



NON-GAAP PERFORMANCE MEASURES – AN ALTERNATIVE OR NOT IN THE COVID-19 ENVIRONMENT

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Abstract: *Non-GAAP performance measures, also referred to as alternative performance measures (APMs), are company’s financial metrics that fall outside the scope of the applicable financial reporting framework and are considered an efficient tool for communication with the stakeholders. As the novel coronavirus tend to impact significantly companies’ financial position, performance and cash flows, a recent discussion was initiated about the relevance of adjusting the existing APMs and introducing new APMs. In light of the ongoing pandemic, this paper is aiming to focus attention of practitioners and academics on the use of APMs in the Covid-19 environment. Their relevance and reliability are discussed through the lens of the guidance, issued by the International Organization of Securities and Commissions, the European Securities and Markets Authority and the SIX Swiss Exchange.*

Key words: *alternative performance measures, Covid-19, adjustments, relevance and reliability.*

Setting the scene

In 2015 the European Securities and Markets Authority (ESMA) published guidelines on alternative performance measures (APMs), addressed to issuers of securities traded on a regulated market as well as to persons responsible for publishing regulated information such as management reports disclosed to the market in accordance with Transparency Directive (Directive 2004/109/EC) and prospectuses under Prospectus Directive (Directive 2003/71/EC) [1], [2]. In the context of those guidelines, the APSs are considered financial metric of company’s financial performance, financial position or cash flows that might be historical or future oriented and fall outside the scope of the applicable financial reporting framework such as earnings before interest, taxes, depreciation and amortisation (EBITDA), net debt, cash earnings, etc. APMs might be presented in a variety of documents issued by a company as press releases, periodic reports such as Management’s Discussion and Analysis, specific reports and disclosures provided to securities regulators and stock exchanges, etc. [3]. Usually the non-GAAP performance measures are derived from the financial statements by adding or subtracting amounts from the presented figures. For instance, in case of applying International Financial Reporting Standards (IFRSs), the adjustments are made to the line items of the statement of profit or loss and other comprehensive income, the statement of financial position or the statement of cash flows [4].

The use of APMs is recently reconsidered in light of the pandemic outbreak and the heightened uncertainty. Many businesses have been significantly impacted and the consequences of Covid-19 might comprise of operational shutdowns, reduced demand of products/services, higher levels of indebtedness, reduced access to additional financing, etc. that deteriorate entity’s operating results and financial position [5]. As the novel

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coronavirus tend to affect significantly companies' financial position, performance and cash flows, a recent discussion was initiated about the relevance of adjusting some non-GAAP financial metrics. They are considered an efficient tool for communication with the stakeholders especially in Covid-19 environment as they might provide useful information for supporting their decision-making process. In particular, some companies attempt to extract losses from their performance measures that were incurred due to the pandemic and the forced lockdowns.

As a response, in a span of a year, regulators issued a variety of guidelines and rules on the use of APMs in light of the current uncertainty resulting from the Covid-19 pandemic. In April 2020, ESMA published a special document comprising questions and answers on some recently raised issues related to APMs, including their application in the context of Covid-19. Further, in May 2020, the International Organization of Securities and Commissions (IOSCO) issued its Statement on Importance of Disclosure about Covid-19, followed by the Canadian Securities Administrators (the Canadian regulator) and the Financial Reporting Council of the United Kingdom [6]. The SIX Swiss Exchange (SIX) issued a special Directive on the use of APMs, in force from 2 January, 2020.

Aim of the paper

In light of the ongoing pandemic, this paper is aiming to gain discussions and shed light on the use of APMs in the Covid-19 environment. Their relevance and reliability are discussed through the lens of the applicable requirements, including IOSCO's statements and ESMA's guidelines. Furthermore, the research focuses on the recommended additional disclosures for companies to reflect how the pandemic outbreak has impacted their operations and financial performance as in the times of heightened uncertainty more complexities are added to the financial statements for reporting the impact of Covid-19. Some recent publications are reviewed for the purpose of assessing the relevance of adjusting the non-GAAP performance measures to reflect the novel coronavirus implications on businesses.

Alternative performance measures – a regulation overview

ESMA's guidelines

We will start our regulation overview with ESMA's Guidelines on APMs issued in 2015 and later complemented by the Q&A document, published in 2020. A brief summary of the initial guidelines is provided in table 1.

Table 1. Summary of ESMA's guidelines on APMs

Guidelines of ESMA/2015/1415en
<i>Disclosure principles – the following information should be provided:</i>
• APMs, their components and the adopted basis of calculation
• Details of any material hypothesis or assumptions used
• Whether the APMs or any of its components relate to the (expected) performance of the past or future reporting period
<i>Presentation</i>
• Definitions of all APMs used must be disclosed in a clear and readable way
• Misleading messages to users must be avoided through meaningful labeling of APMs reflecting their content and basis of calculation



<i>Reconciliations</i>
<ul style="list-style-type: none">• A reconciliation of the APM to the most directly reconcilable line item, subtotal or total presented in the financial statements of the corresponding period should be disclosed• The most directly reconcilable line item, subtotal or total presented in the financial statements relevant for that specific APM should be provided
<i>Explanation on the use of APMs</i>
The use of APMs should be explained to allow users to understand their relevance and reliability
<i>Prominence and presentation of APMs</i>
<ul style="list-style-type: none">• APMs should not be displayed with more prominence, emphasis or authority than measures directly stemming from financial statements
<i>Comparatives</i>
<ul style="list-style-type: none">• APMs should be accompanied by comparatives for the corresponding previous periods• In situations where APMs relate to forecasts or estimations, the comparatives should be in relation to the last historical information available• Reconciliations for all comparatives should be presented
<i>Consistency</i>
<ul style="list-style-type: none">• The definition and calculation of an APM should be consistent over time• In case an APM is no longer presented, the reason for considering that this APM no longer provides relevant information should be explained

Source: [4], pp. 7-10.

Guidelines related to consistency issue are very important in light of the Covid-19 pandemic due to the recent discussions about the possibilities for adjustments of existing APMs and the challenges of their modification. Redefinition of an APM is considered an exception and in such a case the issuer or the person responsible for the prospectus should explain the changes as well as the reason why they provide more reliable and relevant information on the financial performance. Moreover, comparative figures should be restated and provided to users.

In the Q&A based guideline of ESMA, issued in 2020, the question of how an issuer should present the impact of Covid-19 to agree with the 2015 initial document was discussed. The European regulator refers to the required consistency of APMs over time and recommends issuers to improve their disclosures and explain the impacts of the pandemic by including narrative information in the communication documents instead of making adjustments to APMs or using new APMs with the purpose of depicting Covid-19 implications. Such explanations may include narrative information on how Covid-19 impacted or is expected to impact their operations and performance. They might also reveal details on how the novel coronavirus has affected the components of APMs as well as the embedded assumptions and estimates used in the calculations of the non-GAAP performance measures such as impairment losses and grants received [7].

IOSCO Statement on Non-GAAP Financial Measures

In June 2016, IOSCO published its final Statement on Non-GAAP Financial Measures to assist issuers in providing clear and useful disclosure for investors and other users of non-GAAP financial metrics. It should be considered as a frame of reference for the disclosure of non-GAAP performance measures that might contribute to the reliability and comparability over time of APMs and reduce the potential for misleading disclosure [3]. The Statement is consistent with ESMA's guidelines from 2015.

SIX Directive on the use of APMs

The Directive on the use of APMs (DAPM) was issued by the SIX Swiss Exchange in June 2019 and is in force for financial years beginning on or after 1 January 2020. It applies to all issuers that are on SIX Swiss Exchange Ltd despite the location of their registered offices. In particular, DAPM regulates the information, disclosed by issuers for the purpose of maintaining listing, and which contains APMs such as annual reports, management commentary and press releases relating to the periodic financial reporting. [8]

The comparative analyses between ESMA's guidelines from 2015, IOSCO's Statement from 2016 and DAPM shows a similar definition of APMs and consistency regarding issues related to presentation, reconciliation, consistency, labeling and accompanying explanations.

IFRSs – IAS 1 Presentation of financial statements

IFRSs provide some guidance on the use of APMs although they are not specifically defined. According to paragraphs 85 and 85A of IAS 1, an entity shall present additional headings and subtotals in the statement of profit or loss and other comprehensive income when such presentation is relevant to an understanding of the entity's financial performance. These amounts should be comprised of line items made up of amounts recognised and measured in accordance with IFRSs. They should be presented and labelled in a clear and understandable manner and be consistent from period to period. Furthermore, it is required these headings and subtotals to be displayed with no more prominence than the required ones under IFRSs. [9]

The alternative performance measures and Covid-19

APMs are usually used to show an operating result that is free of infrequent and non-recurring events and transactions, as the operating result reported under the applicable financial reporting framework is crucial for the companies in their communication with the existing and potential shareholders. The latter make their investment decisions based on company's financial statements that are past oriented and other published information. Examples of APMs, provided in [8] and [10], include: operating earnings, cash earnings, earnings before non-recurring expenses, EBITDA, net debt, organic growth or similar terms designating adjustments to line items of statement of profit or loss and other comprehensive income, statement of financial position or statement of cash flows. Physical measures such as number of tones or non-financial performance measures as well performance measures defined in other regulations applicable to issuers (e.g. solvency) are excluded from APMs. Adjustments of EBIT/EBITDA for restructuring expenses or for acquisition related expenses are also considered non-GAAP financial metrics [11]. According to [8], financial ratios that are calculated using figures directly stemming from the financial statements such as IFRSs figures are also treated as APMs unless they are disclosed in accordance with applicable legislation, other than the applicable financial reporting framework.

The pandemic outbreak is a unique and definitely infrequent event as the last similar event was the outbreak of the Spanish Flue in 1918. Existing and potential investors should have a profound understanding on how the pandemic impacted the business and what are the current and potential financial implications. For instance, they might need additional information on how Covid-19 has affected company's financial performance to understand the current and past financial results and forecast the future returns in the evolving uncertainty [11]. Transparency and reliability have never been such important than in the Covid-19 environment [12]. For example, some companies introduced EBITDAC (earnings



before interest, taxes, depreciation, amortization and coronavirus) as a modification of EBITDA with a quantifiable adjustment, reflecting the Covid-19 implications [13].

In this context, a recent discussion has been initiated on the relevance of adjusting the existing APMs or introducing new ones that exclude the effects on company's financial results caused by the novel coronavirus disease. Many companies consider it as an opportunity for helping users of financial information to form an opinion about future results. In fact, the use of APMs is increasing as many companies see them as an important opportunity for communication with the stakeholders. When used appropriately, APMs might efficiently and effectively explain the pandemic effects on the reporting entity. Furthermore, company's management might use them to monitor the full impact of Covid-19 on every aspect of entity's activity. However, despite the usefulness of APMs, they might be transformed into a manipulation tool when masking the underlying performance of the company and misleading the users of financial information. That is way, regulators approach this hot issue with great caution and increase their focus on the use of the non-GAAP performance measures in the Covid-19 environment. Moreover, some of them published documents, reminding the requirements and guidelines already in force [6].

Extended disclosures – the recommended alternative

Grant Thornton provides a summary of some best practices for the use of APMs in times of pandemic that are in line with ESMA's guidelines. Companies might use APMs in different ways to reflect and communicate the impact of the coronavirus disease with users. One alternative is to add extra line items in their financial statements. A second option is to expand the provided disclosures in the notes. However, it is difficult and sometimes even impossible to isolate the Covid-19 impacts on the company's financial results and that is required for a consistent presentation through adjusting the existing APMs by eliminating the effects of the pandemic outbreak [11]. One of the implications are the additional costs of the entity incurred as a result of Covid-19, referred to as incremental costs in the relevant literature. However, the assessment of those costs requires significant judgements due to the complexity of separating them from other costs. At least, their identification implies disclosure of the criteria used. In addition, for avoiding ambiguity incremental costs need to be described clearly and precisely. They might be divided into two categories – costs that could be separable and costs that are unlikely to be separable. Examples that fall into the first category are: the additional cleaning costs, fees for termination of contracts, expenses for personal protection of employees, bonus payments to employees working at increased risk due to Covid-19. The second category might encompass: utility costs, insurance paid, increased costs for IT facilities because of the employees' remote work, excess capacity costs, etc. [6, p. 10]. Other incurred costs associated with the pandemic outbreak could be unrecoverable. The second alternative for companies operating in the Covid-19 environment is to expand disclosures in their financial statements. It is advisable to provide a detailed analysis of the coronavirus impact and present it as a separate note. The affected reporting periods should be also disclosed accompanied by relevant and reliable analysis.

In May 2020, IOSCO's published its statement on the importance of disclosure about Covid-19 that are consistent with ESMA's guidelines. In light of the pandemic, the securities regulator highlights the importance of transparent and complete disclosures that need to explain:

- how the pandemic affected and is expected to affect entity's financial position, performance and cash flows

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- how the entity’s strategy and targets have been adjusted to address the impact of the novel coronavirus
- measures taken for mitigating the effects of the pandemic outbreak.

The challenging issues may differ from one user to another due to industry of operations and other factors but there are few common areas that require significant judgements and estimates and thus need greater transparency in disclosures such as the going concern assessment [14], subsequent events, impairments of assets, including goodwill and financial assets, fair value measurements, etc. Presentation of forward looking information is encouraged as being relevant for projecting future cash flows in an environment of heightened uncertainty.

In regard of APMs, IOSCO states that their use should not be misleading. The non-GAAP financial measures need to be reliable and informative and users should apply them to supplement rather than to obscure the provided financial information that is in accordance with the applicable financial reporting framework. The document raises several important issues, including the recurring nature of some Covid-19 effects, the possibility for impairment indicators to exist prior to the pandemic outbreak and the inappropriateness of the use of hypothetical sales and/or profit measures. [15]

Conclusion

Companies should be aware that currently regulatory bodies are more focused on APMs. The non-GAAP performance measures are powerful tool for communication with the stakeholders as they might be used by the management to reflect the impact of Covid-19 pandemic as well as to express its strategy for operating in a challenging economic environment and mitigating the risks associated with the novel coronavirus induced disruption [16]. Instead of adjusting existing APMs or introducing new APMs, entities are encouraged to expand their disclosures and include narrative information to explain the Covid-19 impact on their financial position, performance and cash flows in the current and future periods [17]. As the guidelines on the use of non-GAAP performance measures vary among jurisdictions around the world, entities should follow guidance of the regulators in the jurisdiction to which they are primarily obligated to submit financial information.

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