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

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6 Summary and conclusions

This dissertation presents empirical evidence about the reporting of alternative performance measures in the EU. These results are based on a comprehensive manual analysis of 17,372 EU financial statements (including directors’ report and other information that is published in combination with the annual accounts) for the period 1996-2007. Companies increasingly report a wide variety of performance measures. Users of financial information in practice use many measures other than GAAP net income to assess the performance of a company. This increased reporting and use of alternative performance measures led to discussion and regulatory concerns, initially in the US and later also in the EU. Those discussions however did not lead to a definite conclusion about whether alternative performance measures are reported to inform or to mislead analysts and investors. Whereas proponents, such as many companies, point to the relevant information contained in the alternative performance measures, critics fear that investors are mislead by companies’ selectivity with regard to the alternative performance measures that they do or do not report. Regulatory concerns and SEC regulation following from it, led to a decrease in the reporting of alternative performance measures in the US. However, research provides mixed evidence about whether this reduction in reporting of alternative performance measures improved the overall quality and reliability of the information in financial statements and directors’ reports for analysts and investors.

The introduction of IFRS in 2005 further led to discussions in the EU regarding inconsistencies in the presentation of various performance measures in consolidated financial statements based on IFRS and the risk that the lack of detailed formats under IFRS would cause an increase in the use of alternative performance measures. The expressed concerns, from among others regulators and academics, are however primarily based on anecdotal evidence and research that has been
performed in the US environment whereas the EU financial markets and reporting environment are different from the US environment, specifically where it concerns the EU code law environment. There is limited research of this phenomenon in the EU and the research conducted so far is primarily limited to the individual country level, especially the United Kingdom (UK) which is a common law country.

In code law countries, accounting has historically been primarily for creditors and tax purposes. In common law countries, accounting has historically been primarily for a dispersed group of outside shareholders. I find significant differences in the use of alternative performance measures, specifically with regard to the type of measures that are used, between code law countries and common law countries. These historical differences result in EBITDA and similar measures being reported significantly more often in code law countries than in common law countries and normalized alternative performance measures being reported significantly more frequently in common law countries (than in code law countries). These differences are explained by these countries’ historical background rather than current institutional factors. The results are not conclusive about whether the implementation of IFRS had a significant impact on the reporting of alternative performance measures. The empirical results indicate that the historical institutional origination and country setting still significantly influence the reporting of alternative performance measures. 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 and governance factors. To draw reliable conclusions a distinction must be made in the type of alternative performance measures and between code law countries and common law countries.
I also find evidence for strategic use of alternative performance measures by EU companies in their financial statements. EU companies significantly more often report an alternative performance measure when this helps meeting a strategic earnings benchmark which is missed based on the company’s GAAP net income. I interpret this as strategic use of these alternative performance measures. Analysts and investors should be aware of such strategic motives and scrutinize alternative performance measures reported by management when strategic reporting motives may drive the performance measures that are reported.

Strategic considerations are a significant factor explaining the reporting of alternative performance measures in both code law and common law countries. EU companies significantly more often report an alternative performance measure when this helps meeting a strategic earnings benchmark which is missed based on the company’s GAAP net income which I interpret as strategic use of alternative performance measures. However, for certain strategic earnings benchmarks strategic use of alternative performance measures is more pervasive in common law countries where companies are generally more shareholder oriented than in code law countries. Contrary to concerns expressed by regulators and academics, the results do not provide evidence that the strategic use of alternative performance measures increased as a result of the introduction of IFRS. This finding should take away some of the concerns in relation to the current flexibility in relation to financial statements presentation in IFRS. It may also guide further discussions in the ongoing financial statements presentation project of the IASB and the FASB.

The general conclusion in chapter 4 that strategic considerations influence companies’ reporting of alternative performance measures adds to the debate about whether the reporting of alternative performance measures should be restricted or even forbidden. The fact that companies may be
strategically motivated to report a measure does as such however not mean that the information
that they report is irrelevant and restricting the use of alternative performance measures may result
in relevant information being withheld from stakeholders. Therefore, in chapter 5 I investigate the
relevance of alternative performance measures that EU companies report. I conclude that
alternative performance measures reported by EU companies are relevant in predicting future cash
flows and provide incremental information beyond GAAP net income in predicting one year ahead
operating cash flow. The decision to report an alternative performance measure however does not
appear to be driven by relevance as the primary motive since the incremental information is not
significantly larger for companies that report the alternative performance measure than for
companies that do not. Additionally, no conclusive evidence is found for strategic reporting
motives in relation to the reporting of alternative performance measures negatively affecting the
relevance of the information provided and thus even though strategic motives may influence
reporting decisions rather than relevance motives, this still results in relevant information being
provided to the users of financial statements via the reporting of alternative performance
measures. Based on these results, it may be more appropriate to criticize those companies that do
not report alternative performance measures, and do not prominently report this relevant
information, than those companies that do.

Overall, I therefore conclude that the reporting of alternative performance measures enriches the
financial information and that concerns in relation to strategic reporting behavior do not justify
imposing restrictions on the use of alternative performance measures. Prescribing the reporting of
both a normalized measure and a measure that excludes depreciation and amortization by all
companies in the EU would be a more appropriate response than forbidding or restricting the use
thereof. This would avoid strategic motives affecting the type of performance measures that are
provided to the users of financial statements while at the same time ensuring that relevant information continues to be provided to them.