Non-GAAP measures

The previous issues of ‘Investor view’ focused on reporting areas such as the net debt reconciliation and funding. Another reporting area that investors consider could be improved is non-GAAP measures. This edition of ‘Investor view’ provides a high-level overview of the principles that investors tell us should be considered when reporting non-GAAP measures, based on PwC research and ongoing engagement with the investor community.

What are non-GAAP measures?

Many companies report financial performance measures that are not prescribed by any accounting standards. Examples of commonly used non-standard measures include ‘operating earnings’, ‘cash earnings’, ‘earnings before one-time charges’ and ‘EBITDA’ (earnings before interest, taxes, depreciation, and amortisation).

These non-standard measures are often referred to as non-GAAP measures, adjusted financials or alternative performance measures (we will refer to these as ‘non-GAAP measures’ here). Non-GAAP measures are measures of performance other than those required by IAS 1, ‘Presentation of financial statements’, such as the profit or loss for the period, other sub-totals or specific line items. Non-GAAP measures usually exclude items that are included in the most directly comparable GAAP measure or include items that are excluded from the most comparable GAAP measure.

Why are non-GAAP measures useful to investors?

The information required to be presented in IFRS financial statements is not ‘one-size-fits-all’. Non-GAAP measures can provide additional insight into an entity’s performance and financial condition as a complement to standard or GAAP measures of performance. Investors find such insights into the recurring and non-recurring nature of events useful in understanding the underlying operational performance of a business, and they are typically factored into their future modelling. Non-GAAP measures can help investors understand the changes in the business (that is, organic versus acquired) and what the impact in the future will be. They can also make management’s monitoring of the business more transparent.
How should non-GAAP measures be presented?

Companies provide information about their businesses to investors and other market participants in many different ways, including interim and annual reports, earnings releases, investor calls and analyst presentations. Non-GAAP measures are often an important part of these communications. PwC's 2007 survey of investment professionals, 'Performance statement: Coming together to shape the future,’ revealed that the majority believe non-GAAP measures are helpful and should be permitted. However, there was strong demand for basic ground rules on the use of non-GAAP measures, including:

- Reconciling non-GAAP measures to GAAP measures.
- Providing definitions of terms used in non-GAAP measures.
- Differentiating non-GAAP measures from GAAP measures.
- Identifying non-GAAP measures as being audited or unaudited.
- Explaining why non-GAAP measures are important to the company.

In some jurisdictions, regulators have promulgated 'best practice' guidance for the use of non-GAAP measures. For example, the Committee of European Securities Regulators (CESR) has acknowledged that non-GAAP measures can provide investors with appropriate additional information if properly used and presented. To that end, the CESR made the following recommendations in 2005:

- Adhere to the basic principles of understandability, relevance, reliability and comparability.
- Provide an explanation of the relevance of the non-GAAP measures and definitions of terms.
- Identify measures as non-GAAP where that is the case.
- Present non-GAAP measures alongside, and with no greater prominence than, GAAP measures. Differences between the measures should be explained, possibly by means of a reconciliation.
- Present non-GAAP measures consistently over time and provide comparatives.

These recommendations have a great deal in common with the ground rules investors called for in our survey. There is also some similarity with the IASB’s recent proposals for guidance on management commentary, which suggested that non-GAAP measures should be identified as such, defined, explained and, where possible, reconciled to GAAP measures. In addition, the SEC has this year revised its guidance in a way that will encourage companies to include more non-GAAP measures in their discussion and analysis of performance.

All of this supports the assertion that non-GAAP measures can provide valuable additional insight into a company’s performance and highlights the broad consensus about how that should be achieved. In contrast, investors tell us that where non-GAAP measures are not portrayed in a balanced and responsible way, this can damage a company’s credibility, sometimes without the company even being aware that this has occurred.