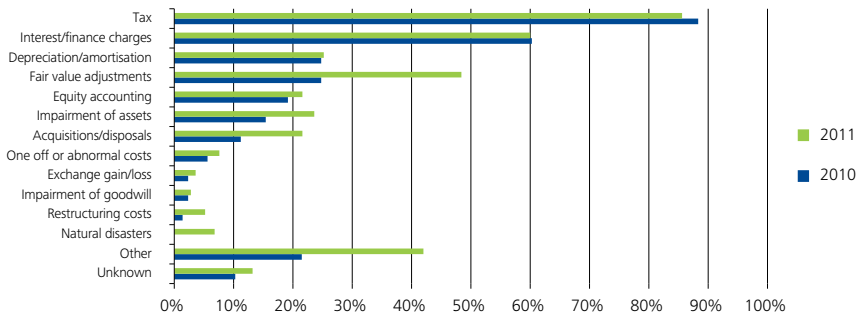
Principle 7: Adjustments consistent with comparatives

For each adjustment made to GAAP financial information, corresponding items should be adjusted in any comparative information.

Figure 3 shows the nature of the main adjustments made by companies to arrive at underlying profit. As noted below, 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) continue to feature highly given the current economic environment. Depreciation/ amortisation are also common exclusions as companies look to remove items that were ‘unrealised’ (effectively non-cash) from reported profit. As

NZ IAS 1: *Presentation of Financial Statements* requires disclosure of equity accounted earnings on the face of the income statement 54 measures excluded this figure. The level of other adjustments has increased significantly on the prior year. Much of this increase relates to removing specific income or expense items such as rebates, legal fees and onerous contract costs. We identified 20 measures where the comparatives presented had been adjusted. For example, one entity decided to remove the Christchurch earthquake impact in its current year underlying profit and restated the comparative to be consistent (although the amount of the adjustment to the comparative was not significant). Some restatements were due to changes in accounting policy, but not all adjustments were explained.

Figure 3: What are the adjustments made to statutory profit to obtain underlying profit?



The FMA draft guidance also notes that it would be misleading to exclude some of the returns on a class of financial assets but not others, for example excluding unrealised losses or impairments but not realised gains, interest or dividends. Consistency is important.

Principle 8: Ensure the measure is unbiased

Non-GAAP financial information should be unbiased and not used to avoid presenting ‘bad news’ to the market.

In 86% of cases underlying profit was greater than statutory profit (2010: 72%) as shown in Figure 4 overleaf. 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.

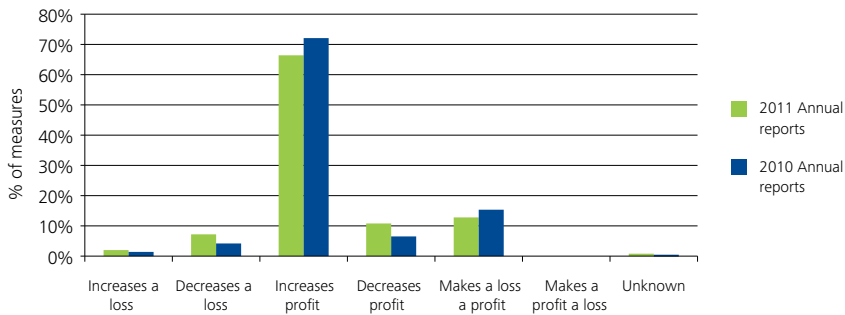
There is no further guidance on when disclosure might be biased. Directors should exercise judgement as to what the purpose of the measure is. A clear policy will enable management to capture the appropriate adjustments and be consistent year on year. For example, if bad debt expenses are excluded, reversals of bad debts should also be excluded.

Principle 9: Take care referring to 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’ or ‘non-recurring’.

18% of measures referred to ‘one-off’ or ‘non-recurring’ 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

Figure 4: How does underlying profit compare to statutory profit?



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)".

Principle 10: Explain if audited or reviewed

If the non-GAAP financial information has been taken from audited or reviewed financial statements then a clear statement should be made to that effect.

One company noted that its measures, presented outside the financial statements, had been taken from audited financial statements. This will be a change to current practice for those measures taken from the financial statements.

Comparison with Australian guidance

ASIC issued Regulatory Guide 230: *Disclosing non-IFRS financial information* in 2011 setting out the principles for disclosing non-GAAP financial information. The FMA draft guidance is largely consistent with the ASIC guidance except that ASIC prohibits the presentation of non-IFRS financial information in financial statements with limited exceptions. The FMA draft guidance does not cover financial statements except to note that “*non-GAAP financial information should not be provided except as is permitted or provided for under GAAP or the Financial Reporting Act and GAAP information should be given prominence. For example, on the face of an income statement the IFRS reported profit or loss should always be the bottom line and given primary prominence and emphasis*”. In addition, sub-totals and additional line items presented on

the face of the income statement or statement of comprehensive income are outside the scope of the guidance if:

- they are permitted by NZ IAS 1
- such information is relevant to an understanding of the entity's financial performance
- they are not represented as being an alternative to the GAAP profit result or another GAAP measure
- they are not given undue prominence relative to the GAAP measure.

As shown in Figure 1 on page 5, some measures are provided as a subtotal in the statement of comprehensive income, or in a table below the income statement, or in a note to the financial statements. Directors will need to consider whether these practices are in accordance with the guidance once issued.

Conclusion

The FMA's draft guidance note will continue to allow directors to provide additional information in the annual report in order to better explain aspects of the performance on an entity. However, the results of the survey compared to the FMA's ten principles above, indicates that some entities may need to consider the purpose of the measures they use and refine their disclosures. As there are areas of judgement, early consideration will be required. We have set out some questions below 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 (currently draft) 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 Deloitte Financial Reporting Survey Series

Our Financial Reporting Survey Series has been following the financial reporting practices of 100 New Zealand companies since 2009. The companies in our sample are primarily derived from listed and other large New Zealand companies with publicly available financial information. While our aim is to follow the same companies to identify trends, we had to replace three companies in the sample due to financial statements no longer being publicly available. More information on the sample can be found in Issue 7.

This publication is an update of issue 6 which considered underlying profit disclosures in 2010 annual reports.

Other issues in the series are available at:

www.deloitte.com/nz/financialreportingsurvey

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/nz/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms.

Deloitte provides audit, tax, consulting, and financial advisory services to public and private clients spanning multiple industries. With a globally connected network of member firms in more than 150 countries, Deloitte brings world-class capabilities and high-quality service to clients, delivering the insights they need to address their most complex business challenges. Deloitte's approximately 182,000 professionals are committed to becoming the standard of excellence.

Deloitte New Zealand brings together more than 900 specialists providing audit, tax, technology and systems, strategy and performance improvement, risk management, corporate finance, business recovery, forensic and accounting services. Our people are based in Auckland, Hamilton, Wellington, Christchurch and Dunedin, serving clients that range from New Zealand's largest companies and public sector organisations to smaller businesses with ambition to grow. For more information about Deloitte in New Zealand, look to our website www.deloitte.co.nz.

This publication contains general information only, and none of Deloitte Touche Tohmatsu Limited, any of its member firms or any of the foregoing's affiliates (collectively the "Deloitte Network") are, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your finances or your business. Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser. No entity in the Deloitte Network shall be responsible for any loss whatsoever sustained by any person who relies on this publication.