Topic **Use of underlying earnings and non-GAAP measures**

Introduction

1. The use of pro-forma numbers provided by management plays an important role in providing investors with, what management of an entity often believe is, a more accurate or relevant view of how the entity is performing and its 'real' financial health as perceived by the management. These alternative measures are generally referred to as non-GAAP measures or underlying (adjusted) earnings, as they are alternative measures to those, which the entity uses to report in its financial statements, which would be its Generally Accepted Accounting Principles (GAAP).
2. This use of non-GAAP measures is driven by the fact that many people believe that the 'true' financial position of an entity is not adequately reflected by a single measure. Therefore the GAAP measures may not provide a complete view of the entity's operating performance and its potential for growth. The constraints of GAAP measures and desire of investors to obtain a more 'realistic' view of the entity have driven financial analysts to develop and rely on other evaluation methodologies.
3. For example, it may be critical, for management of an entity, when issuing a financial report following a change or transition in accounting practice to offer these pro forma numbers on what the performance would have been had there not been a change in the accounting principles.
4. What are the most common adjustments entities make to their reported numbers in the financial statements? This is not a highly researched area, especially for IFRS users. However, a report by Citigroup Global Market in November 2010

on adjusted earnings in Europe identified four main types of adjustments in reported earnings under IFRS:

(a) Non-recurring income/expense, which are often described as 'exceptional items' (restructuring costs, goodwill impairment, large provisions and write-downs).

(b) Accounting adjustments, often described as 'non-cash' charges (intangibles amortisation, volatile IAS 39 items, options expenses, pensions and deferred tax adjustments).

(c) Pro-forma adjustments for change in scope of business (acquisitions included for full year, or discontinued operations excluded).

(d) Non-core income/expense (gains/loss from fixed asset disposals, even if these occur regularly.

What are the problems with these alternative measures?

5. The main problem with these non-GAAP measures is that they lack the rigor and evolved literature to provide answers to the detailed issues in financial reporting. In addition they may not be consistently applied across companies and geographical areas as they are unregulated. These measures may not have a common definition and can therefore by differently applied in different jurisdictions. It can therefore be very difficult, if not impossible to compare these reported numbers between entities.

6. Regulators have tried to deal with the issues of non-GAAP measures by issuing regulations which require entities to clearly label these numbers as non-GAAP, setting requirements to present them outside the financial statements and requiring reconciliation of the non-GAAP numbers to reported GAAP numbers. However, how and to what extent regulators have issued regulation on this differs between jurisdictions.

7. Can this use of non-GAAP measures also be perceived as a problem for standard-setters? There are some that believe that is does. The widespread use

non-GAAP measures could be perceived as undermining the integrity of the numbers reported under GAAP and should therefore be of interest or even concern to standard-setter. Some might even go as far as saying that this the widespread use of these measures could indicate that the numbers presented in accordance with GAAP are not meeting the needs of users and standards-setters should take a look at the areas where non-GAAP numbers are produces to see if the is a need to amend the accounting standards dealing with these issues.

8. This is however as stated earlier the use of non-GAAP measures has not been widely researched and it might therefore be of interest to the IASB to see which are the areas where these measures are most used and whether for example the adoption of IFRS's in the past years has increased or decreased the use of these non-GAAP measures.

Question for Council members
Do Council member think that this is an issue which should be of interest to the IASB and do members think that the Council should investigate it further?