INTERNATIONAL GOOD PRACTICE GUIDANCE

Developing and Reporting Supplementary Financial Measures—Definition, Principles, and Disclosures

International Federation of Accountants®

The mission of the International Federation of Accountants® (IFAC®) is to serve the public interest by: contributing to the development of high-quality standards and guidance; facilitating the adoption and implementation of high-quality standards and guidance; contributing to the development of strong professional accountancy organizations and accounting firms and to high-quality practices by professional accountants, and promoting the value of professional accountants worldwide; and speaking out on public interest issues.

The Professional Accountants in Business (PAIB) Committee serves IFAC member bodies and professional accountants worldwide who work in commerce, industry, financial services, education, and the public and not-for-profit sectors. Its aim is to promote and contribute to the value of professional accountants in business. To achieve this objective, its activities focus on:

- increasing awareness of the important roles professional accountants play in creating, enabling, preserving, and reporting value for organizations and their stakeholders; and
- supporting member organizations in enhancing the competence of their members through development and sharing of good practices and ideas.

The PAIB Committee extends its appreciation and thanks to CPA Canada, especially to Chris Hicks, CPA, CA, Principal, Research, Guidance, and Support, CPA Canada, for assisting the PAIB Committee in developing this International Good Practice Guidance.

ISBN: 978-1-60815-189-9

Published by: International Federation of Accountants®

Table of Contents

The Importance of Supplementary Financial Measures

Numerous financial measures, referred to in this guidance as supplementary financial measures, are not defined by accounting standards.[1] Many are widely used in both internal and external reporting, for example: Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA); Underlying Profit; Net Debt; and Free Cash Flow. Additionally, supplementary financial measures are used outside financial reporting, for example, as a component in the financial ratios of debt agreement covenants. While investors say they value these measures, they also frequently complain about the measures' lack of transparency, comparability, and consistency.

There can be several motivations for reporting a supplementary financial measure. It might provide additional insight about current or future performance of an organization. For example, a company may report a measure that reflects management's perspective on earnings after eliminating non-recurring items or report sustainable operating cash flow after deducting those capital expenditures necessary to maintain current performance. In other cases, the measure may eliminate some aspect of the jurisdiction's generally accepted accounting principles (GAAP) that the company believes is not useful in representing its performance. For example, the company might not believe that depreciation and amortization provide a useful representation of the costs of consuming capital assets. On the other hand, some commentators believe that organizations use such measures in their external reporting to obscure a poor performance under GAAP.

A professional accountant in business may want to develop and report a supplementary financial measure to assist management, investors, and other stakeholders in understanding some aspect of an organization's performance. This guidance aims to help the professional accountant develop and report useful measures that address the aforementioned comments by providing principles for determining the qualities a measure should exhibit for it to be reported and, when reported externally, the disclosure that should accompany it. Many of the principles noted below should apply equally as well to non-financial measures, such as churn rates in the telecommunications industry, greenhouse gas emissions, or barrels of oil equivalent production in the oil and gas industry.

Financial statements prepared for external purposes report the financial performance and financial position of an organization, presented in accordance with all the requirements of an accounting framework. This guidance on developing and reporting supplementary financial measures should not be construed as expressing dissatisfaction with some aspect of local GAAP. Rather, it recognizes that many users want to supplement GAAP-reported information with management's perspective about the organization's performance.

Readers should note that many jurisdictions regulate the use and disclosure of externally reported supplementary financial measures. Accordingly, this guidance needs to be considered in light of the regulations in the particular jurisdiction in which it is being applied.

[1] Many supplementary financial measures are known as non-GAAP financial measures.

The Role of the Professional Accountant in Business

In *Competent and Versatile: How Professional Accountants in Business Drive Sustainable Organizational Success* (IFAC 2011), the roles professional accountants in business perform are summarized as creators, enablers, preservers, and reporters of sustainable value for their organizations in both performance and conformance dimensions.

In order to develop and report supplementary financial measures in organizations, all four roles are important and relevant as effective reporting is about creating, enabling, preserving, and reporting sustainable value. However, the emphasis of this guidance is on how professional accountants in business enable transparent communication via effective reporting of the organization's delivery of sustainable value to stakeholders.

The principles in this guidance support professional accountants in business use of supplementary financial measures for the organizations for which they work. These principles do not prescribe a specific approach but highlight a number of areas for specific consideration when developing and reporting supplementary financial measures.

Definition

This guidance uses the following definition: *Supplementary financial measures are those financial measures not specifically identified by a GAAP framework.*

Supplementary financial measures do not have any generally accepted definitions and use information selectively such that they either add or omit amounts from a GAAP measure. Amounts added or omitted may be GAAP-determined measures themselves or may be based on management's assumptions, judgments, and estimates without reference to GAAP.

Characteristics of Useful Financial Information

The International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) have jointly published various chapters of a Conceptual Framework for Financial Reporting (Conceptual Framework), including a chapter that addresses qualitative characteristics of useful financial information—that is, financial information provided in financial statements as well as financial information presented in other ways.[2]

The qualitative characteristics identified by IASB and FASB comprise two fundamental characteristics:

- **Relevance—**financial information that is capable of making a difference in the decisions made by users; and,
- **Faithful representation—**financial information that faithfully represents the phenomena it purports to represent. A perfectly faithful representation would be complete, neutral, and free from error.

In addition, IASB and FASB identify four enhancing qualitative characteristics:

- **Comparability**—the ability to identify and understand similarities and differences among items (consistency in the use of the same methods for the same items contributes to comparability);
- **Verifiability—**different knowledgeable and independent observers could reach consensus that a particular depiction is a faithful representation;
- **Timeliness—**information should be available in time to be capable of influencing decisions;
- **Understandability—**information should be classified, characterized, and presented clearly and concisely for users.

While the Conceptual Framework is directed to financial reporting for external users, the Professional Accountants in Business Committee believes these qualitative characteristics should also apply to management's internal financial reporting. Accordingly, this guidance discusses how they apply to supplementary financial measures.

[2] The International Public Sector Accounting Standards Board is in the process of developing a similar framework, *Public Sector Conceptual Framework*.

Principles for Developing and Reporting Supplementary Financial Measures

When considering whether a supplementary financial measure has sufficient attributes to be reported, consideration may be given to the following:

A. Relevant

For a supplementary financial measure to be reported, it should either be used by management in assessing performance or should be employed by knowledgeable users of the external report.

A supplementary financial measure needs to be capable of influencing users' decisions, for example, when used by management to assess performance. However, knowledgeable users may also self-select a measure's relevance even though that measure is not used by management, for example, a measure that investors use to compare companies' performance and estimate value**.**

B. Complete

A supplementary financial measure should provide all the information necessary for a user to understand the phenomenon being depicted.

Completeness is achieved when the measure is not in need of adjustment or additional complementary information. For a supplementary financial measure, completeness is assessed by considering whether the description of the measure, together with any contextual discussion necessary to explain the purpose of adjustments to a GAAP measure, provide all the information necessary for a user to understand the phenomenon being depicted. For example, to ensure completeness, a measure of cash flow from operations that excludes cash provided or consumed by working capital changes may need to be accompanied by a discussion of the organization's working capital cycle and how that cycle provides and consumes cash. Additionally, to be complete, when management uses the measure, the components of the externally reported measure should be the same as those used by management, or the differences and reasons for the difference should be explained.

C. Neutral

A supplementary financial measure should not be biased, slanted, weighted, or manipulated to obtain a desired result.

Adjustments to GAAP measures need to address all relevant positive and negative items. For example a supplementary financial measure that purports to represent income before non-recurring items should be adjusted for both non-recurring costs and corresponding non-recurring revenues.

D. Transparent

The description of a supplementary financial measure should align with its components. Additionally, a supplementary financial measure should be accompanied by sufficient explanation to render it as free as is practicable from uncertainty and estimation error.

The caption for a supplementary financial measure needs to align with its components. For example, a measure that is captioned as operating income but excludes certain non-cash operating charges, such as depreciation and amortization, would not be transparent.

Many supplementary financial measures involve significant uncertainty and the possibility of estimation error. When the uncertainty or estimation results from applying GAAP, any disclosure necessary for the measure to be considered transparent is likely to be already required by the relevant accounting standard. However, when the measure's uncertainty or potential for estimation error does not arise from applying GAAP additional disclosure may be necessary. In these circumstances, for example, maintenance capital expenditures where some assets have both maintenance and growth attributes, transparency relates to the completeness of the process in computing the measure. Accordingly, users need to understand the process followed by management, for example, any assumptions made, from what range an estimate is selected, and how the selected amount is determined.

E. Understandable and Verifiable

***Knowledgeable users need to understand a supplementary financial measure's construction and limitations and see that it is verifiable by being able to reach consensus that a measure faithfully represents what it purports to depict*.**

Since supplementary financial measures are derivatives of a measure from a GAAP framework, users need to be able to identify and understand the adjustments from the GAAP measure and how they were constructed, and the reasons and implications for their inclusion or exclusion. A reconciliation of the supplementary financial measure and the GAAP measure should be helpful.

F. Comparable

***Users need to be able to compare supplementary financial measures between entities in the same industry and between periods*.**

The absence of standard definitions for supplementary financial measures results in measures with similar terms potentially having different components. Accordingly, an organization may wish to consider the measures used in its industry and how they are constructed. Additionally, to maximize comparability, an organization needs to define a supplementary financial measure in sufficient detail as to facilitate comparability with its peers, including definitions of adjustments not determined in accordance with GAAP, for example maintenance capital expenditures. In addition, measures should be prepared on a consistent basis from period to period—users need to understand when and how the components of a measure have changed.

When a new supplementary financial measure is introduced, the organization also should present that measure for the comparative periods.

G. Timely

***A supplementary financial measure should be reported at the same time as the related financial statements*.**

Users of reports need access to all relevant information in order to be able to make an informed decision. Accordingly, for a supplementary financial measure to be useful in communicating performance, it should be reported along with the related financial statements.

Disclosure of Supplementary Financial Measures

A measure that is relevant, complete, neutral, transparent, understandable and verifiable, comparable, and timely should be capable of being reported as a supplementary financial measure. The following disclosure guidance should assist professional accountants in business in applying these principles to external reporting. This disclosure guidance should also be useful for internal reporting, such as to senior management, the governing body, and the audit committee.

Definition and purpose for the measure

To avoid confusion, a supplementary financial measure should be clearly defined, for example, the definition of "same-store" in "same-store sales" should be clarified. Additionally, a measure's purpose should be disclosed when used by management, including the economic phenomena presented by the measure. Further, supplementary financial measures should be labeled as such and be clearly distinguished from GAAP measures.

Change in composition of a supplementary financial measure

When the components of a measure change or their basis of calculation changes, the reason for the change should be explained and the comparative amounts should be restated to the new basis of calculation.

Quantitative reconciliation to GAAP measure

An organization that reports a supplementary financial measure should provide a quantitative reconciliation of the measure to the most directly comparable reported GAAP measure, showing each adjustment made to the GAAP measure for all periods presented. The definition and purpose of each adjustment should be explained and the corresponding item in the financial statements should be identified, located, and quantified. When an adjustment is not a GAAP measure, the basis for its computation should be explained. While this disclosure will assist investors in comparing measures between entities, it will also be useful to state that the measure may not be directly comparable with those of its peers.

Accompanying contextual disclosure

Since supplementary financial measures add or omit items from the nearest GAAP measure, contextual discussion about the additional or eliminated items often complements an understanding of a measure's limitations. If an organization's EBITDA has increased because technological changes have replaced labor costs with capital assets, for example, it would be useful to provide context to the EBITDA change by discussing its impact on depreciation and amortization.

A supplementary financial measure should be presented with concise but sufficient information to enable a user to understand its components and assess whether the measure is complete, neutral, and free from error. When a supplementary financial measure's neutrality could be questioned, for example, when interest expense but not interest income is eliminated from an earnings measure, this should be discussed and the reason provided. Similarly, when a measure involves uncertainty or estimates, disclosing the assumptions and range from which the estimate was selected helps provide context for the measure.

Location and presentation

A supplementary financial measure that is reported externally should be located so that it complements but does not overshadow an organization's GAAP measure.

The location for an externally reported supplementary financial measure will vary according to the components of an organization's reporting package and the regulations in the jurisdiction in which the organization reports. To avoid confusing readers about a supplementary measure's authority, care should be taken not to present such a measure with more prominence or emphasis than the nearest related GAAP measure. Factors to consider include the order of presentation of supplementary financial measures and GAAP measures, and the relative typeface sizes of the measures. In addition, supplementary financial measures should be easily distinguishable from GAAP measures. Since the primary objective of externally reporting a supplementary financial measure is to provide additional insight about an element of performance beyond that which is communicated in the external financial statements, the best place for externally reporting such measures will often be in material that explains the financial statements, for example, management commentary.

International Financial Reporting Standards (IFRSs) require items to be reported in the financial statements or the notes when their presentation is relevant to understanding any of the financial statements presented. It should be noted, however, that in light of the financial statements' intent of providing a relatively objective assessment of performance and financial position in accordance with accounting standards, several jurisdictions restrict or prohibit reporting supplementary financial measures in the financial statements.

Assurance

Obtaining internal or external assurance on an organization's supplementary financial measures contributes to additional accountability, transparency, and reliability. The organization should, therefore, weigh the costs and benefits of such assurance. When obtaining internal or external assurance is not a matter of compliance, the organization should, therefore, consider voluntary internal or external assurance on its supplementary financial measures.

Appendix A: Definitions

External reports: reports from an organization containing both financial and non-financial information that are useful to the intended stakeholders in making informed decisions on behalf of or about the organization.

Financial statements: A structured representation of historical financial information, including related notes, intended to communicate an entity's economic resources or obligations at a point in time or the changes therein for a period of time in accordance with a financial reporting framework. The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information. The term "financial statements" ordinarily refers to a complete set of financial statements, as determined by the requirements of the applicable financial reporting framework, but it can also refer to a single financial statement. (*This definition is from the International Audit and Assurance Standards Board*.)

Investor: a current or future holder of debt or equity in a company or corporation.

Management commentary: the IFRS Practice Statement, *Management Commentary—A Framework For Presentation,* provides the following description:

Management commentary is a narrative report that provides a context within which to interpret the financial position, financial performance, and cash flows of an entity. It also provides management with an opportunity to explain its objectives and its strategies for achieving those objectives. Users routinely use the type of information provided in management commentary to help them evaluate an entity's prospects and its general risks, as well as the success of management's strategies for achieving its stated objectives. For many entities, management commentary is already an important element of their communication with the capital markets, supplementing as well as complementing the financial statements.

Organizational performance: the actual outcomes or outputs of an organization as measured against its intended environmental, social, and economic outcomes or outputs.

Stakeholder: any person, group, or entity that has an interest in an organization's activities, its resources, or output, or that is affected by that output. Stakeholders include regulators, shareholders, debt holders, governing bodies, managers, employees, customers, suppliers, advocacy groups, governments, trade unions, media, and society as a whole.

Supplementary financial measure: a financial measure not specifically identified by a GAAP framework.

Appendix B: Resources

Business reporting is dynamic and no list can cater for all reporting needs; therefore, this list may not be sufficient for the needs of all users. Additional resources from IFAC, its member bodies, and third parties can be found through the IFAC Global Knowledge Gateway.

Financial Reporting Supply Chain: Current Perspectives and Directions (IFAC 2008) presents the results of a study on whether financial reporting has improved in recent years. Additionally, the global research study, *Developments in the Financial Reporting Supply Chain—Results from a Global Study Among IFAC Member Bodies* (IFAC 2010), indicates that in many countries and jurisdictions, progress has been made in numerous areas of governance, financial reporting, and auditing. However, both studies highlight several persistent and important remaining issues.

Integrating the Business Reporting Supply Chain (IFAC 2011) includes recommendations from 25 prominent business leaders on what should be done to effectively improve governance, the financial reporting process, audit, and the usefulness of business reports in the aftermath of the financial crisis. The report provides a summary of interviewees' recommendations in each area and highlights some of IFAC's related initiatives.

MIFRS Practice Statement: Management Commentary, A Framework for Presentation (IASB 2010) provides a broad, non-binding framework for the presentation of management commentary that relates to financial statements prepared in accordance with International Financial Reporting Standards.

Conceptual Framework for Financial Reporting (FASB and IASB 2010) aims to create a sound foundation for future accounting standards that are principles based, internally consistent, and internationally converged.

Combating Clutter (UK Financial Reporting Council 2011) seeks to be a catalyst to removing unnecessary text and data from annual reports, as does the Financial Reporting Lab.

Producing Financial Information for Canadian Capital Markets (CPA Canada 2010) summarizes the key elements of the financial information production process, including the parties involved in the process. While recognizing the separate and distinct roles of the various parties, the paper emphasizes that for the production process to be reliable those parties need to work together in an environment of respect and cooperation.

Business Insights (Institute of Chartered Accountants in Australia), regularly published on a variety of subjects, are designed to offer practical, relevant advice and information to Chartered Accountants in business. Each guidance note is written by members for the benefit of other members by offering expertise and practical examples of some of the day-to-day challenges they face in the business world.

Re-Assessing the Value of Corporate Reporting (Association of Chartered Certified Accountants 2012) points out that corporate reports are being held back by confusion over their different audiences, complexity, and lack of timeliness. The report signals a need for a greater focus on forward-facing plans, risk management, and the effective integration of these and other issues into corporate reports in a more coherent way.

Simple, Practical Proposals for Better Reporting of Corporate Governance (Report Leadership 2011) offers suggestions on how companies can adopt a new reporting structure that integrates key governance information with the rest of their business reporting; implement, measure, and communicate sound business principles; and tell the governance story, while also ensuring compliance with relevant codes and legislation. Report Leadership is a multi-stakeholder group consisting of the Chartered Institute of Management Accountants, PwC, and Radley Yeldar.

Reporting Business Risks: Meeting Expectations (Institute of Chartered Accountants in England and Wales 2011) analyzes problems with risk reporting and recommends how it can be improved in practice.

Financial Reporting Lab (UK Financial Reporting Council) provides an environment where investors and companies can come together to develop pragmatic solutions to today's reporting needs. Most useful for the readers of this guidance may be the content on reporting of net debt and cash flow.

Non-GAAP Financial Measures—Enhancing their Usefulness (PwC, 2014) and *Non-GAAP Measures—Insights from the Investment Community* (PwC, 2013) indicates that investors find non-GAAP measures useful, for example, in forecasting future cash flows and understanding management's perspective of the business.

Guidance Note: Disclosing Non-GAAP Financial Information (Financial Market Authority New Zealand, 2012) sets out the Authority's expectations on the use of financial information in corporate documents, such as transaction documents and market communications, where that financial information is not presented in accordance with GAAP or is presented as an alternative to the statutory profit.

Regulatory Guide 230 Disclosing Non-IFRS Financial Information (Australian Securities and Investments Commission, 2011) sets out the Commission's guidance on the use of financial information in financial reports and other corporate documents, such as transaction documents and market announcements, where that information is presented other than in accordance with accounting standards (non-IFRS financial information).

Consultation Paper: ESMA Guidelines on Alternative Performance Measures (European Securities and Markets Authority, 2014) promotes transparency on alternative performance measures (APMs) used by issuers by ensuring their adherence to general qualitative characteristics that enhance usefulness of financial information to users.

Proposed Statement on Non-GAAP Financial Measures (International Organization of Securities Commissions, 2014) sets out expectations for issuers regarding their presentation of financial measures other than those prescribed by GAAP. Open for comment until December 5, 2014.

International Federation of Accountants
529 Fifth Avenue, FL 6
New York, NY 10017
USA
T +1 212 286 9344
www.ifac.org