The audit committee's role in reporting on alternative performance measures

The reporting of alternative performance measures (APMs) is currently the focus of much debate in Europe. In 2015 the European Securities and Markets Authority published guidelines on APMs, saying it wanted "to encourage European issuers to publish transparent, unbiased and comparable information on their financial performance in order to provide users with a comprehensive understanding of their performance".[1] The International Organization of Securities Commissions had previously issued its own proposed guidance in 2014.[2] Regulators want to obtain assurance that companies are not conveying information that could mislead investors, analysts and other important stakeholders. In this respect, regulators in Europe are more regularly asking questions to preparers around APMs (amongst others France, UK, the Netherlands and Norway).

While a company must ascertain that its financial statements comply with the generally accepted accounting principles (GAAP) applicable in its own jurisdiction, reporting on APMs is optional and provides greater flexibility. Regulators expect entities, with the involvement of their audit committees, to make certain that APMs are reported in a consistent, transparent way and are reconciled to the financial statements.

What is an APM?

APMs are also known as non-GAAP financial measures and non-financial KPIs. They cover a broad range of areas that can be relevant to the performance of a company.

Examples of financial APMs that are commonly used in company reporting include:

- Earnings before interest, taxes, depreciation and amortization (EBITDA)
- Earnings before interest and tax (EBIT)
- Adjusted earnings
- Free cash flow
- Debt ratio
- Return on capital employed (ROCE)
- Order intake and backlog

Examples of non-financial APMs that are commonly used in company reporting include:

- Production metrics
- Sales metrics
- Reserves
- Injury frequency tables
- Total water or energy consumed
- Workforce
- Cost savings
- Greenhouse gas emissions

Advantages and disadvantages of reporting on APMs

Audit committees should be aware that, while there are many advantages to reporting on APMs, there are also some significant disadvantages. Understanding both is the key to ascertaining the quality of their companies' reporting.

Advantages of reporting on APMs:

- **Offer valuable insight to analysts and investors** — together with GAAP measures, APMs can provide a holistic view of the company and lessen the likelihood of share price volatility.
- **Highlight key value drivers** — APMs are a way for management to highlight the key value drivers within the business that may not be obvious in the financial statements. For example, organic company growth or heightened product demand.
- **Provide a useful comparison** — analysts and investors can find APMs a useful means to compare and contrast the prospects of different companies within the same sector.
- **Set benchmark for corporate reporting** — APMs can provide a useful link between financial results and non-financial performance, setting the scene for broader and more relevant integrated reporting.

Disadvantages of reporting on APMs:

- Lack of comparability between peers — if the company does not report on similar APMs to its peers, the work of analysts and investors becomes more difficult, possibly to the detriment of the company's share price.
- Risk of management bias — management may report on measures that lead to favorable results. APM reporting is then being used as a marketing tool, rather than as a means of improving transparency.
- Risk of disqualifying the financial statements — if APM reporting is not reconciled to the GAAP reporting, they might contradict each other, rendering the financial statements meaningless.
- Risk of share price volatility — market participants sometimes pay more attention to APMs than to GAAP measures. This increases the risk of share price volatility if management predictions are not met.
- Lack of external verification — since the data is not subject to the statutory audit process, it could be inaccurate and give a misleading impression of the company.

To capitalize on the advantages of reporting on APMs, and reduce the perceived effects of potential drawbacks, companies need to respond to the challenge of consistency over time. If there is a year-on-year variance in terms of which APMs are reported on, the usefulness will be hindered. There is also a risk of causing alarm to market participants if a performance measure that was previously reported on – for example, order volumes – is suddenly dropped. Market participants may interpret this as being a negative indicator for the company.

The roles of the audit committee and the independent auditor

While terms of reference vary by jurisdiction, it is typically the audit committee's responsibility to oversee a company's financial reporting process, which could include reporting on APMs. Therefore, it is recommended that audit committees question management on its selection of the reported APMs and their significance. The audit committee would then request assurance from management that the company has the right internal controls in place to ensure accurate and meaningful reporting.

Independent auditors do not bear any responsibility for the accuracy of APM reporting, except when APM figures are included in the audited financial statements. However, they must read the management report, as well as any additional communications to shareholders.

The audit committee can take several steps to make APM reporting effective, such as:

- Ask to see reconciliation schedules — to be effective, APM reporting should be aligned with GAAP reporting. The audit committee should ask management for reconciliation schedules that align the two kinds of reporting.
- See that the company communicates clearly and regularly – audit committees should assess how the company communicates its decisions about APM reporting. For example, if the company wants to start or stop reporting on a specific APM, it should explain its reasons for this decision in order to avoid unsettling market participants. Furthermore, the regularity of APM reporting is important. If a company produces statutory financial information on a quarterly basis, it should also report on its APMs using the same time frame. While communication is important, regulators do not expect companies to make an increased volume of disclosures as a result of their APM reporting. The relevance of the disclosures continues to be more important.
- Challenge the company's interaction with the press – audit committees should ask to see any proposed press releases associated with the company's financial or non-financial reporting. They should assure that APMs are not given precedence over GAAP measures in any published information. Finally, they should review press coverage of the company's reporting to check that journalists are not focusing on the company's APMs at the expense of its GAAP performance.

Questions for the audit committee to consider

- What are management's reasons for publishing these APMs? (This is particularly important if the APMs are new.)
- Why have certain APMs been discontinued or had their definition changed?
- Can the APMs be clearly understood by parties outside the company?
- Can the data in the APMs be verified? (This is particularly important for adjustments, EBITDA or restatements.)
- How are the APMs reconciled with GAAP measures?
- What is best practice for reporting on APMs within the company's sector?
- Should APMs be reported according to segments within the company?
- How have analysts reacted to the publication of these APMs in the past?
- Has the company received any comment from regulators about its APM reporting?

Endnotes

1. *ESMA Guidelines on Alternative Performance Measures*, European Securities and Markets Authority, 2015.
2. *Proposed Statement on Non-GAAP Financial Measures*, International Organization of Securities Commissions, 2014.

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