"Profit, performance, perception": a research into the use of alternative performance measures in the European Union

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1 Introduction

A company’s financial statements must provide information about the performance of the company. The performance of a company can be measured and reported in various different ways and analysts, investors and other stakeholders in practice use various performance measures to make their decisions. The reporting of alternative performance measures increased significantly during the end of the last century and the beginning of this century and has become common practice in many countries. This raised discussions about the reporting motives that companies may have to either inform investors by providing relevant information or mislead them by strategically emphasizing information that provides a more favourable picture of the company’s results. These discussions started in the United States (US) and gained momentum in the European Union (EU) as a result of the EU wide adoption of International Financial Reporting Standards (IFRS) in 2005. The lack of detailed financial statement formats in IFRS compared to existing EU requirements in this regard caused concerns about decreased comparability of financial information and increased opportunities to use alternative performance measures to provide a more favourable picture of the company’s performance. Limited comprehensive evidence however exists about the use, strategic use and relevance of alternative performance measures that are reported by EU companies. This dissertation presents empirical evidence about the reporting of alternative performance measures in the EU based on a comprehensive manual analysis of approximately 17,000 EU financial statements for the period 1996-2007.

Chapter 2 of this dissertation provides an overview of relevant regulation and literature. It summarizes relevant accounting theories that explain why companies may be motivated to report alternative performance measures and why investor decision making may be affected by the choices that a company makes with regard to the reporting of alternative performance measures.
Voluntary disclosure of additional alternative performance measures often only concerns the provisioning of existing information in a different format or with a different emphasis. Based on the efficient market hypothesis, one could argue that the presentation format of financial information does not affect investors’ decision making when the information is already present in another form. The Incomplete Revelation Hypothesis introduced by Bloomfield (2002) and the Limited Attention Theory from Hirshleifer and Theo (2003) however provide a theoretical explanation of how the provisioning of alternative performance measures in financial information may affect investor decision making which is not necessarily in conflict with the efficient market hypothesis.

Furthermore, in chapter 2 a comprehensive overview is given of US research into the use of alternative performance measures, covering experimental research, capital markets based research into the relevance of various performance measures as well as investigation of actual reporting practices and their impact on investor decision making. The overall conclusion from both empirical and experimental evidence is that investors are affected by the presentation of information and the inclusion of alternative performance measures in financial reports. Furthermore, most alternative performance measures and additional break downs of net income that are reported by management in the US provide additional useful information to investors. However, the empirical evidence also indicates that management strategically emphasize measures that portray better performance. No final answer can be given yet about whether management provide alternative performance measures to inform or to mislead. EU research in this field is limited and this dissertation aims at filling that gap to be able to provide a more robust basis to ongoing discussions about the use of alternative performance measures in the EU environment.
Chapter 3 first investigates the magnitude of reporting of alternative performance measures in the EU and the development thereof as well as the type of alternative performance measures that are reported in the EU, focusing on performance measures that exclude depreciation and amortization and normalized alternative performance measures. Differences in the use of alternative performance measures in general as well as the type of measure that companies use are investigated focusing on the historical differences between EU code law and common law countries. Historically, accounting in code law countries has primarily been for creditors and tax purposes whereas in common law countries accounting has historically served the information needs of a dispersed group of outside shareholders. These differences have not only affected recognition and measurement rules and practices in those countries, but as the results presented in chapter 3 show also the type of alternative performance measures that are reported by companies in their financial statements. The differences are explained by these countries’ historical background rather than current institutional factors. Furthermore, the impact of the EU wide introduction of IFRS is investigated and the results are not conclusive about whether the implementation of IFRS had a significant impact on the reporting of alternative performance measures. Overall, the empirical results presented in chapter 3 indicate that the historical institutional origination and country setting still significantly influence the reporting of alternative performance measures and that this is only to a limited extent affected by the alignment of accounting policies or other harmonization efforts such as the implementation of IFRS. Furthermore, treatment of the EU as a homogeneous group when investigating (aspects of) the reporting of alternative performance measures is likely to result in misinterpretation of results, even when controlling for current institutional factors.

Companies may report alternative performance measures to either inform investors by providing information that is useful for decision making or to mislead them by providing information that
solely serves for portraying a more positive picture of their performance. In chapter 4 and 5 both motives are further explored. Chapter 4 investigates whether and which alternative performance measures are used by EU companies to strategically meet important earnings benchmarks. Differences in strategic use between code law and common law countries and the impact of the adoption of IFRS on the strategic use of alternative performance measures are investigated in response to concerns expressed about IFRS leaving more room for management decision making in this regard and anecdotal and US based evidence about strategic use of this flexibility.

Strategic use of alternative performance measures however does not mean that those alternative performance measures are irrelevant for decision making. Information that is strategically reported to the market may be very relevant at the same time. In order to understand how strategic motives and relevance interact, chapter 5 provides insight into the relevance of both types of alternative performance measures and explicitly relates the relevance of the reported performance measures to companies’ decisions to report such a measure or not. Furthermore, I investigate whether potential strategic motives that companies may have in making their decision to report alternative performance measures is reflected in the relevance of the measures that they report.
The relationship between the empirical research in chapter 3, 4 and 5 can be visualized as follows:

*Figure 1.1: relationship between empirical research in chapters 3, 4 and 5*

Finally, chapter 6 gives a summary of the major findings of this thesis and the overall conclusion.