ICAEW REPRESENTATION 72/14

ESMA GUIDELINES ON ALTERNATIVE PERFORMANCE MEASURES

ICAEW welcomes the opportunity to comment on the consultation paper *ESMA Guidelines on Alternative Performance Measures* published by ESMA on 13 February 2014, a copy of which is available from this link.

In reviewing ESMA's draft guidelines, we found it useful to refer to a recent article 'The Information GAAP' by Professor Steven Young of; Lancaster University Management School, published in the January 2014 edition of *By All Accounts*, the Financial Reporting Faculty's journal. A copy of the journal has been sent to ESMA for information under separate cover.

This response of May 2014 has been prepared on behalf of ICAEW by the Financial Reporting Faculty. Recognised internationally as a leading authority on financial reporting, the Faculty, through its Financial Reporting Committee, is responsible for formulating ICAEW policy on financial reporting issues and makes submissions to standard setters and other external bodies on behalf of ICAEW. The Faculty provides an extensive range of services to its members including providing practical assistance with common financial reporting problems.

The Institute of Chartered Accountants in England and Wales
Chartered Accountants' Hall
Moorgate Place London EC2R 6EA UK
icaew.com

T +44 (0)20 7920 8100
F +44 (0)20 7920 0547
DX 877 London/City

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For more information, please contact: frfac@icaew.com

icaew.com

MAJOR POINTS

Support for the initiative

1. ICAEW welcomes ESMA's efforts to encourage and harmonise best practice in the use of alternative performance measures (APMs) throughout Europe. We support the central aim of the draft guidelines, as set out in paragraph 13 of the consultation paper: to promote 'transparency on APMs used by issuers'. But we do not think it is necessarily best achieved 'by ensuring their adherence to general qualitative characteristics that enhance usefulness of financial information to users' where this leads to over-prescription and the removal of reasonable flexibility not damaging to users. So while we agree that it is appropriate for ESMA to take the initiative in promoting consistency in this aspect of reporting to the market, we have some serious concerns over the current draft of the guidelines, which we set out below.

2. We welcome ESMA's acknowledgement of the importance of APMs in assisting investors to make decisions. We strongly agree that regulators should not prevent or discourage issuers from presenting APMs, which can help investors to better understand the performance and prospects of a reporting entity.

More evidence needed

3. ICAEW's starting point in assessing proposals for regulatory change is that they should be supported by a clear and demonstrable need that is not currently being met by existing guidance and requirements. While we appreciate the objectives of ESMA in producing new requirements in this area, we do not think that a clear case has been made for an approach that is in places significantly more prescriptive than the existing CESR recommendation on APMs, issued in October 2005, and which have effective mandatory application through the onus placed on member states. In particular, we are not aware of any published research which throws light on (a) how widespread the undesirable practices outlined by ESMA in the introduction to the draft guidelines are in recent documents made publically available by issuers in the European Union (EU) and European Economic Area (EEA) (b) the level of concern amongst users about such practices and (c) the extent to which national enforcement bodies are not currently addressing this matter through their existing regulatory frameworks.

4. For this reason, we would welcome clarification by ESMA of why the existing CESR recommendations are considered to be deficient, differentiating between problems which have arisen from a lack of adherence to the recommendations and those which have arisen from any 'gaps' in the recommendations. It may be that elevation of the CESR recommendations, with some modification, to the status of ESMA 'guidelines' may have gone a long way to address the concerns outlined by ESMA, without the need to introduce significantly more prescriptive requirements.

The risks of excessive prescription

5. APMs are an important way for users to better understand an entity's financial performance. Accordingly, regulatory approaches should not become so prescriptive that they result in the disclosure of 'boilerplate' or unnecessary information - clutter. Such boilerplate and clutter would act to undermine the ability of the company to tell its 'story' in a clear, concise, imaginative way, would result in disclosure that is less meaningful and more challenging to determine key messages, and might even lead to a decision by the issuer to desist from the use of particular APMs to avoid that outcome. It is therefore important that an understandable focus on consistency should not undermine the exercise of professional judgement or stifle helpful innovation in reporting practice.

6. One way of identifying unnecessary prescription may be for ESMA to review the draft guidelines and replace 'should' with 'consider' for those aspects which go beyond the underlying principle ESMA is seeking to establish. A useful starting point might therefore be to take the existing CESR recommendations as the core principles. Any new requirement which goes beyond these core principles should be analysed critically to assess whether it would be better presented as an optional consideration designed to help issuers to apply the core principle while still allowing scope for innovation and flexibility.

7. As it stands, the draft guidelines contain many examples of excessive prescription, some of which are highlighted below in our responses to ESMA's specific questions. Overall, we think that ESMA may, if it issues these 'guidelines' with little modification, perversely damage the usefulness of APMs in Europe, to the detriment of investors and the European economy.

Need for clarity

8. In several places, the draft guidelines are unclear or ambiguous, and this needs close attention by ESMA before they are issued as final. For example:

- It is not clear enough from the draft guidelines what the phrase 'other issued documents containing regulated information' is intended to cover (paragraph 16 below).
- The practical implications of the recognition by ESMA that the draft guidelines cannot be applied to some APMs designed to demonstrate the physical context of an issuer's business, for example sales per square metre, are not explained clearly (paragraphs 29 to 30 below).
- The statement that APMs presented outside financial statements should be displayed 'with less prominence, emphasis or authority' is too imprecise to be helpful (paragraphs 38 to 39 below).

RESPONSES TO SPECIFIC QUESTIONS

Question 1:

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 Members State 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?

9. Yes, we agree that it is reasonable for guidelines on APMs to apply to all issuers whose securities are admitted to trading on a regulated market in the EU/EEA.

Question 2:

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?

10. We support the proposal that the guidelines should apply to APMs included in financial statements prepared in accordance with applicable financial reporting frameworks and which are made publicly available.

11. In addition, we accept that APMs may be presented outside of the financial statements and management reports issued under the Transparency Directive and that for this reason the scope of the draft guidelines may usefully be extended, in some cases, to cover these other documents. However, it is not clear enough from the draft guidelines what the phrase 'other issued documents containing regulated information' is intended to cover. It appears very broad and would include any publically available document which includes information that is regulated, regardless of whether the document itself is regulated eg, press releases or analyst presentations. In our opinion, this may lead to an unhelpful – possibly unintended - extension in the scope of the draft guidelines. It may well result in unnecessary clutter in these documents and inhibit effective communication by companies.

12. We note that paragraph 8 of the draft guidelines (page 24 of the consultation paper) states that for published press releases, the disclosure requirements outlined in the draft guidelines may be replaced by reference to another document which contains these disclosures and is readily accessible to users. This appears to be a practical way of promoting effective communication while signposting users to additional disclosures, where necessary.

13. We recommend that ESMA considers extending the exemption provided in paragraph 8 to a wider range of 'other' documents, and possibly to situations where reporting entities provide the same APMs on a regular basis in their communications to investors, including interim reports.

14. Notwithstanding the above suggestions, we would welcome further clarification from ESMA as to what would fall within the scope of 'other issued documents containing regulated information.'

Question 3:

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

15. In general terms we do not see any reason why the requirements for APMs used in 'prospectuses and other related documents' should be significantly different to those used in the financial statements. On the other hand, we are not aware of any evidence to suggest that there is widespread concern over the current use of APMs in 'prospectuses and other related documents'. Therefore, we would welcome further research by ESMA, or the publication of such research if it exists, to demonstrate the extent to which there is a need to extend the scope of the requirements in this way.

16. Notwithstanding the need for further evidence, we have a number of concerns with the draft ESMA requirements, as outlined in this representation letter. It is important for these matters to be addressed before any decision over whether to expand the scope of the guidelines to include 'prospectuses and other related documents'.

Question 4:

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?

17. In the introduction to the draft guidelines, ESMA has outlined a number of concerns arising from the use of APMs. These are:

- In some cases, financial data cannot be easily derived from or reconciled back to the financial statements.
- APMs may be described in terms which are neither defined by issuers nor included in accounting literature.
- Even when terms are defined, issuers often depart from those definitions rendering the measure concerned difficult to contextualise or compare.
- Comparatives are lacking, or if provided, it is not possible to derive them from or reconcile back to the comparatives in the financial statements.

18. These practices are undesirable and should be discouraged. However, we are not aware of any research which throws light on how widespread these undesirable practices are in recent documents made publically available by issuers in the EU and EEA. Indeed, in paragraph 5 of the introduction to the draft guidelines, ESMA only notes that in 'some cases' APMs 'may appear to be used' by issuers to present a confusing or optimistic picture of the entity's performance. While it then goes on to state that even if this is not the case, APMs can be misleading if inconsistently applied or presented, it is noticeable that no evidence is presented to suggest that this is a widespread issue requiring a more detailed approach than that taken in the CESR recommendations.

19. For this reason, we would welcome clarification by ESMA of why the CESR recommendations are considered to be deficient, differentiating between problems which have arisen from a lack of adherence to the existing CESR recommendations and those which have arisen from any 'gaps' in the existing recommendations. It may be that elevation of the CESR recommendations, with some modification, to the status of ESMA 'guidelines' may have gone a long way to address the concerns outlined by ESMA, without the need to adopt a significantly more prescriptive approach.

20. Furthermore, we strongly believe that the ESMA requirements on APMs should be no more extensive than is strictly necessary. As acknowledged by ESMA, APMs are an important way for users to better understand an entity's financial performance. Accordingly, ESMA's approach should not be so prescriptive that it results in the disclosure of 'boilerplate' or unnecessary information, nor restrict companies from giving useful insights to investors. Boilerplate and clutter would act to undermine the ability of the company to tell its 'story' in a clear, concise, imaginative way; would result in disclosure that is potentially less meaningful and might even lead to a decision by the issuer to desist from using particular APMs to avoid that outcome.

21. It is therefore important that an understandable focus on consistency should not undermine the exercise of professional judgement or stifle helpful innovation in reporting practice, particularly as annual reports are frequently criticised for their length and complexity and, in the UK at least, companies are being encouraged to find better ways to communicate through restructuring information in their financial statements, while still complying with the relevant standards and guidelines.

Question 5:

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

22. ESMA defines an APM as 'any numerical measure of historical cost, current or future financial performance, which relates to the financial position, comprehensive income or cash flows, other than a measure defined by the applicable financial reporting framework.' However, very few performance measures are defined under IFRS. Similarly, IFRS does not impose detailed formats for the presentation of financial statements nor does it define the sub-totals or line items which must appear in those financial statements. As a result, we are concerned that the proposed scope of the term APM is too broad and will have an adverse impact on the reporting of operating performance in the financial statements.

23. For example, a company describing its operating performance in terms of its operating profit would apparently be required to disclose the additional analysis set out in the draft guidelines. This would not be useful to investors and would result in increased clutter and confusion in the financial statements (and any other documents intended to be within the scope of these guidelines). For this reason, we propose that the following amendments are made in relation to the scope of the term APM as set out in paragraphs 15 -16 in the draft guidelines:

> *15. For the purpose of these [draft] guidelines an APM is any numerical measure of historical, current or future financial performance, which relates to the financial position, comprehensive income or cash flows, other than a measure ~~defined by~~ presented in accordance with the applicable financial reporting framework.*

16. APMs are usually derived from (or based on) the financial statements prepared in accordance with the applicable financial reporting framework, most of the times by adding or subtracting amounts from the figures presented in financial statements. Examples of APMs include: ~~operating earnings,~~ cash earnings, earnings before one-time charges, earnings before interest, taxes, depreciation and amortisation (EBITDA), net debt, or similar terms denoting adjustments to line items of statements of comprehensive income, statements of financial position or cash flow statements.

16A. Some consider operating earnings to be another example of an APM, notwithstanding that it is presented by most issuers. In IAS 1, Presentation of Financial Statements, the IASB recognises in its Basis for Conclusions that operating earnings is not defined in the IFRS framework. In such cases, the IASB notes that an entity should ensure that the amount presented is representative of activities that would normally be regarded as 'operating'. In the IASB's view, it would be misleading and would impair the comparability of financial statements if items of an operating nature were excluded from the results of operating activities, even if that had been industry practice. For example, it would be inappropriate to exclude items clearly related to operations (such as inventory write-downs and restructuring and relocation expenses) because they occur irregularly or infrequently or are unusual in amount. Similarly, it would be inappropriate to exclude items on the grounds that they do not involve cash flows, such as depreciation and amortisation expenses. If operating earnings are presented on a basis consistent with the IASB's views expressed in this paragraph, such measures are not considered APMs for the purpose of these [draft] guidelines.

24. We welcome recognition by ESMA that the draft guidelines cannot be applied to some APMs designed to demonstrate the physical context of an issuer's business, for example sales per square metre. In paragraph 24 on page 12 of the consultation paper, ESMA states that 'when complying with these [draft] guidelines, issuers may not follow all the principles defined therein because it may not be practicable (when the cost of providing the information outweighs the benefits obtained) or the information provided may not be useful to users'. In paragraph 20 of the draft guidelines (pages 25-26 of the consultation paper), ESMA restates this principle, a little differently: 'Compliance with these [draft] guidelines implies providing a definition of the measure and its components as well as their basis of calculation. However… ESMA concedes that when complying with these [draft] guidelines, issuers may not follow all the principles defined herein because it may not be practicable or because the information provided may not be useful to users'.

25. The principle at stake here is important, and greater clarity is required in the draft guidelines, especially as ESMA goes on in paragraph 20 to refer to releasing issuers in this context only from 'the need to provide reconciliations between those APMs and figures included in financial statements'. It needs to be made clear in the draft guidelines that the exemption here is much wider, that the release from providing reconciliation is only one example, as we assume was ESMA's intention.

Question 6:

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

26. No. We think this is an example of over-prescription. It imposes an unnecessary restriction on how an issuer presents information on APM definitions.

27. While we agree that issuers should generally define APMs, including the basis of calculation adopted and details of any hypotheses or assumptions used, we do not believe that it is necessary for this information to be included as an appendix. Issuers should be able to choose the most suitable place to include such definitions, for example, as a note to the accounts or as an accounting policy

28. One way of identifying unnecessary prescription may be for ESMA to review the draft guidelines and replace 'should' with 'consider' for those aspects which go beyond the underlying principle it is seeking to establish. In this example, issuers should define the APMs used and consider the use of an appendix to list these definitions. A useful starting point might therefore be to take the existing CESR recommendations as the core principles. Any new requirement which goes beyond these core principles should be analysed critically to assess whether they would be better presented as optional considerations which enable issuers to apply the core principle while still allowing a degree of innovation and flexibility.

Question 7:

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?

29. Yes, we agree that providing a reconciliation of an APM to the most relevant amount presented in the financial statements is an effective way to improve the transparency and usefulness of APMs.

30. We note that ESMA has proposed an exemption from this requirement when the APM is a total or subtotal directly readable from the financial statements. We agree with the proposed exemption. However, unhelpful disclosures may result from the definition for an APM being set too wide, encapsulating a wide range of commonly-used performance measures (eg, operating profit). Companies currently and often usefully give non-IFRS mandated sub-totals, columns and boxes on the face of the financial statements. However, we would not wish to see companies starting to introduce additional, unhelpful subtotals in their financial statements simply in order to take advantage of this exemption. We strongly recommend that the definition of an APM and the detailed requirements should be reviewed again with this, and possible other unintended consequences, in mind.

Question 8:

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

31. Yes, but paragraph 26 of the draft guidelines (page 26 of the consultation paper) is again too prescriptive. Requiring an explanation of the benefits of using each APM presented and the purposes for which the issuer uses the APM is far too inflexible, and is likely to lead to copious amounts of pointless boilerplate that users will generally disregard.

32. ESMA needs to rethink its approach to this and other aspects of the draft guidelines.

Question 9:

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?

33. The statement in paragraph 32 of page 20 of the consultation paper that APMs presented outside financial statements should be displayed 'with less prominence, emphasis or authority' is too imprecise to be helpful. All sorts of factors might be taken as impacting the relative 'prominence' of information. Some illustrative guidance may be useful to prevent confusion and diverse practice.

34. We think in any case that the formulation in the CESR recommendation, referring to <u>equal</u> prominence, is more appropriate. We do not agree that in every case it is appropriate for APMs to be presented with less prominence, emphasis or authority then measures directly 'stemming' from the financial statements. In some circumstances this will lead to the inclusion of cumbersome and lengthy information, especially (in the light of paragraph 29 of the draft guidelines) where a detailed analysis of performance using APMs has to be repeated in full – and with greater prominence – than the corresponding numbers from the financial statements.

Question 10:

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

35. Yes, we agree that issuers should explain the reasons for redefining an APM or changing the basis of its calculation.

Question 11:

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

36. Yes, we believe that, where practicable, comparatives and/or restatements should be provided when an APM is redefined or a different basis of calculation is used.

Question 12:

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

37. While we agree that explanations for why an APM is no longer in use may be appropriate in some cases, this should be balanced against the possibility of encouraging inclusion of excessive or unhelpful narrative in the financial statements. In our opinion, it may be more helpful for the guidelines to be less prescriptive on this point. They could perhaps outline when a company should consider providing an explanation for any APMs no longer used and illustrate what that explanation might look like.

Question 13:

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

38. We agree that principles-based guidelines can help ensure transparency, neutrality and comparability of APMs used by issuers but have raised above a number of major concerns about the current proposals.

Question 14:

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.

39. We welcome the cost-benefit analysis carried out by ESMA but note that no attempt is made to quantify the costs. In our view, this severely limits the usefulness of the analysis for the purpose of assessing the overall impact of the draft guidelines. Furthermore, as already explained, we would like to understand better before the rules are finalised the evidence that the concerns raised by ESMA are widespread in practice and of concern to users.