

Performance reporting and the pitfalls of non-GAAP metrics

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Speaker: Hans Hoogervorst, Chairman, International Accounting Standards Board

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Introduction

Ladies and gentlemen, distinguished academics, it is a pleasure to address this conference in my home country and especially in the lovely city of Maastricht.

My thanks go to the organising committee of the European Accounting Association for hosting this conference. I also thank Mark Vaessen, Chair of the FEE Corporate Reporting Policy Group, for inviting me to join this discussion.

The great American President Theodore Roosevelt once said that “Nothing in the world is worth having or worth doing unless it means effort, pain and difficulty.”

This is also true for our work. Our Standards are worthwhile, because they play a vital public interest role. IFRS Standards bring transparency, accountability and efficiency to the world economy. They help to keep capitalism honest. These values are firmly embedded in our mission statement that you see on the screen.

However, as Roosevelt predicted, the ‘doing’ part can be difficult. Setting accounting standards can be very challenging. Strong vested interests can lead to fierce battles, while conservatism can also result in resistance to change. That is not surprising, given that any change to the Standards will affect tens of thousands of companies around the world.

So the International Accounting Standards Board (the Board) cannot just say ‘we are right, and you are wrong’. Our standard-setting needs to be evidence-based. We need to provide robust information on the problem we are trying to solve. We need to tap into the best brains in accounting as we develop the underlying principles.

In this regard, academia has a very important role to play. You can provide the Board with research that helps us to separate out evidence from opinion. And that is what you do. I have had a long career in public service, working in the fields of social security, finance and the capital markets. Nowhere else have I seen the academic community play such an important role as in the field of accounting.

So, I am here today to roll out the red carpet. To invite you to become more involved in our work. There are plenty of opportunities for us to work together. Let me provide you with a couple of examples where this cooperation has been very effective.

Lease accounting

Perhaps the best example is provided by our recently issued Standard on lease accounting, IFRS 16.

Tackling lease accounting was always going to be difficult and controversial work. First, we had to make the case for change. To do that, the Board borrowed heavily from academic research that lay bare the faults in the old standard. One Board paper cited 30 different pieces of academic research. Your work helped convince the Board that improvements were needed, and that we needed to move forward with the project.

IFRS 8 Post-Implementation Review

Another example of our reliance on academic research is in the Post-Implementation Review (PIR) of IFRS 8 Operating Segments. As you may know, the Board now routinely carries out a PIR of major Standards—normally two years after their effective date. IFRS 8 was the first major Standard to be subject to a PIR.

Early on in the PIR process, we teamed up with Professor Ann Tarca, from Western Australia, who was working with us as an Academic Fellow at the time. Professor Tarca conducted a review of the academic literature on the effect of IFRS 8. Her study was one of the principal sources of evidence used during this PIR.

Submission of comment letters

Finally, academia contributes to our work regularly via the submission of comment letters. We like the independent quality of academic comment letters, which are unfettered by commercial interest. In particular, I would like to pay tribute to very high quality comment letters provided by the European Accounting Association on the *Conceptual Framework* and Disclosure Initiative projects. My staff always recommend that I pay close attention to your comment letters.

Future cooperation

Looking forward, where are the opportunities for future cooperation between the Board and the academic community?

First of all, our website contains a research centre which provides a shopping-list of projects where relevant accounting research is required. This includes research projects at different stages of the standard-setting process. There are also issues that are of more general interest to the Board. For

example, does frequent reporting encourage or discourage short-term behaviour by investors and preparers?

Second, there are various mechanisms for cooperation between the Board and the academic community. Once a year we host an Academic Research Forum, and this year's event will take place in Ontario, Canada on 15 October, in conjunction with the 2016 Contemporary Accounting Research conference.

We are also supporting the IAAER-KPMG project to encourage and fund research that informs the Board's standard-setting process. Those who receive research funding will benefit from feedback from established researchers, as well as from the Board and technical staff. We also have a one-year IASB academic fellowship for someone on sabbatical leave from their university.

Finally, our Education Initiative arranges a series of IFRS teaching workshops with academics around the world, like the one held this morning. These workshops provide information and resources to IFRS teachers and most of them are hosted jointly with academic associations alongside major accounting conferences.

So, in sum, the Board works very closely with the academic community and we look forward to continue working with you in the coming years.

Performance reporting

In the second part of my speech I would like to focus on a topic which will likely form a major part of our Agenda in the next couple of years: performance reporting. There is much inconclusive academic research on this topic, so there is a lot of work to be done by all of us!

The Board has already made progress on performance in our work on the *Conceptual Framework*. First of all, we have stated clearly that we see profit or loss as the primary indicator of performance. We have also made clear that other comprehensive income (OCI) should only be resorted to if it enhances the relevance of profit or loss. If these principles are used rigorously, in future the IASB should resort to OCI more sparsely than we have done in the past.

Current developments in pension schemes, for example, really cast doubts on the wisdom of including changes in the pension liability in OCI, rather than profit or loss. As you are aware, the current low interest rate environment has a devastating effect on defined benefit pension schemes. A recent report predicted that in the United Kingdom alone around 1,000 pension schemes are in such problems, that

it is very unlikely that the pensions will ever be paid in full. 400 companies are even considered likely to be bankrupted by their pension liabilities.¹

Recent events have shown that these dire predictions are already coming true. Some major British companies that currently face insolvency are showing big pension holes in their balance sheet.

While the pension liability is in full view on the balance sheet, its effect on performance is hidden in the semi-darkness of OCI. One cannot help wondering what would have happened if the pension liability were to directly hit profit or loss. It would have likely led to more realistic pension arrangements and/or more cautious distribution of dividends in many cases.

While I believe our work on profit or loss and OCI is significant, it certainly does not provide the final answer on performance. Indeed, our Agenda Consultation makes clear that we will most likely continue working on performance reporting after finalising the *Conceptual Framework*.

Many investors ask us to start by providing a definition of performance. However, I believe that trying to do so is as illusory as trying to define beauty. Beauty is a multifaceted quality which to a large extent is in the eyes of the beholder. Giving the term a 100 per cent objective definition is therefore next to impossible.

At the same time, most people recognise beauty when they see it. Let me give you the example of George Clooney. Personally, I fail to see why his athletic build, full head of hair and chiselled chin necessarily make him into a handsome devil. Yet, one has to accept begrudgingly that at least half of mankind seem to find Clooney simply irresistible.

Financial performance is not that different. It is multifaceted, to some degree subjective, but at the same time most people recognise it when they see it.

The question is whether IFRS Standards provide sufficient criteria by which performance can be judged by users of financial statements. Even if they look at profit or loss as the primary indicator of performance, users generally want to dig deeper so that they can better judge which components of income have a high degree of persistence or not. Drilling down to specific components of income is necessary in order to predict future cash flows.

The fact is that IFRS Standards prescribes very little in the way of formatting the income statement. Companies have considerable freedom in the way they present the components of income that make up profit or loss. As a result, there is little comparability above the bottom line, making it difficult for users to judge performance.

¹ Financial Times, 13-12-2015

There is another reason why the Board may have to do more in terms of formatting requirements of the income statement. There is growing evidence showing increasing use of non-GAAP measures, and of these measures becoming increasingly misleading.

More than 88 per cent of the S&P 500 currently disclose non-GAAP metrics in their earnings release. Of those releases, 82 per cent show increased net income and are clearly designed to present results in a more favourable light.² One study showed that the popular metric ‘core earnings’ was on average 30 per cent higher than GAAP earnings.³ While these are numbers for the American market, securities regulators in the world of IFRS Standards are also concerned that non-GAAP numbers are getting increasingly detached from reality.

In this light it is rather unnerving that most management remuneration packages are based on adjusted earnings. Knowing that even GAAP numbers can be vulnerable to earnings management, remuneration committees should be extremely wary to base their policies on earnings adjusted by management itself!

Recently, a shareholder revolt broke out over an increase in remuneration of the CEO of a major company which had just suffered a hefty loss. His remuneration was based on non-GAAP measures that almost completely insulate his income from factors that are considered to be outside the control of management.

One of these measures is an ‘underlying profit’ notion, which is also considered to be an important performance metric for the company as a whole. Well, whenever a company starts talking about ‘underlying profits’, I always get very curious what’s on top! In this case, the metric excluded costs such as restructuring and impairment charges. In my view, these costs are part of daily life of any big company and should be considered normal operating expenses.

Other adjustments were more reasonable, but the effect of all adjustments taken together was that they turned a loss of more than \$6 billion under IFRS Standards into an underlying profit of almost \$6 billion. So this non-GAAP metric was more than \$12 billion higher than the IFRS numbers! While it is true that the company in question has to deal with big expenses of a hopefully exceptional nature, this example shows what can happen when non-GAAP diverges too much from the actual losses experienced by shareholders.

The irony of this case is that the company’s shareholders had previously approved the remuneration policy, apparently without anticipating what the consequences could be. Clearly, both shareholders and remuneration committees need to be much more aware and critical of the role of non-GAAP measures in remuneration formulas.

² Audit Analytics, 1-12-2015

³ Citi research equities, 15-4-2016

Cutting back the use of non-GAAP measures is primarily the task of securities regulators. But the Board should also look at its own role in this matter. We have to acknowledge that non-GAAP measures are also popular because we provide too little guidance in terms of formatting the income statement. The enormous flexibility under existing accounting standards is an open invitation for non-GAAP to step in.

So it seems we have some work cut out for the Board here. There are some potential remedies that we can consider. We probably need to define more subtotals in the income statement. We may need to provide a principle-based definition of operating income which does not allow for obfuscating restructuring or impairment charges. We may need to create a rigorous definition of the commonly used non-GAAP metric EBIT. We may have to do all of the above— and maybe more. We may want to look for better solutions for some elements of income and expense that are currently parked in OCI. There are many other issues we may have to delve into.

I believe the Board should try to provide more rigorous definitions of performance metrics above the bottom line. These could provide more reliable information to the investor than the sugar-coated realm of non-GAAP. We have to give the investor more tools to decide whether a company is a George Clooney or the Hunchback of Notre Dame.

Having said all this, I do believe that the bottom line of the income statement will always remain the most important performance measure over time. A quote of Warren Buffett best expresses why I think this to be the case. Buffett once expressed his deep suspicion of companies that trumpet earnings projections and growth expectations. 'Businesses seldom operate in a tranquil, no-surprise environment, and earnings simply don't advance smoothly'.⁴

This is not only a fair warning to preparers, it is also a reality check for users who make their living by forecasting earnings based on their perception of the persistence of earnings.

Economic reality is to a great extent unpredictable and very difficult to control by management. That is why I believe that ultimately the number that counts most is the unadjusted bottom line, where all elements of income come together, both recurring items and exceptional items, whatever those may be. No-one can predict the extent to which seemingly extraordinary elements of income are recurring and not. That is why it is important that the bottom line is as inclusive as possible and that it shows everything, warts and all.

⁴2002 Berkshire Hathaway Annual Report

Closing

Making progress in performance reporting is going to be a very challenging and we need all the help we can get. The academic community has a very important role to play. Please follow our work closely and provide us with your insights where possible. Thank you for your attention and I wish you a good conference.