



Ref: CESR/05-178b

**CESR Recommendation on
Alternative Performance Measures**

OCTOBER 2005



Introduction

This recommendation contains several proposals to encourage European listed companies which decide to provide the financial markets with alternative performance measures to do so in a way that is appropriate and useful for investor's decision making. These proposals are relevant since the traditional mandatory formats for consolidated financial statements do not hold due to the Regulation (EC) No 1606/2002 of the European parliament and of the Council of 19 July 2002 on the application of international accounting standards. This recommendation is expected to reinforce market confidence on financial information released by listed companies. This recommendation was essentially inspired by the experience of CESR members in the supervision and enforcement of financial reporting on financial markets.

This draft recommendation relates primarily to:

- Definition of alternative performance measures.
- Guidance for the presentation of alternative performance measures.
- Auditor's involvement.

This draft recommendation does not apply to financial information included in prospectus pursuant to EU legislation on prospectuses.

This Recommendation has been finalised, after public consultation, by CESR's operational Committee in the area of endorsement and enforcement of financial reporting standards in Europe (CESR Fin) chaired by M. John Tiner, Chief Executive of the Financial Services Authority in the UK. The project of this recommendation was more specifically prepared by the Sub-Committee on International Standards Endorsement (SISE) chaired by M. Paul Koster, member of the board of The Netherlands Authority for the Financial Markets.

A Feedback Statement of the public consultation has been published along with this final version of the Recommendation.



A. BACKGROUND AND OBJECTIVES OF THIS RECOMMENDATION

1. It can be observed that, in their financial reporting to markets, European listed companies widely use diverging financial data that are not as such extracted from the issuer's audited financial statements. This additional financial data, called Alternative Performance Measures in this recommendation, can either be derived from the audited financial statements or stem from other sources or alternative methodology to conventional accounting. The first category includes for instance "operating earnings", "cash earnings", "earnings before one-time charges", "EBITDA - earnings before interest, taxes, depreciation, and amortization" and similar terms denoting adjustments to line items of income statement, balance sheet or cash flow statement. The second category includes additional performance indicators reflecting business activity (e.g. production or activity levels), projection of future cash flows (e.g. the European Embedded Value in insurance sector) or forward-looking indicators. These are only a few example of possible alternative measure, as CESR's purpose is not to determine a list of accepted alternative performance measure for use in the EU.
2. As such, alternative performance measures can provide investors with appropriate additional information if properly used and presented. In such cases, these measures can assist investors in gaining a better understanding of a company's financial performance and strategy. However, when improperly used and presented, these kinds of measures might mislead investors by hiding the real financial position and results or, by making the profitability of the reporting entity seem more attractive. As such, the CESR Recommendation aims at avoiding this by providing guidance on the best way to appropriately use and present alternative performance measures.
3. In a cautionary statement of May 19th, 2002 IOSCO already identified the importance of providing a framework for fostering an adequate use of non-GAAP Results Measures in financial reporting to markets (IOSCO Cautionary Statement Regarding Non-GAAP Results Measures). .
4. The adoption of IFRS for European listed companies has an important consequence since the European Commission has announced¹ that the formats for financial statements, laid down in the 4th and 7th accounting Directive, will not be binding any more for consolidated accounts. In addition, one feature of IFRS is that it does not impose detailed formats for presentation of financial statements and it only mandates a limited number of definitions of measures or line items to be included in these statements. Formats and presentation of financial statements is an important problematic that needs to be addressed at the appropriate level, in order to foster comparability and facilitate common understanding of financial statements under IFRS.
5. EU regulatory developments on annual management reports (called MD&A or OFR in some jurisdictions) might also have an impact on the content and scope of this Recommendation.
6. CESR will closely monitor these important regulatory developments and will subsequently re-assess this Recommendation in light of possible future regulatory changes.
7. The public consultation on this Recommendation highlighted that, in some cases, what is considered as alternative performance measure under this Recommendation is already ruled by guidance issued by self-regulatory organisation (e.g. regulated markets or industry guidance), local regulations, administrative measures or even laws. CESR has not made an exhaustive review of such other framework which remains relevant and applicable depending on their local legal environment. Against this background the **objective of this Recommendation** is to ensure that investors are not mislead through the use of alternative performance measures. This Recommendation does not intend to determine which the appropriate or relevant Alternative Performance Measures are; nor does it provide definitions for such measures.

B. DEFINITION OF ALTERNATIVE PERFORMANCE MEASURES

¹ see appendix 1 to this recommendation.

Alternative Performance Measure

8. An Alternative Performance Measure is any measure other than a defined measure considering that, as explained below; the defined measures are those included in audited financial statements in view of providing a true and fair view. Alternative Performance Measures are often called non-GAAP measures.
9. Alternative Performance Measures are usually *derived from (or based on) the financial statements prepared in accordance with applicable financial reporting framework*, and include for instance "operating earnings", "cash earnings", "earnings before one-time charges", "EBITDA - earnings before interest, taxes, depreciation, and amortization" and similar terms denoting adjustments to line items of income statement, balance sheet or cash flow statement. In this case Alternative Performance Measures *resemble* but differ from defined measures.
10. Alternative Performance Measures can also be *based on other sources or alternative methodology* to conventional accounting and include for instance additional performance indicators reflecting business activity (e.g. production or activity levels), projection of future cash flows (e.g. the European Embedded Value in insurance sector) or forward-looking indicators.

Defined Measures

11. Defined measures are all GAAP measures.
12. In general, this Recommendation is drafted with a focus on entities reporting under IFRS, as this is expected to cover the most common situations on regulated markets. However, the principles developed below are also valid, *mutatis mutandis*, for financial reporting made under national reporting frameworks in the EU. Subject to further EU regulatory developments on requirements for entities reporting under third country accounting standards recognised as equivalent, these principles should also be considered *mutatis mutandis* for these entities.
13. Most national reporting frameworks developed in the EU under the 4th and 7th accounting Directives contain very detailed formats for the presentation of financial statements as well as detailed definition of line items or captions that have to be shown on the face of different statements. In this context, it is usually easier to determine what defined measures are.
14. One of the characteristics of IFRS is that it does not impose binding formats for the presentation of financial statements. IFRS prescribes that, as a minimum, some line items must be presented on the face of the balance sheet, income statement, statement of changes in equity and cash flow statements (see IAS1, Presentation of Financial Statements). IFRS also prescribes that additional line items, headings and subtotals shall be presented on the face of the balance sheet and income statement when such presentation is relevant to an understanding of the entity's financial position (IAS 1, Para 69 and 83). Different IFRS define and impose presentation of some additional specific data (or performance measures), e.g. IAS 7 Cash Flow Statements, IAS 14 segment Reporting, IAS 33 Earnings per Share. All standards also require numerous disclosures which have to be included in the notes to the financial statements and whose objective is to enable the readers to understand and assess the entity's financial position and performance. CESR's approach is to consider as defined measure all information included in audited IFRS financial statements in view of providing a true and fair view, either on the face of the balance sheet, income statement, statement of changes in equity, cash flow statements or in the notes. Defined measures are calculated and presented in accordance with IFRS.

C. DIFFERENT TYPES OF FINANCIAL INFORMATION

15. IFRS provides guidance for the preparation and presentation of annual and interim financial statements. Jurisdictions may have varying requirements as to the extent of regulation of other financial information, including management discussion and analysis (MD&A), in the framework of the Transparency and prospectus Directives or not.
16. The principles described in this draft recommendation should however also apply to any kind of reporting (with the exception of prospectuses; see paragraph 20) to markets by issuers, when such reporting includes information of a financial nature.
17. Press releases, in particular those on the outcome of the financial year, are generally published earlier than the financial statements themselves and have wide press coverage. Whenever the press release includes alternative performance measures, a proper use of these measures is crucial for investors and transparent financial markets.

D. RECOMMENDATIONS FOR THE PRESENTATION OF ALTERNATIVE PERFORMANCE MEASURES

(i) Scope

18. This recommendation applies to financial performance figures of listed companies and aims at transparent and unambiguous information on financial performance for investors. CESR encourages issuers to consider the following recommendations.
19. This recommendation does not apply to prospectuses published in accordance with EU legislation on prospectus. In February 2005, CESR published a recommendation for the consistent implementation of the European Commission's Regulation on Prospectuses n° 809/2004 (ref CESR/05-054b – this document is available on CESR's website). This recommendation on prospectus included a special section on "Financial data not extracted from issuer's audited financial statements" (paragraphs 95 to 97). The approach developed in this recommendation is similar to that followed in the present paper although the terminology used in the two papers is not identical due to the fact that their specific context is different.

(ii) Respect the IFRS-principles for financial statements for all types of financial information.

20. IFRS is based on several principles for financial reporting, notably included in the Framework and IAS1, Presentation of Financial Statements. Pursuant to IAS Framework (Paragraph 24 and seq.), there are four qualitative characteristics that make the information provided in financial statements useful to users: understandability, relevance, reliability and comparability, . As such, these principles apply only to financial statements prepared under IFRS. CESR believes that issuers should always follow these principles for preparation and presentation of financial information including the preparation of alternative performance measures.
21. CESR believes that these principles should also be considered by issuers reporting under Member State national accounting standards or under third country GAAP considered as equivalent.

(iii) Define alternative performance measures

22. Issuers should define the terminology used and the basis of calculation adopted (i.e. defining the components included in an alternative performance measure). Clear disclosure is key to the understandability of any alternative performance measure and its relevance. Disclosure is especially important if market practice or academic theory is divided about the components of that measure. Where applicable, the disclosure of the basis of calculation should include indications on hypothesis or assumptions used.
23. Where relevant, investors should be made aware of the fact that Alternative Performance Measures are not prepared in accordance with the accounting standards applied to audited financial statements and may omit certain recognition, measurement and presentation requirements of these standards.

24. Alternative performance measures should be given meaningful names reflecting their basis of preparation in order to avoid misleading messages.

(iv) Present alternative performance measures additionally to defined measures and explain the differences.

25. Where possible issuers should present alternative performance measures only in combination with defined measures. Furthermore, issuers should explain the differences between both measures; this might be through a reconciliation of figures to provide investors with enough information to fully understand the results and financial position of the company.

26. This principle is essentially relevant for alternative performance measures which resemble defined measures (see above, paragraph 11).

(v) Provide comparatives

27. If the company chooses to present alternative performance measures, it should provide comparable information for other periods as well. The number of periods covered should correspond to the number of periods covered by the audited financial statements.

(vi) Present alternative performance measures consistently over time

28. The definition of the measures should be consistent over time to avoid that investors' decisions are taken on wrong assumptions. In the exceptional circumstances that the issuer chooses to redefine its alternative performance measures, this should be explained thoroughly to investors, together with comparative figures.

(vii) Prominence of presentation of defined measures versus alternative performance measures

29. It can be observed that issuers tend to present alternative performance measures, sometimes even more prominently than the defined measures directly stemming from audited financial statements. To ensure that investors are not misled, CESR recommends that issuers highlight the defined performance measures with greater prominence than alternative performance measures derived from audited financial statements and which resemble defined performance but do actually not have the characteristics of the defined measures (to be audited, based on an identified reporting framework, consistent and comparable with performance measures of other enterprises).

30. In other cases, defined measures and alternative measures will be presented according to their usefulness to portray the entity's performance, considering that alternative measure should not be presented with greater prominence.

(viii) Explain why alternative performance measures are presented and how they are used internally

31. Issuers may internally use alternative performance measures for measuring and controlling the company's profitability and financial position. Generally issuers explain this as the reason to presenting alternative performance measures to investors. CESR expects issuers to give an explanation of the internal use of alternative performance measures in order to make investors understand the relevance of this information. This explanation is useful only when presented in direct relation to the alternative performance measures.

E. AUDITOR INVOLVEMENT

32. The issuer should disclose whether the alternative performance measures have been subject to separate auditor's review and, if so, indicate the nature of such a review and its conclusion.

33. CESR believes that the management of the reporting entity should always inform its auditors about its use of alternative performance measures, and thereby enable the auditor to consider



the requirements of applicable audit standards (e.g. ISA 720 or, if applicable, national standards could provide useful guidance in those circumstances).

Appendix 1: Comments from the European Commission on IASs formats and a chart of accounts²

“IASs describe the manner in which the items disclosed on the face of the profit and loss account and the balance sheet should be determined.

In respect of the profit and loss account, IASs permit two approaches, disclosure by function or by nature. Where disclosure by function is adopted, certain additional information by nature is required. Disclosure by function or nature follows the same principles that determine the alternative formats set out in the Fourth Council Directive.

In respect of the balance sheet, assets are presented either in order of their liquidity or on the basis of a current/non-current distinction. These presentations are very similar to those envisaged by the Fourth Council Directive which requires distinctions between fixed and current assets and between short- and long term liabilities.

As IASs are only relevant to external, general purpose financial reporting, there are no explicit requirements in IASs concerning the structure of the internal management information (or chart of accounts) which must be maintained by the company; though clearly such internal information must be at least sufficient to support the preparation of the information required for external financial reporting.

As the IAS Regulation applies directly to individual companies, Member States cannot impose their own formats and therefore endorsed IASs shall be applied.”

² Par. 4.2 of the EC Comments concerning certain Articles of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards and the Fourth Council Directive 78/660/EEC of 25 July 1978 and the Seventh Council Directive 83/349/EEC of 13 June 1983 on accounting, November 2003