

ORGANISATION

What to consider when reporting underlying profit

Profit that is reported other than in accordance with International Financial Reporting Standards (IFRS) in annual reports, profit announcements or other company reporting is called non-IFRS profit. Non-IFRS profit can be described in a number of ways and the most commonly used is underlying profit/earnings.

Other terms include non-statutory profit, alternative earning, alternative performance measures, cash earnings/basis (commonly used in banks), non-GAAP earnings, earnings before interest and tax (EBIT) and earnings before interest, tax, depreciation and amortisation (EBITDA). Some not-for-profit entities might disclose a surplus from operational activities as an alternative performance measure.

The Australian Securities and Investments Commission (ASIC) defines non-IFRS financial information as 'financial information that is presented other than in accordance with all relevant accounting standards' and provides reporting guidance through its Regulatory Guide 230 *Disclosing non-IFRS financial information* (RG230)¹. There are other guides that have also been issued by regulators around the world. Despite this, many companies choose not to adopt this guidance, prompting media and consultants alike to question the source of the information and its applicability. This level of scrutiny is symptomatic of the five year low in business trust announced in the 2018 Edelman Trust Barometer.

Boards and audit committees have an important responsibility on behalf of company shareholders to oversee the financial reporting process. They act as a bridge between management and investors to evaluate the sufficiency of related disclosures in order to ensure that such disclosure is not misleading. In order to fulfil this core duty, and improve trust and confidence in business in the current climate, boards and audit committees should take a renewed look at their company's presentation of non-IFRS profit measures.

This guide will focus on the most commonly used measure of non-IFRS reporting – underlying profit – and provide some sample questions that may assist boards and audit committees to help determine whether:

- The entity is complying with the ASIC guidance on this topic; and
- Underlying profit measures are assisting analysts and investors to understand the business and its performance.

1. <http://asic.gov.au/regulatory-resources/find-a-document/regulatory-guides/rg-230-disclosing-non-ifrs-financial-information>

Why report underlying profit?

Reporting underlying profit is an increasingly common occurrence both in Australia and globally amongst listed companies. Research² indicates that the frequency of ASX 500 listed entities reporting underlying profit increased from 15 per cent in 2002 to 42 per cent in 2014. Non-listed entities (even not-for-profit entities) can also report on this measure, although this is less apparent than within listed entities and has not been the subject of any specific research.

A recent New Zealand study³ indicates that 88.5 per cent of respondents found alternative performance measures (or underlying profit) useful or sometimes useful. Respondents to the study use alternative performance measures to clarify, understand and assess a company's business, underlying performance and future prospects.

A recent publication of the Centre for Audit Quality⁴ reveals the following reasons as to why companies present underlying profit measures:

- **Demand from investment analysts** – it helps investors to better understand the company's underlying business performance or forecast the company's long-term value;
- **Desire to tell the company's story** – it provides users with insight as to how management evaluates the company performance internally. This may, in some cases, be an input into how the company compensates employees for company performance.

Why is it important to discuss underlying profit?

The questions included in this guide are meant to initiate a dialogue among directors, audit committees, management and auditors, on the underlying profit measures presented by companies. They are not meant to provide an exhaustive list of questions or be seen as a definitive checklist. Collectively they can assist directors and audit committees in assessing whether the information presented to investors and other stakeholders is meaningful and not confusing or misleading. This publication does not reproduce RG230. Each company will have specific considerations unique to the entity.

ASIC guidance on using underlying profit information

ASIC's main concern about the use of underlying profit is that the information is not misleading. RG230 applies to all documents issued in conjunction with the release of profit results (such as director reports, investor's reports, media releases, profit announcements, operating and financial review and the financial report).

In short, RG230 provides the following considerations:

- Underlying profit information may not be included in the financial statements;
- IFRS financial information should be given equal or greater prominence compared to underlying profit information, in particular IFRS profit;
- Underlying profit information should be:
 - explained and reconciled to the IFRS financial information;
 - calculated consistently from period to period; and
 - unbiased and not used to remove 'bad news'.

Board questions to support transparency

The following questions may help boards and audit committees consider the transparency of the company's underlying profit disclosures and whether improvement may be needed.

- What is the purpose of the underlying profit measure? Does management use the measure?
- Does the disclosure indicate why the directors believe presentation of this information is useful for investors? Would a reasonable investor be misled by the underlying profit measure?
- Has the underlying profit measure been given more prominence than the comparable statutory profit measure?
- Is the underlying profit financial information appropriately labelled to distinguish it from statutory financial information?
- Has a clear explanation been provided as to how the non-IFRS information is calculated and has a reconciliation between the underlying profit and IFRS financial information been provided?

2. J Coulton, A Ribeiro, Y Shan and S Taylor, 2016, *The Rise and Rise of Non-GAAP Disclosure: A survey of Australian practice and its implications*, Chartered Accountants Australia & New Zealand, November.

3. External Reporting Board, 2017, *Alternative Performance Measures: Are they meeting user needs*, July.

4. Centre for Audit Quality, 2018, *Non-GAAP Measures: A roadmap for audit committees*, March.

Board questions to support consistency and comparability

Questions should be focused on ensuring a consistent and comparable approach is taken from period to period without bias, thereby providing insight into a company's performance. According to a 2016 study⁵ in recent years there has been a tendency to report higher underlying profit compared to IFRS earnings, (61 per cent in 2014 compared with 44 per cent in 2000).

- Are the underlying profit measures presented by the company balanced, in that they eliminate similar items affecting both revenue and expense?
- Has the company presented this measure before? Has the company stopped presenting certain measures?
- If the measure or the calculation has changed from the previous period, is there an explanation about the nature of the change, the reasons for the change and the financial impact of the change?
- Do adjustments made in the current period have a relevant corresponding item as an adjustment in the comparative period?
- Have items described as 'one-off' or 'non-recurring' occurred in the past two years or likely to recur again in the next two years?

Board questions to support correct reporting procedure

These questions are procedural and relate to the processes that support reporting transparency, consistency and comparability.

- Does management maintain a policy on underlying profit measures? Does that policy address the calculation, presentation and disclosure of these measures?
- What is the source of information used in the calculation? Are there adequate controls and oversight in place over both the calculation and disclosure of the measure?
- Has management taken account of comments made by regulators (either general statements or statements made in financial reporting surveillance programs) in relation to the presentation of underlying profit information and considered these in making its own presentation?
- What level of involvement do the external or internal auditors have with the company's underlying profit measures? What feedback have they given management?
- Has a clear statement been made on whether the underlying profit information has been audited or reviewed in accordance with Australian Auditing Standards?

5. Coulton et al, 2016, op cit.

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