THE COMMITTEE OF EUROPEAN SECURITIES REGULATORS

Ref: CESR/05-178

CESR Recommendation on
Alternative Performance Measures

CONSULTATION PAPER

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Introduction

This draft recommendation contains several proposals to encourage European listed companies to provide the financial markets with appropriate and useful performance measures. These proposals are relevant since the traditional mandatory formats for consolidated financial statements do not hold due to the Regulation (EC) No 1606/2002 of the European parliament and of the Council of 19 July 2002 on the application of international accounting standards.

This draft recommendation relates primarily to:

- Definition of alternative performance measures.
- The presentation of alternative performance measures.
- Auditor's involvement.

This draft recommendation does not apply to financial information included in prospectus pursuant to EU legislation on prospectuses.

The draft recommendation has been prepared by CESR's operational Committee in the area of endorsement and enforcement of financial reporting standards in Europe (CESR Fin) chaired by M. John Tiner, Chief Executive Officer of the Financial Services Authority in the UK. The project of this recommendation was more specifically prepared by the Sub-Committee on International Standards Endorsement (SISE) chaired by M. Paul Koster, member of the board of The Netherlands Authority for the Financial Markets.

The present draft recommendation has been released on 11th May 2005 for public consultation. The public consultation will close on 11th July 2005. Responses to the consultation should be sent via CESR's website (www.cesr-eu.org) under the section "Consultations".

In order to give interested parties an opportunity to express their opinion on this paper, CESR will hold a public hearing (details for the public hearing will be available on CESR's website).

A. Background and objectives of this recommendation

1. The adoption of IFRS for European listed companies has an important consequence since the European Commission has announced[1] that the formats for financial statements, laid down in the 7th accounting Directive, will not be binding any more for consolidated accounts.

2. It can be observed that European listed companies widely use diverging financial data in press releases and other documents. In some cases these financial data are not extracted or can not be derived from the issuer's audited financial statements and in other cases these data are terms which are not defined. Both forms are representations of alternative performance measures. CESR expects that the adoption of IFRS and the elimination of binding formats will increase the use of alternative performance measures.

3. Most commonly used are alternative performance measures for revenues, earnings and earnings per share. However, this list is not exhaustive. There may be other alternative measures used, such as alternative cash flow measures and certain balance or interest covering ratio's.

4. In a cautionary statement of May 19th, 2002 IOSCO already identified the following terms: "operating earnings", "cash earnings", "earnings before one-time charges", "EBITDA - earnings before interest, taxes, depreciation, and amortization", "adjusted earnings" and similar terms denoting adjustments to net income.

5. Alternative performance measures may provide investors with appropriate additional information. Properly used and presented, these measures can assist investors in gaining a better understanding of a company's financial performance.

6. The objective of this recommendation is to provide guidance on the best way to appropriately use and present alternative performance measures. This recommendation is addressed to CESR members, as securities regulators who, in turn can recommend national listed companies to follow these guidance and inform investors of the risks of inappropriate use or misuse of alternative performance measures.

Question 1: should additional elements be considered in terms of background? Do you agree that current practice of presenting alternative financial performance measures justifies CESR's initiative? If not, please indicate why.

Question 2: do you think that a recommendation is a appropriate tool for dealing with this issue?

B. Definition of alternative performance measures

7. From IAS1, Presentation of Financial Statements (par. 81 and 83) and IAS33, Earnings per Share, CESR concludes that revenue, profit or loss and earnings per share are defined measures. CESR assumes all other financial performances measures are not defined.

8. IASB has underlined in IAS1, BC 12 and 13 that result from operating activities is not a defined measure. However, IASB considers excluding items clearly related to operations (such as inventory write-downs and restructuring and relocation expenses) to be inappropriate, just as excluding depreciation and amortisation expenses.

9. Par. 83 of IAS 1 outlines that issuers are required to introduce any other additional line items, headings and subtotals which are relevant to an understanding of the entity's financial performance.

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[1] see appendix 1 to this recommendation.

10. However, these line items, headings and subtotals are not defined in the general IFRS environment. Relevant though these measures could be in context of the income statement, they create a diversity of measures which do not contribute to transparency of the financial markets if they are not used appropriately.

Question 3: Do you agree with this definition of alternative performance measures? If not, please state your reason.

C. DIFFERENT TYPES OF FINANCIAL INFORMATION

11. IFRS provides guidance on regulated information such as financial statements and interim reports. Jurisdictions may have varying requirements as to the extent of regulation of other financial information, including management discussion and analysis (MD&A).

12. The principles described in this draft recommendation should however also apply to any kind of reporting (with the exception of prospectuses; see paragraph 15) to markets by issuers, once such reporting includes information of a financial nature.

13. Press releases, in particular those on the outcome of the financial year, are generally published earlier than the financial statements themselves and have wide press coverage. Whenever the press release includes alternative performance measures, a proper use of these measures is crucial for investors and transparent financial markets.

Question 4: Do you agree that the principles described in this draft recommendation are valid for any kind of reporting to markets by issuers (with the exception of prospectuses)? If not, please state your reason

D. RECOMMENDATIONS FOR THE PRESENTATION OF ALTERNATIVE PERFORMANCE MEASURES

(i) Scope

14. This draft recommendation applies to consolidated financial performance figures of listed companies and aims at transparent and unambiguous information on financial performance for investors. CESR encourages issuers to consider the following recommendations.

15. This draft recommendation does not apply to prospectuses published in accordance with EU legislation on prospectus. In February 2005, CESR published a recommendation for the consistent implementation of the European Commission's Regulation on Prospectuses n° 809/2004 (ref CESR/05-054b – this document is available on CESR's website). This recommendation on prospectus included a special section on "Financial data not extracted from issuer's audited financial statements" (paragraphs 95 to 97). The approach developed in this recommendation is similar to that followed in the present paper although the terminology used in the two papers is not identical due to the fact that their specific context is different.

(ii) Respect the IFRS-principles for financial statements for all types of financial information.

16. IFRS is based on several principles for financial reporting, notably included in the Conceptual Framework and IAS1, Presentation of Financial Statements. Examples of these principles are relevance, comparability, consistency and understandability. As such, these principles apply only to financial statements prepared under IFRS. CESR believes that, where relevant, issuers should always follow these principles for preparation and presentation of financial information.

(iii) Define alternative performance measures

17. Issuers should define the terminology used and the basis of preparation adopted (i.e. defining the components included in an alternative performance measure). Disclosure is especially important if market practice or academic theory is divided about the components of that measure.

(iv) Present alternative performance measures additionally to defined measures and explain the differences.

18. Issuers should present alternative performance measures only in combination with defined measures. Furthermore, issuers should explain the differences between both measures, and provide investors with enough information to fully understand the results and financial position of the company.

(v) Provide comparatives

19. If the company chooses to present alternative performance measures, it should provide comparable information for other periods as well.

(vi) Present alternative performance measures consistently over time

20. The definition of the measures should be consistent over time to avoid that investors' decisions are taken on wrong assumptions. In the exceptional circumstances that the issuer chooses to redefine its alternative performance measures, this should be explained thoroughly to investors, together with comparative figures.

(vii) Present defined measures with greater prominence than alternative performance measures

21. Issuers tend to present alternative performance measures with remarkable prominence, sometimes even more prominently than the defined measures directly stemming from financial statements. To ensure that investors are aware of the defined measures, CESR recommends that issuers present defined performance measures with greater prominence than alternative performance measures.

(viii) Explain why alternative performance measures are presented and how they are used internally

22. Issuers may internally use alternative performance measures for measuring and controlling the company's output. Generally issuers explain this as the reason to presenting alternative performance measures to investors. CESR expects issuers to give an explanation of the internal use of alternative performance measures in order to make investors understand the relevance of this information. This explanation is useful only when presented in direct relation to the alternative performance measures.

Question 5: Do you agree with the scope of this recommendation (paragraph 14) and the content of this recommendation (paragraph 16 to 22)? If not, please state your reason.

E. Auditor involvement

23. The auditor could have a role in assuring issuers provide reliable, comparable and consistent information to investors in relation to alternative performance measures. Therefore, CESR believes that management of the company should consider involving the auditor in relation to alternative performance measures.

Question 6: Do you agree with CESR's recommendation to involve the auditor in relation to alternative performance measures? If not, please state your reason

Appendix 1: Comments from the European Commission on IASs formats and a chart of accounts[2]

"IASs describe the manner in which the items disclosed on the face of the profit and loss account and the balance sheet should be determined.

In respect of the profit and loss account, IASs permit two approaches, disclosure by function or by nature. Where disclosure by function is adopted, certain additional information by nature is required. Disclosure by function or nature follows the same principles that determine the alternative formats set out in the Fourth Council Directive.

In respect of the balance sheet, assets are presented either in order of their liquidity or on the basis of a current/non-current distinction. These presentations are very similar to those envisaged by the Fourth Council Directive which requires distinctions between fixed and current assets and between short- and long term liabilities.

As IASs are only relevant to external, general purpose financial reporting, there are no explicit requirements in IASs concerning the structure of the internal management information (or chart of accounts) which must be maintained by the company; though clearly such internal information must be at least sufficient to support the preparation of the information required for external financial reporting.

As the IAS Regulation applies directly to individual companies, Member States cannot impose their own formats and therefore endorsed IASs shall be applied."

[2] Par. 4.2 of the EC Comments concerning certain Articles of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards and the Fourth Council Directive 78/660/EEC of 25 July 1978 and the Seventh Council Directive 83/349/EEC of 13 June 1983 on accounting, November 2003