17 July 2020
(Friday)

NON-GAAP FINANCIAL MEASURES

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(for KPMG Financial Reporting Webinar Series: Non-GAAP measures and the way forward for performance reporting)

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NON-GAAP FINANCIAL MEASURES

A. Using non-GAAP financial measures

- A non-GAAP financial measure is a numerical measure of an issuer's historical or future financial performance, financial position or cash flow that is not specified, defined or determined under the issuer's GAAP. Non-GAAP financial measures are often used in the annual reports, including in the business review or MD&A, to supplement information prepared in accordance with GAAP. There is generally no standardised definition and method for calculating the non-GAAP financial measures.
- In recent years, there is an increasing market focus on the use of non-GAAP financial measures. In April 2019, the Exchange published the Guidance Letter GL103-19 (https://en-rules.hkex.com.hk/sites/default/files/net_file_store/new_rulebooks/g/l/GL103-19.pdf) which provides guidance on the presentation of the non-GAAP financial measures in any documents pursuant to the Rules (such as financial reports, announcements and circulars), including the following:

Using non-GAAP financial measures

Key elements for presenting non-GAAP financial measures
(a) **Definitions –** Each non-GAAP financial measure presented should be defined and a clear explanation of the basis of calculation should be provided. Also, they should be clearly labelled in such a way that they are distinguished from GAAP measures. Labels should be meaningful and should reflect the composition of the measure.
(b) **Prominence –** Non-GAAP financial measures should not be presented with more prominence than the most directly comparable measure calculated and presented in accordance with GAAP.
(c) **Explanations for using non-GAAP financial measures –** Issuers should set out the reasons for presenting the non-GAAP financial measures including explanations of why the information is useful to investors, and for what additional purposes, if any, management uses the measures.
(d) **Reconciliation and nature of adjusting items –** Issuers should provide a clear and concise quantitative reconciliation from the non-GAAP financial measure to the most directly comparable GAAP measure presented in the financial statements. The adjustments should be explained. This helps to enhance transparency so that investors can understand how significant the variances are between GAAP and non-GAAP figures.
(e) **Comparatives –** Issuers should present comparatives and disclose non-GAAP financial measures consistently over time.

Recommendation

a. Issuers should take note of the requirement under MB Rule 2.13(2) / GEM Rule 17.56(2) such that any corporate communication (including financial reports) should be accurate, complete and not misleading. Issuers are also reminded that Code Provision C.1.5 requires that the board should present a balanced, clear and understandable assessment in annual and interim reports and other financial disclosure required by the Rules.

b. Non-GAAP financial measures are neither prohibited nor required. It is important that their use does not replace or obscure GAAP measures. Issuers should consider the Guidance Letter GL103-19 as an opportunity to step back and take a holistic view of their current non-GAAP financial measures and consider revising their disclosure.

c. In addition, issuers should establish written policies that provide guideline to follow when preparing and presenting non-GAAP financial measures. This would help promote consistency in the presentation of non-GAAP financial measures and the way they are calculated. Also, having policies in place can help in making judgments on the treatment of a one-time transaction in non-GAAP financial measures and avoid giving the appearance of “cherry picking” to achieve a positive measure.

d. Audit committee is recommended to assess management’s reasons for presenting non-GAAP financial measures; evaluate the sufficiency of the related disclosure that is consistent with the Rules and guidance; and determine whether the measures present a fair and balanced view of the issuer’s performance and position.

B. Examples from IPO vetting enquiries and FSRP review enquiries

i. Is the measure misleading?

ii. Is the non-GAAP financial measure presented necessary and appropriate for investors to understand the performance of the listing applicant?

iii. Is the measure presented with the most directly comparable GAAP measure and with no greater prominence than the GAAP measure?

iv. Is the measure appropriately defined and described, and is it clearly labeled as non-GAAP financial measure?

v. Does the reconciliation between the GAAP and non-GAAP financial measure clearly label and describe the nature of each adjustment, and is each adjustment appropriate? The reconciliation should begin with the GAAP measure (such as, profit for the year) and be reconciled to the non-GAAP financial measure.

vi. Is there transparent and company-specific disclosure of the substantive reason(s) why management believes that the measure is useful for investors and the purpose for which management uses the measure?

vii. Is the measure balanced (that is, does it adjust not only for non-recurring expenses but also for non-recurring gains)?

viii. Does the measure appropriately focus on material adjustments and not include immaterial adjustments that would not seem to be a focus of management?

ix. Do other listing applicants present this measure or similar measures? If not, why is this measure important to the listing applicant but not its peers?

C. Poor examples of non-GAAP adjustments

i. Adjust for share of losses of associates and joint ventures when they relate to the normal activities of the group.

ii. Adjust for fair value gains and losses for financial assets at fair value through profit or loss when they are recurring in nature.

iii. Lack of adequate explanation of reasons why the adjusting items were adjusted to arrive at “Adjusted EBITDA” or “Adjusted net profit” and also the lack of justification of why the non-GAAP financial measures were presented (i.e. how the measures were useful to investors).

In summary:

(i) Ensure proper explanations so that information is useful to investors!

(ii) Ensure no “cherry picking” to achieve a positive result!

Thank you for your kind attention