The Association of
Accountants and
Financial Professionals
in Business

May 23, 2014

International Federation of Accountants (IFAC)
Professional Accountants in Business (PAIB) Committee
(via IFAC Website)

Dear PAIB Committee Members:

The Committee on Ethics (CoE) of IMA® (Institute of Management Accountants) is pleased to submit its views to the Professional Accountants in Business (PAIB) Committee of the International Federation of Accountants (IFAC) regarding its proposed International Good Practices Guidance *Developing and Reporting Supplementary Financial Measures.*

IMA is a global association representing more than 70,000 accountants and financial professionals in business. Our members work inside organizations of various sizes, industries, and types, including manufacturing and services, public and private enterprises, not-for-profit organizations, academic institutions, government entities, and multinational corporations.

The CoE is IMA's technical advisory committee on ethics-related matters. It is responsible for encouraging IMA members, their organizations, and other individuals to adopt, promote, and execute superior business practices in management accounting and finance consistent with IMA's mission by advocating the highest ethical principles. It maintains and promotes IMA's principal business and ethics guidance, the *IMA Statement of Ethical Professional Practice*, and oversees the administration of IMA initiatives designed to ensure compliance with the *IMA Statement*. The CoE also reviews and responds to research studies, statements, pronouncements, proposals, and other documents issued by domestic and international agencies and organizations.

History and Summary

Since IMA's membership includes professional accountants employed by small and midsize privately owned enterprises as well as large publicly held corporations, academics, and others, it has many times expressed its public opinion that there should be only one definition of Generally Accepted Accounting Principles (GAAP). We have consistently expressed the view that all companies of every size and industry, publicly or privately owned, should utilize the same principles to measure, recognize, and present the results of their economic activity.

Consequently, we believe that publication of good practice guidance that includes public reporting of measures of earnings containing significant deviations from GAAP as part of an entity's periodic GAAP-based financial reporting process is not in the best interests of professional accountants in business. For clarity, this opinion applies only to public reporting of earnings and not to public reporting of other measures or to internal or private communication of financial information.

Good Practice Guidance Should Improve Performance

We strongly support the PAIB's strategy of issuing guidance that will foster the adoption and use of good business principles and practices by professional accountants in business as they function in their various roles. We agree that such guidance should be applicable internationally to all companies in any industry, whether public or private, large or small.

We do not support the practice of U.S. companies publicly reporting non-GAAP enterprise earnings performance measures that are individually designed, are not subject to independent attestation, and may be inconsistent over time and noncomparable among entities in the same industry. This practice is likely to add complexity to the public reporting process and may cause confusion on the part of readers. It could also add to management's temptation to present better results that match market expectations and maximize their own bonuses. Empirical evidence in the U.S. shows this appears to be happening.[1]

Non-GAAP Measures of Earnings Should Not Overshadow GAAP Measures

GAAP measures of financial performance, such as earnings per share, are created through a transparent due process by independent bodies and public comment. They represent the gold standard of accounting and reporting and are designed to have all of the qualitative characteristics of useful information described in the Exposure Draft. Large and small companies spend considerable sums to gather information, prepare reports in accordance with GAAP, and have them independently audited. Encouraging the public reporting of alternative non-GAAP earnings measures is likely to dilute the value, acceptance, and utilization of GAAP and is likely to result in other adverse consequences.

In contrast, the determination of some non-GAAP measures of earnings is markedly different. Instead, these measures appear to be arbitrarily created by the reporting company to achieve a particular goal, usually resulting in larger reported earnings that tend to reach a predetermined level. They are not independently audited, may be inconsistent over time, and are not always comparable to similarly styled metrics used by others.

Adverse Effects of Non-GAAP Earnings Reporting

In 1973, the U.S. Securities & Exchange Commission (SEC) issued Accounting Series Release No. 142, "Conditions for Use of Non-GAAP Financial Measures," warning of possible investor confusion from the use of financial measures outside of GAAP. This release states, "If accounting net income computed in conformity with generally accepted accounting principles is not an accurate reflection of economic performance for a company or an industry, it is not an appropriate solution to have each company independently decide what the best measure of its performance should be and present that figure to its shareholders as Truth." A 2000 academic study shows a "dramatic increase in the proportion of corporate expenses that are classified as excluded" resulting in a "growing gap between GAAP EPS and the [Wall] Street numbers [non-GAAP]."[2]

One of the objectives of the Sarbanes-Oxley Act of 2002 (SOX) was to "eliminate the manipulative or misleading use of non-GAAP financial measures and, at the same time, enhance the comparability associated with the use of that information." A Stanford University research study in 2010 states that "Over half of all companies in the Dow Jones Index make such [non-GAAP] adjustments when reporting quarterly net income."[3] Recent anecdotal evidence shows that companies of all sizes in a variety of industries voluntarily report their periodic financial performance using non-GAAP measures of earnings.[4] It appears these companies may be attempting to divert attention from their financial performance on a GAAP basis. We believe non-GAAP financial measures of earnings should not supplant or become more important than GAAP measures.

A 2013 academic study reported that "managers who exclude recurring earnings components from their self-constructed non-GAAP earnings figures use higher impression management in earnings press releases."[5] An academic research study of U.S. disclosures in 2011 reports that "managers are opportunistically using the discretion afforded them in defining non-GAAP earnings to exclude enough

[1] Jeffrey T. Doyle, Jared N. Jennings, and Mark T. Soliman, "Do Managers Define Non-GAAP Earnings to Meet or Beat Analyst Forecasts?" August 2011, http://ssrn.com/abstract=1933882.
[2] Mark Thomas Bradshaw, Matthew Moberg, and Richard G Sloan, "GAAP versus The Street: An Empirical Assessment of Two Alternative Definitions of Earnings," June 2000, http://ssrn.com/abstract=232981.
[3] David F. Larcker and Brian Tayan, "Pro Forma Earnings: What's Wrong with GAAP?" August 20, 2010, *Rock Center for Corporate Governance at Stanford University Closer Look Series: Topics, Issues and Controversies in Corporate Governance No. CGRP-09*, http://ssrn.com/abstract=1678066.
[4] Curtis C. Verschoor, "Is Non-GAAP Reporting Unethical?" *Strategic Finance*, April 2014.
[5] Encarna Guillamon Saorin, Helena Isidro, and Ana Christina Marques, "Impression Management and Non-GAAP Reporting in Earnings Announcements," March 1, 2013, http://ssrn.com/abstract=2011889.

expenses to allow them to exceed analyst forecasts."[6] This study also found that this practice has begun to increase in recent years.

Another study in 2008 of European practices notes there is no European regulation of these voluntary disclosures and "What measures are disclosed and how much emphasis is given to them varies based on several firms' characteristics: size, performance, leverage, corporate governance practices, country, and industry affiliation. Finally, only 35% of the non-GAAP financial measures are explained by managers, but that this percentage has been growing."[7]

Management has High Motivation and Opportunity to Boost Reported Performance

In the United States, a considerable portion of senior management compensation is based on company performance. This is partially driven by U.S. tax law. Since passage of the Revenue Reconciliation Act of 1993, executive salaries more than $1 million are not tax deductible, but bonus payments of any amount are deductible if they result from the achievement of established performance goals. Thus management can be tempted to increase non-GAAP earnings to boost the amount of the bonus pool. A February 27, 2014, *Wall Street Journal* article notes that more U.S. companies are using nonstandard accounting measures to compute bonus payments.[8]

A 2013 academic research study on earnings quality concluded that even earnings based on U.S. GAAP were commonly manipulated to manage earnings, stating "in any given period, about 20% of firms manage earnings to misrepresent economic performance, and for such firms 10% of EPS is typically managed."[9] A 2013 global survey of investors published by the Association of Chartered Certified Accountants (ACCA) reports that "Nearly two-thirds believe that management has too much discretion in the financial numbers reported."[10]

We would be pleased to discuss our comments at your convenience. The attached Appendix answers the PAIB Committee's questions from Page 4 of the Exposure Draft.

Sincerely,

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[6] Doyle, Et. Al., August 2011.
[7] Helena Isidro and Ana Christina Marques, "Non-GAAP Financial Disclosures: Evidence from European Firms' Press Releases," *AAA 2009 Mid-Year International Accounting Section (IAS) Meeting*, September 11, 2008.
[8] David Hall, "The Morning Ledger: Nonstandard Measures Play Bigger Role in Bonuses," *The Wall Street Journal*, February 27, 2014.
[9] Illia D. Dichev, John R. Graham, Campbell R. Harvey, and Shivaram Rajgopal, "Earnings Quality: Evidence from the Field," May 7, 2013, http://ssrn.com/abstract=2103384.
[10] ACCA (the Association of Chartered Certified Accountants), *Understanding Investors: Directions for Corporate Reporting*, June 2013.

APPENDIX
GUIDE FOR COMMENTATORS

The Terminology

1. Does the title fit in the context of this IGPG or should it be replaced by a different or more refined title or term?

   We believe the title should clearly state whether it is applicable to external reporting, internal reporting, or both. We believe different guidance is required for external reporting than that for internal or private reporting.

2. Are the definitions in Appendix A suitable for this guidance? Can or should they be further clarified?

   We believe the definition of a supplementary financial measure should be expanded to include financial measures reported only internally or privately, not just measures that "add or omit items from the nearest GAAP measure," (paragraph 5.5). Examples could include discounted cash flow, return on investment, and analysis of cost variances.

   The definition also should include measures having no or only a remote relationship to GAAP, such as "same store sales" and details of loan agreement covenants.

The Principles

3. Do the principles cover all the fundamental areas for establishing a benchmark for good practice in developing and reporting supplementary financial measures?

   We believe a stronger term, such as "unbiased," should be added to the term "neutral."

The Guidance

4. Is the application guidance for each principle adequate to guide good practice?

   As stated in our letter, we believe that strong motivation exists for management to publicly report better earnings performance using non-GAAP rather than GAAP measures. Thus we fear any application guidance is not likely to result in best practice. Even specific rules are subject to clever manipulation by those searching for loopholes. We recommend further study of the subject of both public and private reporting of non-GAAP measures.

5. Is the disclosure guidance for supplementary financial measures adequate to guide good practice?

   We believe more study and consideration of public reporting of non-GAAP earnings performance measures is necessary.

6. Are there other resources on supplementary financial measures that should be considered for inclusion in the appendices?

   This subject is regularly covered in the financial media in the United States.

Other Issues

7. How useful do you find this IGPG?

   Its usefulness in its present form is limited because of the reasons previously stated.

8. Does there need to be additional IGPGs in the area of business reporting?

   We believe guidance for public reporting of non-GAAP financial measures should be separated from guidance appropriate for internal or private reporting.