



Underlying profit revisited



Underlying profit – useful or misleading?

Since the introduction of New Zealand equivalents to International Financial Reporting Standards (NZ IFRS), entities have found ways to disclose the earnings that directors believe more accurately reflect the entity's underlying financial performance, in addition to the statutory profit (which is net profit after tax as determined by NZ IFRS). These measures take many different labels with some of the more common measures shown being 'EBITDA', 'EBITDAF', 'operating profit', 'normalised profit', 'underlying earnings' and in the past year earnings before the government's tax law changes (particularly due to the removal of depreciation deductions allowed for buildings).

In 2010, the annual reports of 87 out of a sample of 100 companies (primarily derived from listed and other large New Zealand companies with publicly available financial information) provided 214 alternative earnings or profit measures. With financial results being discussed in so many ways the question arises as to whether this additional information is useful or misleading.

Since we looked at this topic a year ago, there has been a lot of commentary in the press arguing that this additional information can be misleading. An article by Brian Gaynor in the New Zealand Herald expressed concern over the use of alternative measures stating *"The road we are heading down, which is where*

companies report their own adjusted profits to shareholders, inevitably leads to tears as far as investors are concerned”¹. This sentiment was echoed by Ashley Balls in NZ Business magazine who asked “Quite why the NZX hasn’t put its oar in is almost beyond belief as it is in no one’s interests for profit figures to be confusing”².

The Chief Executive Officer of the New Zealand Institute of Chartered Accountants (NZICA) wrote a column for The Dominion Post in December 2010 to explain why NZICA advocates so strongly for the consistent use of IFRS. The column also provides advice for shareholders on what to look for when considering pro forma financial information because *“in many cases you would be hard pressed to understand the numbers in the pro forma statement, and any reason for the adjustments may be incomprehensible”³.*

To avoid the outcome of misleading users of financial statements, the Securities Commission, in its Cycle 12 report on the financial reporting surveillance programme, stated that it continues to support additional disclosures that improve investor understanding *“as long as they are properly disclosed and communicated, consistently applied year on year and are not attempting in any way to substitute for the statutory financial information required by NZ GAAP. Neither should such non-GAAP measures be disclosed more prominently than financial*

information required by NZ GAAP”⁴. The Commission noted that it intended to closely review the use of non-GAAP measures and take action where required.

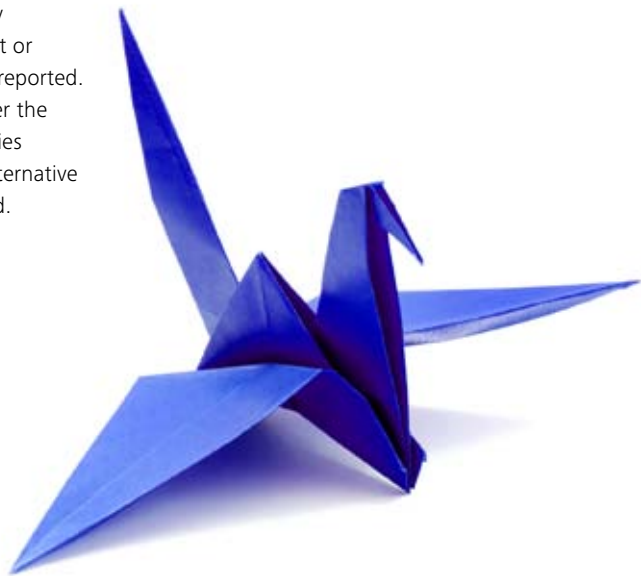
With the Financial Markets Authority taking over the role of the Securities Commission, the question is whether New Zealand issuers will be allowed to continue with this practice, particularly with the Australian regulator focusing its attention on the common use of alternative profit measures in Australia. In March 2011 the Australian Securities and Investments Commission (ASIC) released a draft guide on the use of non-conforming financial information. The ASIC Commissioner noted that *“While non-conforming financial information can provide useful information to investors and differing users of financial information, it also has the potential to be misleading if for example it is used to mask bad news or to smooth results given undue prominence”⁵.*

ASIC’s proposals look to largely prohibit the use of alternative measures in financial statements especially where they have previously been presented as subtotals on the income statement. There are limited exceptions where non-conforming information will be allowed, for example, in the segment reporting note, to explain the basis of director or executive remuneration where not based on statutory profit, to outline compliance with debt covenants, or where necessary for the

financial statements to provide a true and fair view (expected to be rare). The proposals state that if non-conforming financial information is provided in documents accompanying financial statements (such as director reports, market announcements etc.) and in transaction documents (prospectuses etc), certain principles should be followed.

New Zealand companies will have to wait and see whether anything is formally introduced in New Zealand to restrict or guide how alternative measures are reported. In the interim entities should consider the commentary provided by the Securities Commission and ensure that their alternative measures are appropriately explained.

This publication considers the practice of reporting underlying profit based on a sample of one hundred 2010 annual reports, makes reference to guidance released in this area and considers what entities should think about when using underlying profit measures.



¹Brian Gaynor *Crisis of accounting's double standards*. www.nzherald.co.nz, 27 November 2010.

²Ashley Balls *Issues with Balls - Crisis in Euroland: does it matter here*. NZ Business, 1 February 2011.

³Terry McLaughlin *Adopting IFRS made more sense than some pro formas*. The Dominion Post, 28 December 2010.

⁴New Zealand Securities Commission *Financial Reporting Surveillance Programme - Review of Financial Reporting by Issuers, Cycle 12*. April 2011.

⁵Australian Securities and Investments Commission *Consultation Paper 150 - Disclosing financial information other than in accordance with accounting standards*. March 2011.

What we found – underlying profit in practice

Deloitte analysed the 2010 published annual reports of 100 entities in order to determine the extent of reporting 'underlying profit'.

87 companies provided 214 alternative earnings or profit figures. A wide range of terms are used to describe these alternative earnings figures such as 'underlying earnings', 'EBITA', 'EBITDA', 'EBITDAF', 'distributable profit', 'net earnings/profit before abnormal/unusual items' and more. Only 18 of these companies presented one alternative measure with other entities presenting up to five different measures of profitability. In several cases a measure was provided before and after tax, but in the main these had different exclusions adding complexity for the reader.

Is underlying profit disclosed more prominently than statutory profit?

As noted on page 2, the Securities Commission has stated that non-GAAP measures should not be disclosed more prominently than those required by NZ GAAP. 34 companies emphasised their alternative measure in the annual report with little or no discussion on statutory profit. As the Securities Commission only released this commentary in October 2010 we expect that this practice will change.

Where is underlying profit disclosed?

Companies provide information about underlying profit in a variety of places, often with multiple references throughout the annual report. The most common places for discussion as noted in Figure 1 were in the annual report, either in the Director or CEO commentary or in a table of financial highlights (such as a five-year summary), and in many instances both. Also common was a subtotal on the face of the income statement. A few companies provided the alternative measure/s in the annual report inside cover along with other financial and non-financial statistics.

Only 22% of measures were also shown in the segment reporting note. While not all companies in our sample are required to comply with NZ IFRS 8: *Operating Segments* (as they are not issuers), this suggests that some companies have chosen to present their results to investors in a different way to how the business is reported internally as set out in the segment reporting note.



Figure 1: Where do companies discuss underlying profit?

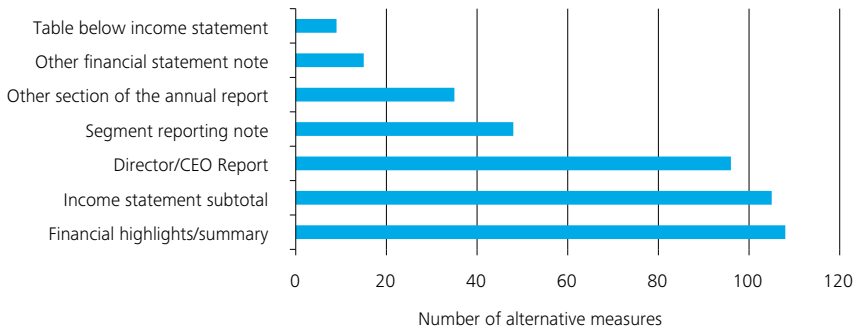
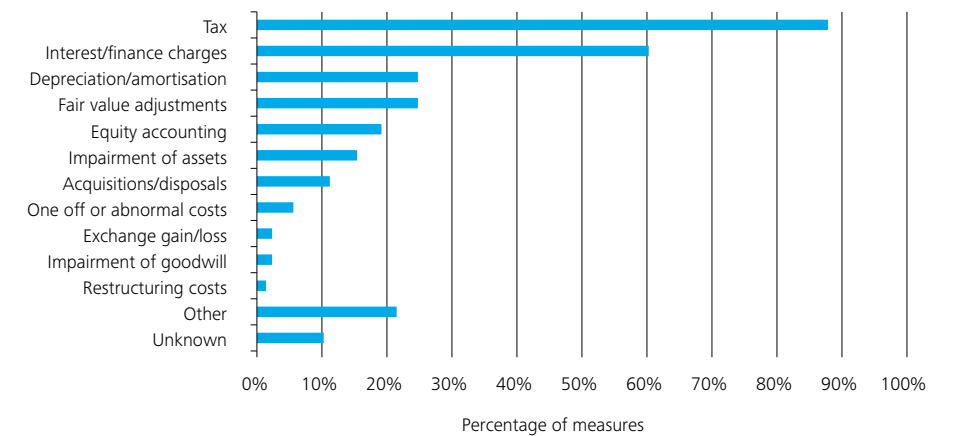


Figure 2: What are the adjustments made to statutory profit to obtain underlying profit?



What are the adjustments made to statutory profit to obtain underlying profit?

Figure 2 above shows the nature of the main adjustments made by companies to arrive at the alternative measures. Many companies start with EBIT (with 127 measures excluding both interest and tax) and then make further adjustments.

It isn’t surprising that fair value adjustments, impairments and acquisitions and disposals (asset or business gains/losses) feature highly given the current economic environment. Depreciation/ amortisation also featured highly as companies looked to remove items that were ‘unrealised’ (effectively non-cash) from statutory

profit. As NZ IAS 1: *Presentation of Financial Statements* requires disclosure of equity accounted earnings on the face of the income statement, 41 measures excluded this figure.

Only 12% of the measures included the tax effect of adjustments made to come to a post tax measure, with the clear majority providing underlying profit before tax.

As a result of the tax law change in May 2010 to remove the ability to claim depreciation deductions on long life properties, many entities had to record increased deferred tax liabilities with the corresponding entry to the tax expense line of the income statement. 20 of the measures made specific reference to

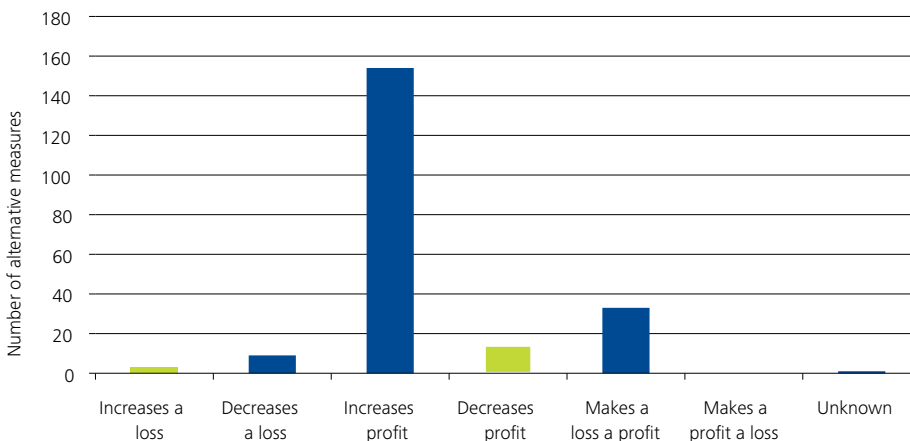
removing this increased 'one-off' tax expense. Of these, six measures were provided solely to exclude the tax expense impact of this change to depreciation deductions.

Of the 214 measures provided 75% were reconciled to statutory profit, either through presentation as a subtotal on the income statement, or through provision of a separate table or discussion of adjustments made in the annual report. 10% had reconciling information provided, but one of the reconciling items was for 'one off' or 'abnormal' items with no further explanation provided. The remaining 15% of measures did not have a clear explanation of all adjustments made between the measure and statutory profit.

How does underlying profit compare to statutory profit?

In most cases (72%) underlying profit was greater than statutory profit, 16% turned a statutory loss into a profit, and 4% reduced a loss. Only 8% posted a figure that made their performance look worse than the statutory result, as reflected in Figure 3. It was not clear for one measure which was provided in percentage terms only in comparison with the prior year.

Figure 3: How does underlying profit compare to statutory profit?



Guidance on presenting underlying profit

NZ IFRS	New Zealand Securities Commission	Australia
NZ IAS 1 (in the Basis for Conclusions) notes that it would be misleading to exclude items of an operating nature from the results of operating activities (such as inventory write-downs, restructuring and relocation expenses, depreciation and amortisation).	- Recommends following the principles set out by the Committee of European Securities Regulators (CESR). These guidelines recommend that alternative performance measures are: - determined following the IFRS principles of understandability, relevance, reliability and comparability - clearly defined, with disclosure of the basis of calculation and noting that they are not prepared in accordance with the accounting standards - presented in addition to defined GAAP measures such as through reconciliation - presented with comparatives for periods covered by the audited financial statements - consistently presented - not presented more prominently than the GAAP measures - presented with explanation as to the reason for the measure (goes to relevance), and - disclosed with a comment as to whether they have been subject to audit or review, with an opinion expressed by the auditor if relevant.	- The Financial Services Institute of Australia (FINSIA) and the Australian Institute of Company Directors (AICD) issued <i>Underlying Profit: Principles for Reporting of Non Statutory Profit Information</i> (available at www.companydirectors.com.au) – the principles are consistent with the CESR guidance referred to by the New Zealand Securities Commission. - The Australian Securities and Investments Commission (ASIC) has released a draft guide for feedback which includes more stringent guidelines. In summary, ASIC: - proposes to prohibit the presentation of alternative profit measures in financial statements with limited exceptions - provides guidance when alternative measures are included in documents accompanying financial reports (such as the director’s report or CEO report, market announcements etc.), and - supports disclosure in transaction documents in order to show users the effects of proposed transactions with guidelines on use provided.

The determination of what adjustments are made to derive underlying profit is a subjective process. The FINSIA/AICD principles note that the following items should not be excluded:

- hedging profits and losses for a company that has a hedging policy relating to its underlying business, as these would be normal items,
- employee share scheme balances as these are a real cost to shareholders, and
- amortisation and depreciation, unless there has been a change to these resulting from a significant event.

ASIC's consultation paper also notes that:

- impairment losses and restructuring costs are likely to be of a recurring nature in many businesses so should not be referred to as non-recurring. If they are excluded the underlying profit should not be described in a way that implies that these items are not an integral part of the performance of the business, and
- fair value movements reflect the volatility that exists in an entity's underlying business and avoids distortion or manipulation of results by the selective realisation of assets. If these are to be excluded additional guidance is provided for entities to follow.

Conclusion

The New Zealand and Australian regulators have noted that there may be situations where users of the annual report and financial statements need additional information in order to better understand aspects of the performance on an entity. Where necessary, directors should carefully consider the purpose of the measure being provided and ensure that this purpose is explained with a clear reconciliation back to statutory profit. The questions for directors set out overleaf will aid in this consideration as will the following illustrative disclosure.



Questions Directors should ask

- Where an alternative profit measure (referred to as 'underlying profit') has been used (such as EBITDA), is this an appropriate way to measure performance and in narrative reporting is it clear which measure is being talked about and why?
- Are the adjustments consistent with other industry players? If not, why?
- Should the board obtain assurance on underlying profit? If yes, from whom?
- Is the alternative profit measure used to determine executive remuneration measures? Are the adjustments made from statutory profit to underlying profit appropriate?
- Has the Securities Commission's guidance on disclosure for alternative measures been applied:
 - What is the purpose of reporting the alternative measure selected, and has this purpose been explained in the annual report?
 - Is there a reconciliation explaining the calculation of underlying profit and how it relates to the statutory profit, and has it been presented in a balanced manner?
 - Is the approach to reporting adjustments transparent and comparable between reporting periods?
 - Is statutory profit disclosed more prominently than the underlying profit?
- Where is the appropriate placement for this information?
- As underlying profit often shows how the board and management view the business, should it be (and is it) consistent with the segment note in the financial statements (which is based on internal reporting)?



Appendix Illustrative underlying profit disclosure

The following example is illustrative only. The purpose of the underlying profit figure and particular adjustments to be included when determining underlying profit will vary between companies. Where this disclosure is provided in an annual report (such as in Chairman or CEO commentary) it should not receive greater prominence than commentary on statutory results.

The company uses underlying profit to comment on its financial performance. Underlying profit provides useful information on the 'normalised' profit of the company, excluding significant one-off gains/losses and expenses including their tax effect. Underlying profit is the measure used internally to evaluate performance, to establish strategic goals and to allocate resources.

This is a non-GAAP financial measure and is not prepared in accordance with NZ IFRS. Underlying profit is not a uniformly defined term and accordingly may not be comparable with measures used by other companies. Non-GAAP measures should not be viewed in isolation, nor considered as a substitute for measures reported in accordance with NZ IFRS.

The following table shows the adjustments made to statutory profit in order to derive underlying profit.

	Group		Company	
	20X1	20X0	20X1	20X0
	NZ\$'000	NZ\$'000	NZ\$'000	NZ\$'000
Net profit after taxation	63,128	67,528	56,172	52,312
Less: Gain on sale of business	(12,150)	-	(12,150)	-
Add back: Debt issue costs ⁽¹⁾	-	1,070	-	1,070
Add back: Provisions for faulty product ⁽²⁾	22,050	-	-	-
Tax effect of adjustments	(2,970)	(321)	3,645	(321)
Underlying earnings after tax	70,058	68,277	47,667	53,061

Notes:

(1) In 20X0 the company considered doing a debt issue to raise funds for a potential asset purchase. The asset purchase and debt issue did not go ahead so these costs were expensed as part of net profit after taxation.

(2) The company has recalled a product identified as faulty. This significant event is outside the normal level of warranty claims for products and has therefore been excluded in deriving underlying profit.



The Deloitte Financial Reporting Survey Series

This publication is Issue 6 in our Financial Reporting Survey Series in which we consider a series of questions regarding the financial reports of a sample of New Zealand entities. This publication is an update of issue 3 which considered underlying profit disclosures in the 2009 annual reports of a smaller sample of companies.

This issue focuses on the annual reports of a sample of 100 entities with 2010 balance dates. The entities in our sample are primarily derived from listed and other large New Zealand companies with publicly available financial information. More information on the sample can be found in Issue 5. Our previous issues released in 2010 (issues 1 – 4) were based on June – September 2009 financial statements. Other issues in the series available at June 2011 include:



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