Non-GAAP Reporting – Information Content and Intransparency

Dr. Karla Linden | University of St. Gallen
karla.linden@unisg.ch | +41 71 224 7418

Non-GAAP measures or Alternative Performance Measures (APMs) are financial metrics that are not defined in the applicable recognized accounting standards. Non-GAAP figures such as «Adjusted Profit», «Core EPS» or «Underlying net profit» have become an integral part of the reporting of many companies, also in the Swiss market. In fact, two thirds of all companies listed in the SLI use at least one, and on average even three non-GAAP earnings measures.

The companies emphasize that non-GAAP figures increase the information content and are a way of eliminating one-off costs, circumventing inflexible accounting standards and presenting the company's situation more truthfully. On the other hand, scientific evidence shows that non-GAAP figures are also used to embellish performance and (consciously) create intransparency. The fact that every third non-GAAP earnings measure influences the remuneration of the SLI management further aggravates the situation.

After the SEC, IOSCO and ESMA, the SIX has now also taken action: On 1 January 2019, it has put a binding guideline on non-GAAP reporting into force.

In a joint study with KPMG, the Chair of Accounting and Auditing at the University of St. Gallen examined the current status of non-GAAP reporting in the Swiss market. In doing so, we examined non-GAAP earnings measures «in a narrow sense» (i.e., excluding EBT, EBIT, etc.) of the 30 SLI companies for 2016 and 2017 with regard to their compliance with the SIX Directive, which was still a draft at that time. The aim was to show the status quo of non-GAAP reporting as well as possible fields of action and recommendations for the Swiss market.

In fact, the findings of other studies have also proved to be true for the Swiss market: More than 85% of all non-GAAP earnings measures are adjusted upwards, and on average, the absolute non-GAAP ratio is 67.5% higher than the GAAP ratio. This corresponds to an average increase in return on sales of 4.9%.

The transparency of non-GAAP reporting is not always given. For 53% of all non-GAAP earnings measures a definition was not available, in another 20% it was only indicated indirectly or insufficiently. The reconciliation, which is very important for investors and analysts, was missing for almost half of the non-GAAP figures. In addition, 62.5% of all non-GAAP figures examined were presented with more prominence than GAAP figures, which is likely to particularly deceive inexperienced investors.

Overall, there is still much to be done, and some multinationals such as Novartis or Roche already present their non-GAAP figures in a very transparent and comparable manner. Here, non-GAAP reporting can contribute to an increased information content.

The study shows that there is still considerable room for improvement in the use of non-GAAP reporting in the Swiss market. According to Art. 716a of the Swiss Code of Obligations, members of the Board of Directors are responsible for a company's reporting. It is therefore their task to ensure transparency and comparability of the financial data used and to avoid breaches of rules and loss of reputation. Specifically, it is recommended to design the process as follows:

- Analysis of existing reporting with regard to external requirements, best practices in the industry and alignment with the business model

⟶ Selecting few but appropriate non-GAAP figures.

- Design the non-GAAP reporting, including internal guidelines, adequate governance processes and structures as well as variable compensation

⟶ Take responsibility.

- The final non-GAAP reporting should be consistent, clear and transparent.

⟶ Strive for continuity.

As this article showed, non-GAAP reporting itself can be a valuable additional information source as long as it is carefully analyzed, guided and implemented.