Alternative financial performance indicators

Oversight | Audit & Reporting Quality

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The Netherlands Authority for the Financial Markets (AFM)

The AFM promotes fairness and transparency within financial markets. We are the independent supervisory authority for the savings, lending, investment and insurance markets. We promote the fair and conscientious provision of financial services to consumers and private investors, as well as professional and semi-professional parties. We supervise the fair and efficient operation of the capital markets. Our aim is to improve consumers' and companies' confidence in the financial markets, both in the Netherlands and abroad. In performing this task, the AFM contributes to the stability of the financial system, the economy and the reputation and prosperity of the Netherlands.

1 Conclusion and summary

The AFM has carried out a thematic review of the use of alternative financial performance indicators in press releases. Its main conclusions are:

- The use of alternative financial performance indicators is increasing, but their application is becoming less consistent. Consistency in the reporting of alternative financial performance indicators is very important to investors, and we therefore recommend that indicators should be consistently reported.
- Important performance indicators for investors are: organic growth, net debt position and the underlying EBIT.
- Alternative financial performance indicators such as organic growth and net debt position are reported mainly by companies in the AEX and AMX indices. Especially in times of economic difficulty, we recommend that net debt should be reported transparently, including a reconciliation.
- The increase in reporting of the underlying earnings and the majority of adjustments have the effect of increasing the earnings. Reconciliation of the underlying earnings with the earnings based on GAAP is an item of attention, especially for companies listed in the ASCX Index.

Increased use of alternative financial performance indicators
The reporting of alternative financial performance indicators is gradually increasing, with the exception of the 'other' listed companies. Most alternative financial performance indicators can be derived from the audited financial statements. If we look at the use of GAAP indicators, usage is consistent.

Consistency is decreasing
The review shows that consistency (i.e. using the same financial performance indicators year-on-year) has declined, particularly since the second half of 2011. The largest decline occurred among some of the companies in the AEX Index, which stopped reporting their organic revenue growth at the end of 2012. We also see a decline in consistency among companies in the AMX Index. Since consistency in the reporting of financial performance indicators is very important to investors, we recommend that indicators should be consistently reported.

Important indicators for investors: organic growth, net debt and underlying EBIT
The interviews the AFM conducted with investors, analysts, the VEB and Eumedion prior to the review revealed that users have a need for alternative financial performance indicators such as organic growth, the net debt position and the recurring/underlying EBIT.

Organic growth

Around half the companies reviewed report their organic growth. Among the local listed companies, only a limited number report organic growth (30%). If we look at the consistency of reporting of organic growth, the most notable feature is that a number of AEX companies stopped reporting this figure at the end of 2012. This may well be due to poor market conditions and performances in 2012. Since consistency in the reporting of financial performance indicators is very important to investors, we recommend that organic growth should be consistently reported.

Net debt position

The review shows that companies in the AEX and AMX report this indicator relatively frequently. However, only a very limited number of ASCX companies and 'other' listed companies report their net debt position. There seems to be room for improvement here. Regarding the net debt position, it is also important to know how the figures are calculated. Of the AEX companies that report their net debt position, 60% on average include a reconciliation for the period under review. Companies in the AMX and ASCX and 'other' listed companies do not present this reconciliation, but the net debt position can be calculated by the users. Among local listed companies, it is possible to calculate the net debt position in only a limited number of cases. Especially in times of economic difficulty, we recommend that the net debt position be reported transparently, including the reconciliation.

Underlying EBIT

In addition to operating profit (EBIT), many companies also report a figure adjusted for 'extraordinary income and expense items'. The review shows that the number of companies reporting this so-called underlying operating result has increased in recent years. This is due to the fact that 'extraordinary expense items' such as reorganisations are becoming more frequent and companies prefer to adjust their figures accordingly. If we look at whether the adjustments have the effect of increasing or decreasing the result, or both, or the effect is unclear, the majority of the adjustments lead to a higher result being reported.

Reconciliation for underlying EBIT is crucial

For users it is important that companies present a reconciliation between the operating result stated in the audited financial statements and the underlying EBIT. Most of the AEX companies present this reconciliation. It is lacking among the AMX companies and 'other' listed companies, but enough information is included so that users can work the reconciliation out for themselves. Only a limited number of the ASCX listed companies in the review report a reconciliation for the period under review. These companies do not present sufficient information to reconcile the figures. We recommend that reporting on the reconciliation with the underlying earnings should be transparent.

2 Objectives, review design and definition of performance indicators

Introduction

Press releases of the annual and quarterly results of listed companies are important for opinion-forming by investors. These press releases also attract much media attention. It is thus important that these press releases give consistent and reliable information.

Objectives

The essential questions for the review of financial performance indicators are: which indicators are applied, and how are they applied (method of calculation, reconciliation with financial statements prepared in accordance with IFRS and consistent application).

The objective of the project is to encourage listed companies to improve the quality of their financial reporting in relation to financial performance indicators in press releases.

Review design

We have carried out a desktop review of the press releases from 40 listed companies. The sample of the 40 listed companies consisted of: 10 AEX companies, 10 AMX companies, 10 ASCX companies and 10 'other' listed companies. The desktop reviews considered the press releases in relation to the semi-annual and annual figures in the period 2008-2012 with respect to the following points:

- Which financial performance indicators (GAAP and non-GAAP) are published by listed companies in their press releases;
- The consistency of application of financial performance indicators (GAAP and non-GAAP) over the years (are the same financial performance indicators reported each year?);
- Disclosure of how non-GAAP financial performance indicators are calculated and how these are reconciled with the financial performance indicators based on IFRS.

Definition of performance indicators

We have based our definition of alternative performance indicators on the recommendation of CESR. *However, the definitions in the CESR recommendation can be interpreted in different ways.* Because of this, we have chosen the following definitions for the purpose of our review:

- Defined profit measures/GAAP financial performance indicators: financial performance indicators based on IFRS/GAAP (Generally Accepted Accounting

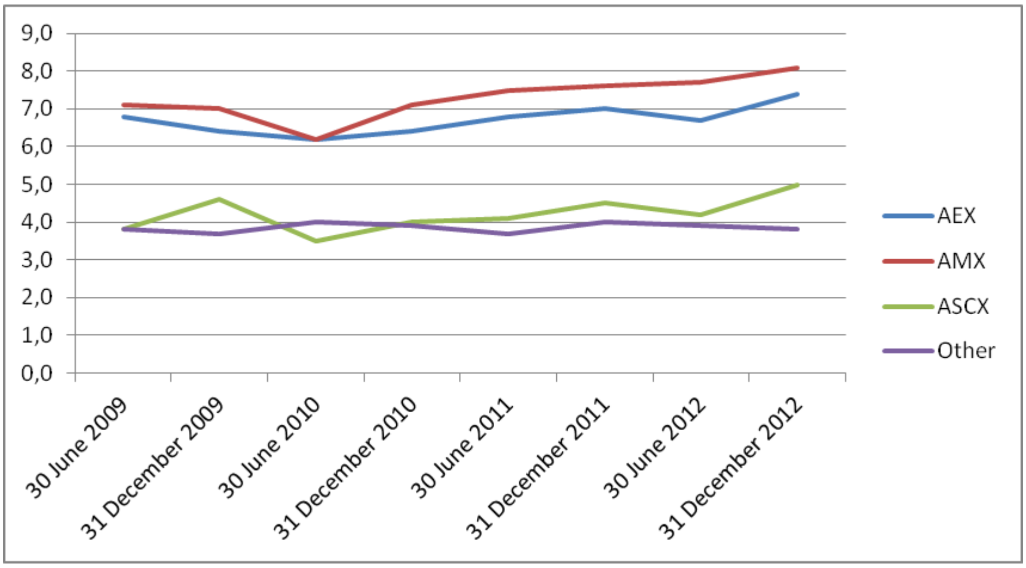
Principles). These are measures which are defined in IFRS, such as revenue, net profit and earnings per share;

- Alternative financial performance indicators/non-GAAP performance indicators: financial performance indicators which are not defined in IFRS, such as EBITDA, gross margin, underlying profit, etc. We have divided these non-GAAP financial performance indicators as follows:
    - Alternative financial performance indicators that can be derived from the audited financial statements, such as gross margin, EBITDA, EBITA, etc.
    - Alternative performance indicators that cannot be derived from the audited financial statements, such as organic growth, net debt, etc.

3 Key review results

The number of alternative financial performance indicators used is increasing
The review shows that alternative financial performance indicators are extensively used in press releases (for this measurement we looked at the headline of the press release on the first page). The use of alternative financial performance indicators by the companies reviewed is gradually increasing, with the exception of the 'other' listed companies. The 'other' listed companies appear to be continuing to focus on the defined profit measures such as net profit and earnings per share, see the figure below.

Figure 1: Average number of alternative financial performance indicators



It appears that the companies are using a variety of terms as alternative financial performance indicators. Apart from widely used terms such as EBIT, EBITA and EBITDA, these include:

- Revenue/EBITDA/operating result/earnings per share before extraordinary income and/or expense items;
- Net profit per share before amortisation of goodwill;
- Cash earnings;
- Organic revenue/result;
- Net debt position.

Most alternative financial performance indicators can be derived from the audited financial statements, as shown in the table below.

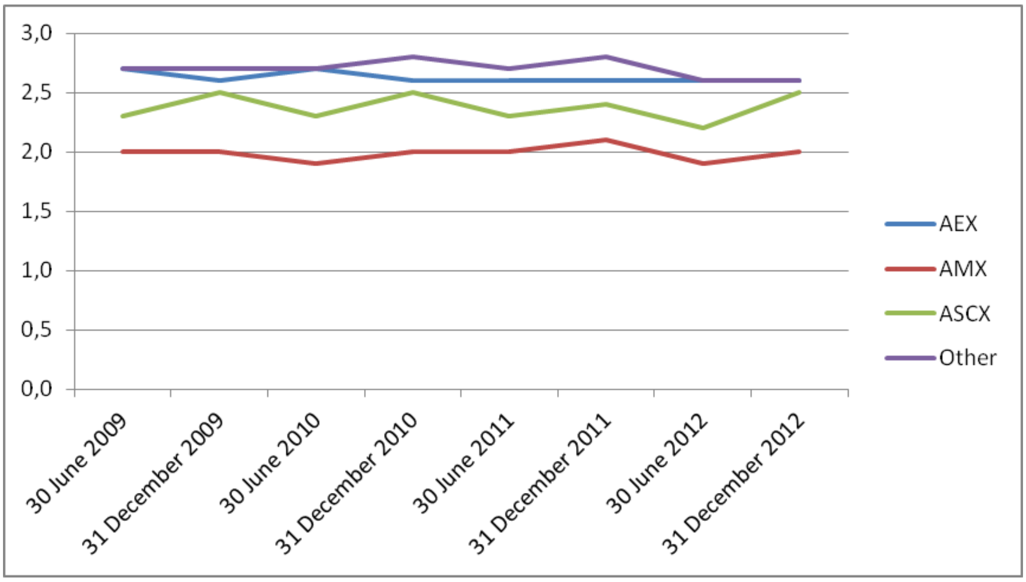
Table 2: Average number of financial performance indicators that can be derived from the financial statements

Index	30 June 2009	31 December 2009	30 June 2010	31 December 2010	30 June 2011	31 December 2011	30 June 2012	31 December 2012
AEX	5,6	5,1	4,8	4,8	5,2	5,6	5,5	5,9
AMX	5,8	5,8	5,0	5,5	6,1	6,4	6,2	6,5
ASCX	2,8	3,5	2,7	3,0	2,9	3,5	3,5	3,9
Other	2,9	2,5	2,8	2,9	2,7	2,9	2,4	2,8

Use of GAAP indicators is stable

The figure below shows that the number of reported defined profit measures (under GAAP) has been relatively stable since June 2009.

Figure 3: Average number of GAAP performance indicators

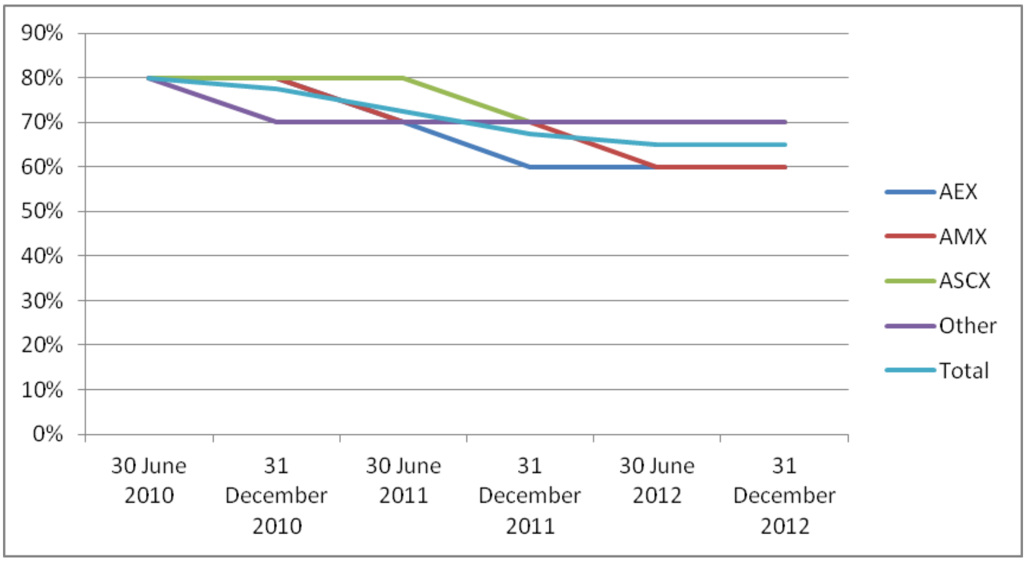


The figure shows that in relative terms the AEX companies and the 'other' listed companies use the highest number of defined measures of profit. Most of these companies report figures for revenue, net profit and earnings per share.

Consistent usage of alternative financial performance indicators is decreasing

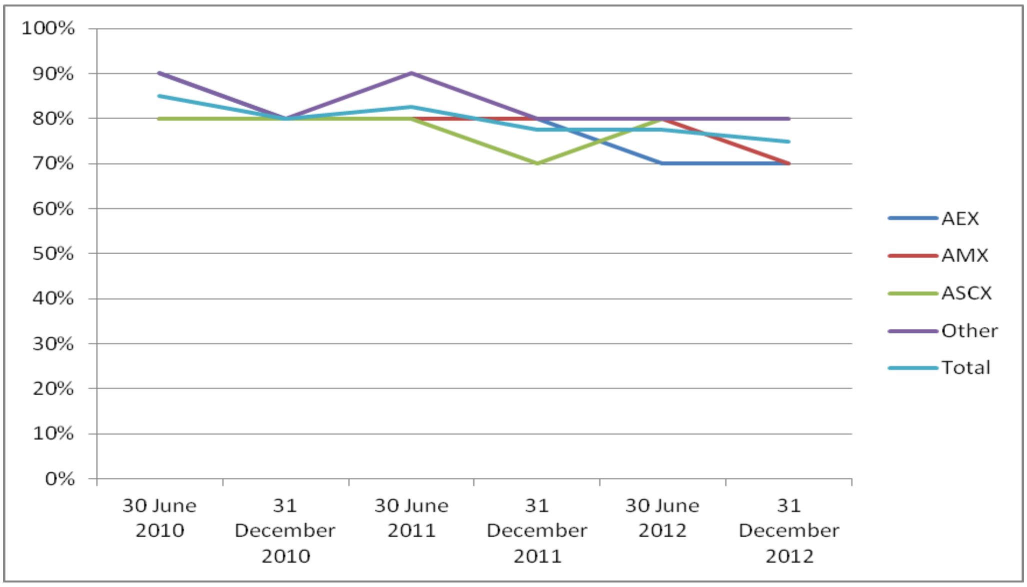
Alternative financial performance indicators should, according to the recommendations from CESR, be applied consistently year-on-year in order to prevent investors basing their decisions on incorrect assumptions.

Figure 4: Consistency of application of alternative indicators



The figure shows that consistency of application has declined since the second half of 2011. The largest decline occurred among the companies in the AEX Index, of which a number did not publish their organic revenue growth at the end of 2012 even though they had reported this figure in previous years. We also see a decline in consistency among companies in the AMX Index. The ‘other’ listed companies have been more consistent, partly due to the fact that they publish fewer alternative financial performance indicators to begin with. If we look at application of the GAAP indicators, we see that these indicators are used more consistently. This is partly due to the fact that most companies report a limited number of GAAP indicators (revenue, net profit and earnings per share).

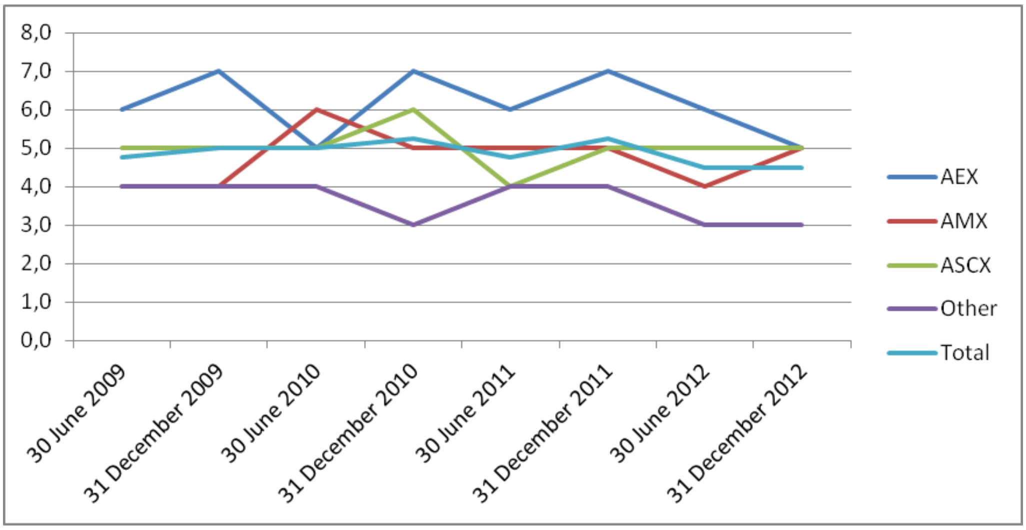
Figure 5: Consistency of application of GAAP indicators



Important alternative financial performance indicators
The interviews the AFM conducted with investors, analysts, the VEB and Eumedion prior to the review revealed that users have a need for alternative performance indicators such as organic growth, net debt position and underlying EBIT.

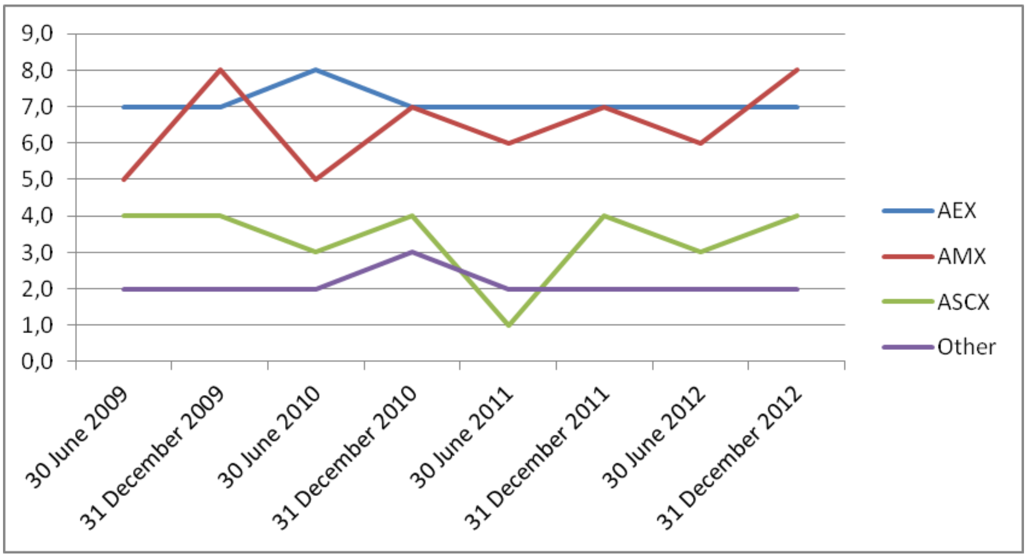
Organic growth
The figure below shows that around half the companies reviewed reported organic growth on 31 December 2012. Only a few of the 'other' listed companies report organic growth (30%). There seems to be room for improvement here.
If we look at the consistency of reporting organic growth, the most notable feature is that a number of AEX companies stopped reporting this figure at the end of 2012. This may well be due to poor market conditions and performances in 2012. Since consistency in the reporting of financial performance indicators is very important, we recommend that organic growth should be consistently reported.

Figure 6: Organic growth (number of companies)



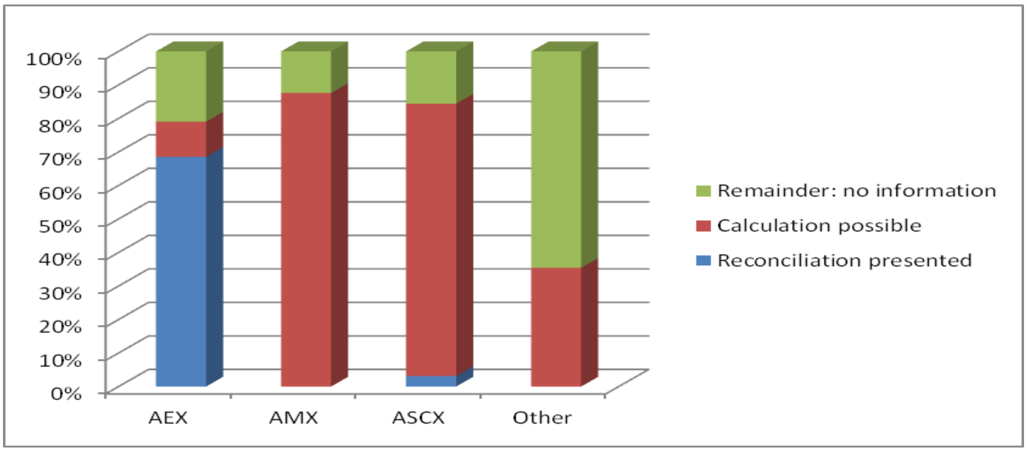
Net debt position
Net debt is also an alternative financial performance indicator that is highly appreciated by investors. The figure below shows that the 10 selected companies in the AEX and AMX indices report this indicator relatively frequently. However, only a very limited number of ASCX companies and 'other' listed companies report their net debt position. There seems to be room for improvement here.

Figure 7: Number of companies reporting net debt position



Regarding the net debt position, it is also important to know how the figures are calculated, especially as net debt position is not a term defined in IFRS. Among the AEX companies that report their net debt position, on average 60% include a reconciliation for the period under review. This reconciliation is not stated by the companies in the AMX, the ASCX and the 'other' listed companies, or only to a very limited extent (in the case of the ASCX companies). Investors have to calculate the net debt position themselves, which is possible for the AMX and ASCX companies in most cases. Among the 'other' listed companies it is possible to calculate the net debt position in only a limited number of cases. Especially in times of economic difficulty, companies would be well advised to report transparently on their net debt position, including a reconciliation.

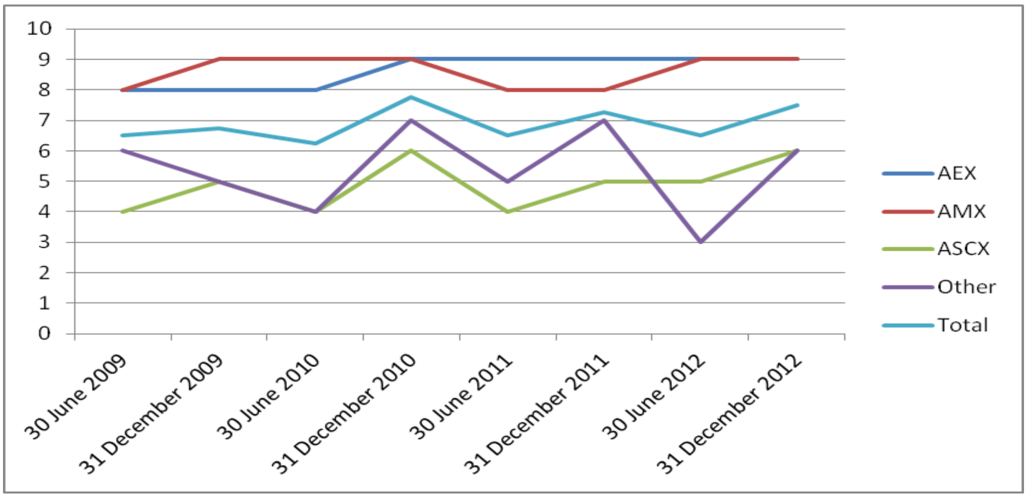
Figure 8: Percentages of companies reporting reconciliation of their net debt position, providing information enabling net debt position to be calculated or not providing any information



Operating profit indicators

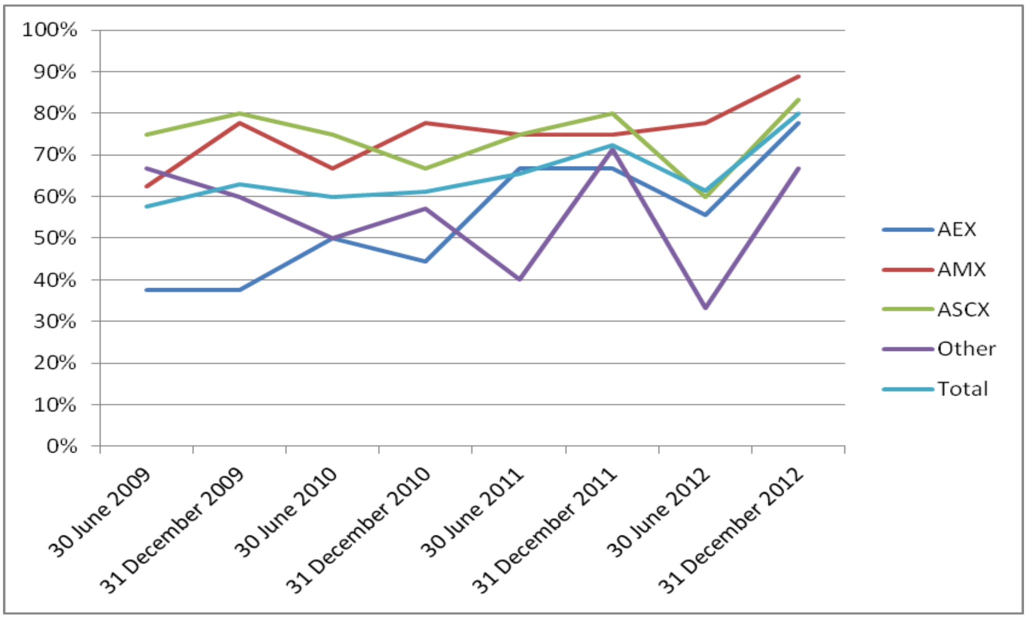
In addition to the GAAP net profit figure, the figure for (underlying) operating profit is important to investors. Our review shows that nearly all of the 10 selected AEX and AMX companies publish their operating profit on the first page of their press release.

Figure 9: Number of companies with a non-GAAP operating result



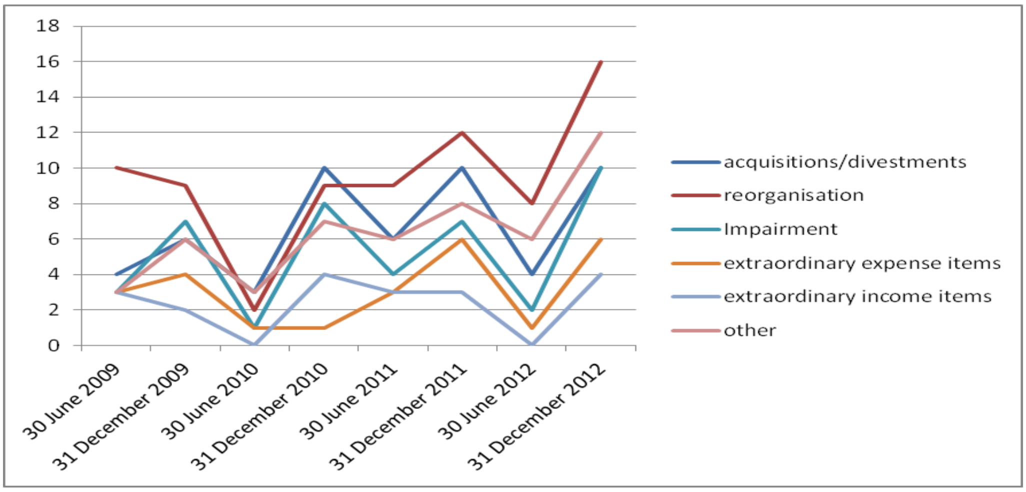
In addition to operating profit (EBIT), many companies also report a figure adjusted for 'extraordinary income and expense items'. We frequently found this figure presented as the underlying/recurring/core operating result. The figure below shows that the number of companies reporting this so-called underlying operating result has increased in recent years.

Figure 10: % of companies reporting underlying operating result



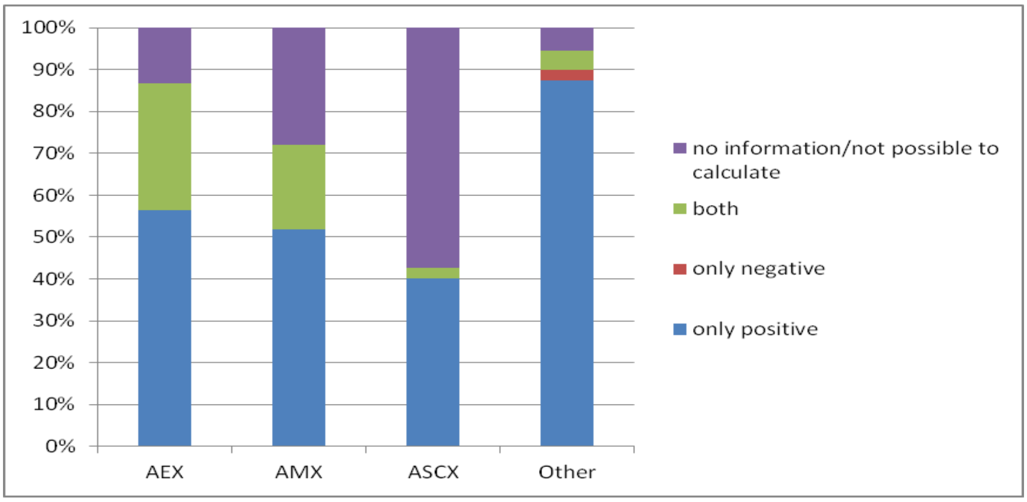
The increase applies mainly to the AEX, AMX and ASCX companies, with 80% to 90% reporting their underlying operating result on 31 December 2012. This is an increase compared to 2009, which is due to the fact that 'extraordinary expense items' such as reorganisations are becoming more commonplace and companies prefer to adjust for these items, as shown in the figure below. Of the 40 companies reviewed, almost half (16) included an adjustment for reorganisation expenses.

Figure 11: Total number of adjustments per category



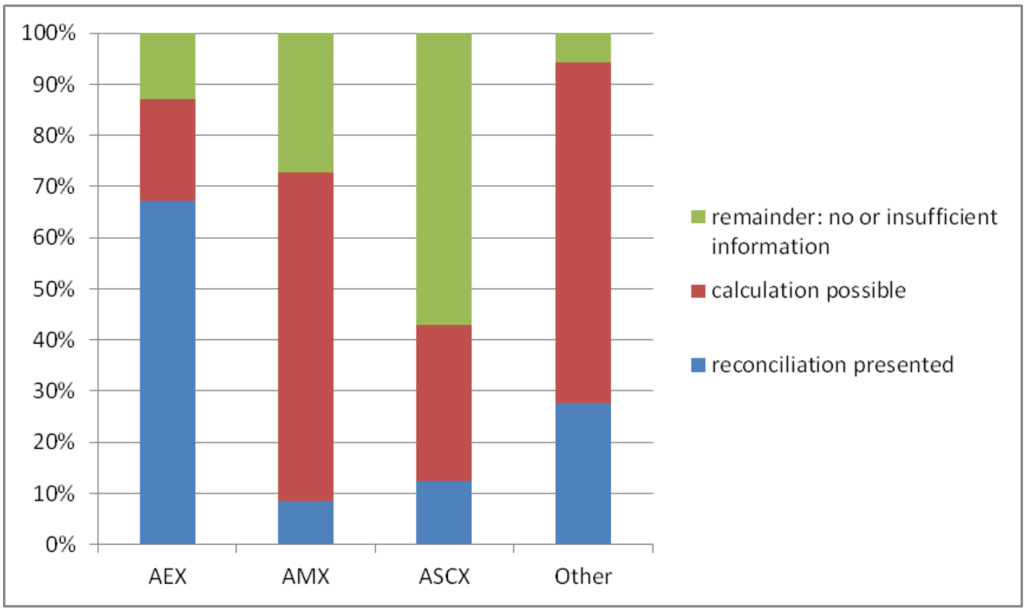
Looking at the direction of the adjustments, in other words whether they are positive, negative, both, or are not clear (not possible for users to make a calculation), the majority of the adjustments are positive; that is, the result is higher. Furthermore, the majority of the ASCX listed companies do not provide sufficient information, so that it is not clear whether the adjustments are positive or negative in nature. We advise these companies to increase the transparency of their reporting with respect to the nature of the adjustments.

Figure 12: Direction of adjustments



For users, it is important that companies present a reconciliation between the operating result stated in the audited financial statements and the underlying/recurring/core operating result that is reported. Most of the AEX companies present a reconciliation. This is lacking among the AMX companies and 'other' listed companies, however enough information is included so that users can work the reconciliation out for themselves. As was also the case with the nature of the adjustments, the ASCX companies reviewed do not report transparently on the adjustments and the reconciliation. Only a limited number of the ASCX listed companies in the review report a reconciliation for the period under review. Only a few of the 'other' listed companies report a reconciliation. In cases where no reconciliation is presented, this can be calculated for the majority of the companies concerned.

Figure 13: Reconciliation of underlying EBIT on average over the time period



The Netherlands Authority for the Financial Markets (AFM)
T +31(0)20 797 3721 | F +31(0)20 797 3800
PO Box 11723 | 1001 GS AMSTERDAM

www.afm.nl

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