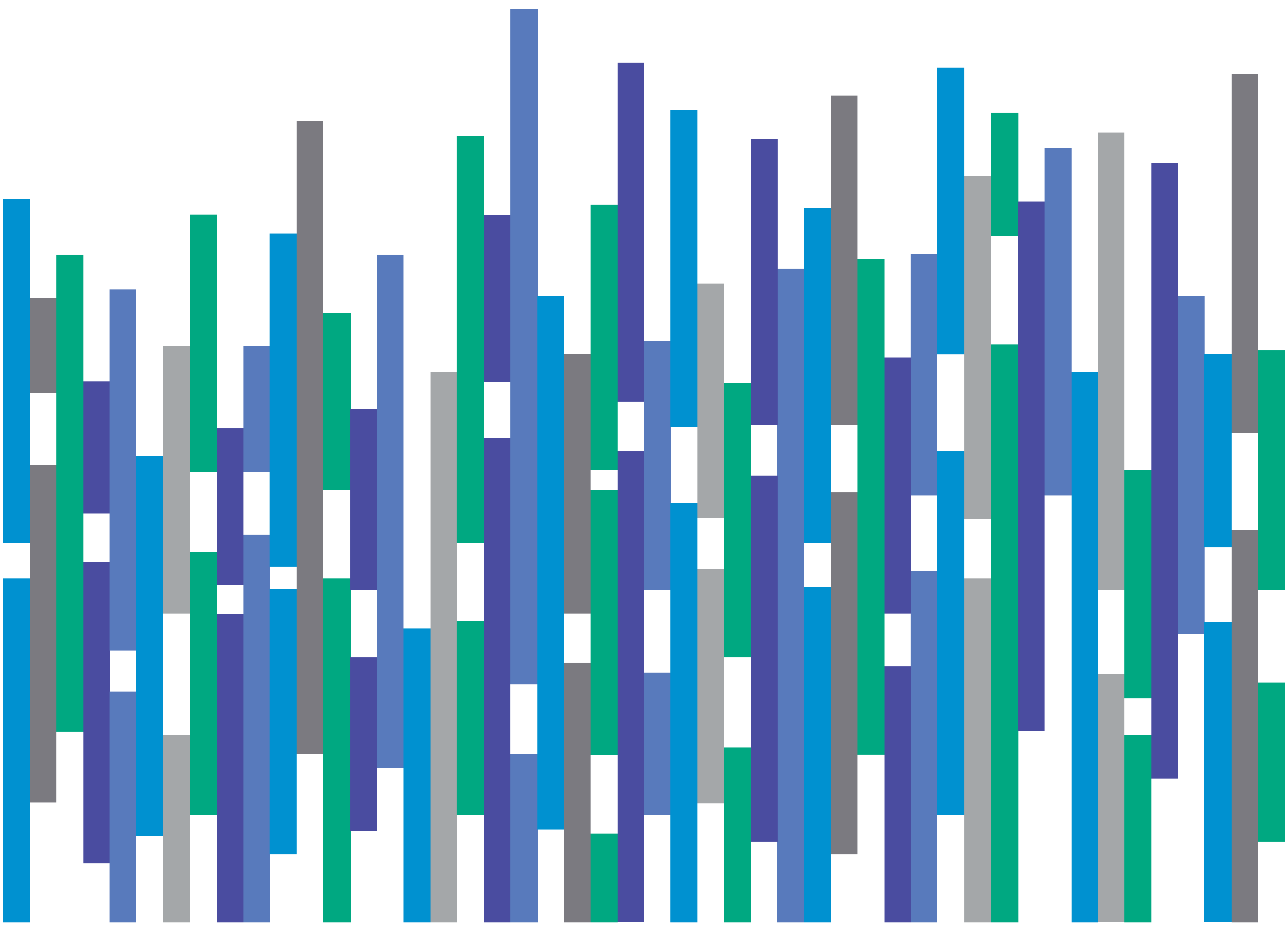
CFA Institute

CFA INSTITUTE MEMBER SURVEY REPORT

Usefulness of Key Performance Indicators and Other Information Reported Outside Financial Statements



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FOREWORD

"We are delighted to see CFA Institute looking more deeply into how investors use and value critical areas of information outside the core financial statements. The report highlights shortcomings with a subset of alternative performance measures, including financial, operational and intellectual capital KPIs, showing there is a real forgotten middle across the financial versus nonfinancial continuum, which Integrated Reporting is ideally positioned to address." – Richard Howitt, CEO, IIRC

EXECUTIVE SUMMARY

Headline findings from the member survey results include the following:

- ***Top three most commonly applied categories of management, discussion, and analysis (MD&A)/narrative reporting information***. An analysis of the relative application by investors of information contained across 11 identified broad categories within the MD&A/narrative reporting portion of the annual report shows that the top three most commonly applied categories were (1) operational metrics, (2) contextualizing strategy and business model descriptions, and (3) supplemental financial information. Sustainability reporting was the least applied category. The findings on relative usage affirm the need for regulators, standard setters, and other authorities (e.g., stock exchanges) to go beyond focusing on non-GAAP financial measures (NGFMs) and environmental, social, and governance (ESG) information and to also focus on other alternative performance measures (APMs), including financial and operational key performance indicators (KPIs).

- ***Top five financial and operational metrics***. Across a subset of 16 financial, customer, and operational metrics, the top five most-used metrics are NGFMs, organic sales growth measures, gross margin disaggregation, market share, and future revenue potential measures. In contrast, customer metrics (5 of the 16) were clustered below the median ranking of relative usage and perceived reporting quality. The results likely reflect the relatively nascent reporting of customer metrics. In general, the survey found a positive correlation between the extent of use and the perceived quality of reporting of individual metrics.

- ***Top three intellectual capital metrics***. Across a subset of 10 intellectual capital metrics, the top three most-used metrics are research and development expenditure as a percentage of sales, new product/research pipeline information, and intellectual property expiry exposure (revenue from products coming off patent in the next “x” years). As with the financial, customer, and operational metrics, the survey found a positive correlation between the extent of use and the perceived quality of reporting of individual metrics.

- ***Similar KPI & NGFM reporting concerns.*** NGFM reporting concerns also apply to financial and operational KPIs. Staple concerns around the reporting of NGFMs can be extended to other KPIs. These include: (a) the lack of comparable reporting of these performance measures across similar business models; (b) period-to-period inconsistencies in management definitions; (c) misleading positive bias; and (d) questionable reliability due to the lack of or inadequate assurances. These shortcomings with NGFMs were highlighted in the 2016 CFA Institute report *Investor Uses, Expectations, and Concerns on Non-GAAP Financial Measures*.

Recommendations made as a result of the findings include an idea that has gotten traction in several stakeholder conversations to ensure consistent reporting of KPIs over time, namely, the need for a “three-year standstill” requirements by securities regulators, whereby issuers have to stick to the same definition of individual metrics for a period of three years.

There is also a potential opportunity for a private-sector–driven industry/business model specific definition of relevant KPIs. It can be quite a balancing act between pursuing desirable comparability versus allowing companies discretion to “tell their story,” bearing in mind that these KPIs are voluntary supplemental measures and are not meant to be mandatory standardized information. Examples of business-model–relevant guidance that currently exists includes the real estate investment trust (REIT) sector definition of the funds from operations and the gold mining sector definition of cash cost per ounce.

Finally, in tandem with improving reporting guidance, the audit standard-setting authorities and regulators, and the audit profession, should evaluate and respond to the demand for increased assurance of this type of information.

1 OVERVIEW

Financial reporting information, including the primary financial statements[1] and notes to the financial statements, is often described as the bedrock of decision-useful[2] information available for investors. At the same time, as portrayed in **Figure 1,** investors depend on a lot more than the main financial statements information when they are evaluating the prospects, financial condition, performance, and value creation story of companies.

A core plank of the filed corporate report (i.e., annual or interim report) is the information located in the "management discussion and analysis (MD&A)" or "narrative reporting" or "management commentary" section. The information reported outside the main financial statements is largely intended to be supplemental and contextualizing to GAAP/IFRS information (e.g., risk reporting). It includes forward-looking information (e.g., capital commitments) and is also meant to convey performance and entity-specific information through the "eyes of management,"

The November 2017 International Accounting Standards Board (IASB) staff paper[3] related to the update of the management commentary practice statement (MCPS) categorizes information outside the financial statements as consisting of (a) prefinancial information (i.e., leading indicators of future periods' financial impact); (b) description of a company's strategy, business model, and operating environment; (c) non-GAAP Financial Measures (NGFMs); and (d) forward-looking information. In effect, the IASB MCPS staff paper affirms that different

[1] Income statement, statement of financial position, statement of cash flows, and statement of equity.
[2] As reflected in the IASB and FASB respective conceptual framework documents, financial statements aim to provide relevant and faithfully representative information.
[3] http://www.ifrs.org/-/media/feature/meetings/2017/november/iasb/wider-corporate-reporting/ap28a-wcr-mcps.pdf

strands of information reported outside are relevant for assessing the value creation of companies.

Figure 1: Relevant Information for Analyzing Companies

OVERVIEW OF GUIDANCE FOR REPORTING INFORMATION OUTSIDE THE MAIN FINANCIAL STATEMENTS

As described below, varied degrees of guidance relate to the information reported within the MD&A or narrative reporting section.

- ***MD&A/narrative reporting guidance varies across jurisdictions**.* MD&A guidance can influence the reporting of alternative performance measures reported outside the primary financial statements. MD&A/narrative reporting guidance varies across countries. Furthermore, in many cases, the guidance tends to be voluntary, high-level and principles based, leaving companies with a lot of discretion on how they report information outside the primary financial statements.

- ***"Tyranny of choice" on sustainability reporting requirements.*** A plethora of initiatives are focused on enhancing companies' reporting of environmental, social, and governance (ESG) factors of interest to different stakeholders. These include guidance from global and stakeholder/industry-driven initiatives as well as stock exchange and country/region-specific guidance[4]. Examples of ESG-reporting guidance include the Sustainability Accounting Standards Board, Global Reporting Initiative, Climate Disclosure Standards Board, and Financial Stability Board Task Force on Climate-Related Financial Disclosures. Among other attributes, these initiatives vary in their intended primary audience, definitions of materiality, and level of specificity in defining metrics. As a result of these varied reporting requirements, investors and other stakeholders are faced with a "tyranny of choice" and a corresponding need for increased levels of alignment across these multiple reporting requirements.

- ***Heightened regulatory focus on enhancing guidance for NGFMs***. NGFMs are defined as measures derived by adjusting GAAP/IFRS line items (e.g., adjusted earnings) or measures derived from GAAP/IFRS information but not defined by GAAP/IFRS financial statement presentation requirements (e.g., free cash flow, net debt). Several securities regulators across the globe (e.g., SEC, ESMA, IOSCO, UK-FRC, and various other country/region regulators) have respectively issued or updated their guidance for the reporting of NGFMs. There has been a justifiable focus on NGFMs by securities regulators due to (a) increasing concerns that these measures are going beyond being supplemental measures and instead are treated by market participants as alternatives to the audited and intended to be decision-relevant GAAP/IFRS information; and (b) high frequencies of period-to-period inconsistent reporting, lack of comparability across similar business models, lack of clarity on the adjustments within the calculation, undue prominence, and often misleading positive bias in companies' reporting of NGFMs.

- ***A subset of key performance indicators (KPIs) is minimally addressed by regulators' guidance***. The concerns related to the potentially misleading reporting of

[4] Examples of country/region requirements include the US SEC climate change disclosures, France Article 173, and EU nonfinancial reporting directive. Furthermore, a UN Conference on Trade and Development report highlights that there are 32 stock exchanges across the globe with ESG reporting requirements.

NGFMs can be extended to other financial, operational, customer, and intellectual capital KPIs that are reported outside the financial statements (e.g., same store sales). Yet, there is a paucity of applicable guidance related to the reporting of this important subset of nonfinancial information and KPIs. This situation of inadequate guidance exists notwithstanding that the communication of these KPIs by companies is intended to be a key part of their value creation story. Despite the limited regulatory guidance, the need for reliable and consistent reporting of other KPIs was emphasized by the SEC Chief Accountant in a 2017 speech.

> *"I believe much of the experience with non-GAAP financial metrics reporting also provides lessons for other kinds of reporting by companies" – SEC Chief Accountant Wes Bricker[5], May 2017*

The observation that there are KPIs, relevant for investment decision making, reported outside the main financial statements—but with limited regulatory guidance—was the motivation for this particular survey with an objective of eliciting investor perspectives on financial, operational, and intellectual capital metrics.

OBJECTIVES OF SURVEY

Over the last few years, CFA Institute has elicited member/investor perspectives on different strands of information reported outside the primary financial statements, including NGFMs[6] and ESG[7] reporting. This survey's objective is to build on these previous surveys by ascertaining investor perspectives on financial, operational, customer, and intellectual capital metrics that are important yet have minimal related reporting guidance.

The survey obtained user views on the high-level usage of a selection of broad sections within the narrative reporting or MD&A sections (i.e., supplemental, financial, operational, business model, customer, risk, governance, intellectual capital, and sustainability information). The survey also established usage of and perceptions on availability and quality of specific financial, operating, customer, and intellectual capital metrics. The specific metrics assessed

[5] http://ww2.cfo.com/auditing/2017/05/issuers-address-other-reporting/
[6] *Investor uses, expectations, and concerns on Non-GAAP Financial Measures*; *Bridging the Gap: Ensuring Effective Non-GAAP and Performance Reporting*.
[7] *Environment, Social and Governance Survey—2017*; *Environmental, Social and Governance Issues in Investing—2015*.

were derived from several related publications (*2016 KPMG Room for Improvement*[8]; *2016 WICI Intangibles Reporting Framework*; *2007 CFA Institute Comprehensive Business Reporting Model*) and from earlier feedback obtained from CFA Institute members.

The survey was primarily targeted at buy-side portfolio managers and research analysts, sell-side analysts, credit analysts, and corporate financial analysts. The survey had 305 initial respondents. Response rates to the detailed questions ranged from 154 to 250. See the Appendix for additional details of the survey.

2 INVESTOR FEEDBACK ON NARRATIVE REPORTING SECTIONS

The member survey findings regarding the extent of use of broad categories within the narrative reporting sections (MD&A or management commentary) are reflected in **Table 1** and **Table 2** below.

Table 1: Extent to which information within different sections is applied

Sections within corporate reports	#	1	2	3	4	5	Av Score	Rank
Operational metrics	250	2%	3%	10%	34%	50%	4.28	1
Description of business model, business plans, and strategy	249	2%	3%	14%	29%	52%	4.27	2
Supplemental financial performance, revenue, asset quality, funding, and liquidity information	249	2%	1%	18%	35%	44%	4.19	3
Capital commitments (near and long term)	249	2%	5%	14%	38%	40%	4.08	4
Principal risks and uncertainties	249	2%	6%	22%	36%	34%	3.94	5
Going concern and business viability related information	250	3%	12%	20%	31%	34%	3.82	6
Off balance sheet arrangements	250	2%	10%	24%	34%	31%	3.82	7
Customer-related metrics	250	2%	8%	33%	34%	24%	3.68	8
Corporate governance information	249	2%	15%	35%	28%	21%	3.51	9
Intellectual capital information	248	6%	22%	38%	21%	13%	3.11	10
Sustainability information (environmental, society, and reputational risk)	249	12%	30%	33%	14%	11%	2.82	11

= Number of respondents; 1 = Never use; 2 = Rarely use; 3 = Sometimes use; 4 = Often use; 5 = Always use. Av Score = Average score—the weighted average of percentage responses to rating 1 to 5.

[8] The KPMG report reviews the state of narrative reporting across 270 companies spread worldwide and has recommendations on metrics that can be insightful for investors.

Table 2: Reasons for applying information within corporate reports

Sections within corporate reports	#	Assess Mgmt Qual	Valuation	S/t risk	L/t risk	F/stat ctxt
Operational metrics	238	48%	73%	40%	54%	52%
Description of business model, business plans, and strategy	237	56%	52%	32%	60%	41%
Supplemental financial performance, revenue, asset quality, funding, and liquidity information	242	29%	72%	46%	55%	56%
Capital commitments (near and long term)	230	21%	65%	48%	61%	32%
Principal risks and uncertainties	229	25%	36%	58%	77%	23%
Going concern and business viability related information	214	31%	30%	46%	61%	17%
Off balance sheet arrangements	221	19%	48%	46%	63%	35%
Customer-related metrics	225	34%	51%	38%	44%	38%
Corporate governance information	207	65%	8%	24%	45%	14%
Intellectual capital information	177	26%	27%	15%	33%	24%
Sustainability information (environmental, society, and reputational risk)	145	32%	11%	16%	38%	10%

= Number of respondents who sometimes (3 rating), often (4 rating), and always (5 rating) use information within sections.
Mgmt Qual = Management quality; S/t = Short-term; L/t = Long-term; F/stat ctxt = Financial statements context.

The following inferences are drawn from the results in Tables 1 and 2:

- ***Top three most commonly applied categories of MD&A/narrative reporting information***. An analysis of the relative application by investors of information contained across 11 identified broad categories within the MD&A/narrative reporting portion of the annual report shows that the top three most commonly applied categories were (1) operational metrics; (2) contextualizing strategy and business model descriptions; and (3) supplemental financial information. Sustainability reporting was the least applied category.

- ***There is varied and extensive use of the information within MD&A or management commentary***. The average score shows that "often used" (i.e., 9 of 11 broad categories had an average score of greater than 3.5) would be a representative characterization on the extent of use for most of the information categories except for intellectual capital and sustainability information where "sometimes used" is the representative score (see Table 1).

- ***Information reported outside financial statements has multiple applications***. The findings reflected in Table 2 confirm that investors use KPIs and information outside financial statements not only to contextualize the information within the main financial statements but also as independent inputs for valuation, assessing management quality, and assessing risk across multiple horizons.

- ***Enhancing ESG information is necessary but should not be the exclusive focus of efforts to enhance information reported outside the primary financial statements***. Several investor surveys, including CFA Institute surveys[9] conducted in 2015 and 2017, affirm the growing importance for investors of ESG information. The 2017 CFA Institute ESG survey shows that 73% of respondents take ESG issues into account in their investment analysis and decisions, with governance being the topmost factor.

  As can be seen in Table 1, this report affirms the findings from past CFA Institute ESG surveys that indicate that most investors use at least one of the ESG factors. Note the following findings:

  - Most respondents (84%) indicated that they “sometimes,” “often,” or “always” use corporate governance information; only 2% never use this information.
  - A majority of respondents (58%) indicated that they “sometimes,” “often,” or “always” use sustainability information; only 12% never use this information.

  At the same time, the results reveal that ESG information is currently used to a lesser extent than supplemental financial, operational, customer, risk-related, and intellectual capital measures. The observed ranking of investors’ application of different sections of MD&A/narrative reporting suggests that any initiative aimed at enhancing the reporting of narrative/nonfinancial information should not be disproportionately focused on just ESG/sustainability information.

- ***Integrated reporting principles should be adopted by companies***. The observed widespread use and by implication relevance of different strands of information reported within the MD&A/narrative reporting section strengthen the case for the greater adoption of the integrated reporting approach as has been proposed by the International Integrated Reporting Council (IIRC). An integrated reporting approach necessitates the connectivity of different material, company-specific strands of information as a way of

[9] *Environment, Social and Governance survey - 2017*; *Environmental, Social and Governance Issues in Investing - 2015*.

conveying the link between performance, value creation, and the risk profile of reporting entities.

- ***An update of guidance related to MD&A/narrative reporting is desirable***. As articulated by many stakeholders, an update of the IASB MCPS could strengthen the quality of narrative reporting practices across the widespread IFRS-reporting jurisdictions. As pointed out by the 2017 MCPS staff paper[10], the IASB nonmandatory guidance issued in 2010 has had a discernible, positive effect, enhancing the quality of narrative reporting. Therefore, an MCPS update has the potential to further strengthen the related reporting. Some of the ideas enunciated in the recent MCPS-related IASB staff paper are: (a) strengthen and make explicit the linkage or connectivity principle; (b) augment the reporting of forward-looking information; (c) enhance the business model and strategy description; and (d) augment the principles of performance reporting (NGFMs, financial, operational, customer KPIs, and intellectual capital metrics) and risk disclosures. The UK FRC strategic report requirements provide an example of effective guidance as it encompasses many of the ideas espoused by the integrated reporting framework and those being thought of by the IASB for its potential MCPS update.

  Along similar lines, the efforts by the US SEC to modernize disclosures (via updating Reg S-K requirements) with the objective of enhancing the information content within reported MD&A sections is a step in the right direction.

3 FINANCIAL, CUSTOMER, AND OPERATIONAL KPIs

3.1 MEMBER SURVEY FEEDBACK

Survey findings (see **Tables 3**, **4**, and **5**) show the following situations.

- ***Top five financial and operational metrics***. Across a subset of 16 financial, customer, and operational metrics, the top five most-used metrics are NGFMs, organic sales growth measures, gross margin disaggregation, market share, and future revenue potential measures. In contrast, customer metrics (5 of the 16) were clustered below the median ranking of relative usage and perceived reporting quality. The results likely reflect the relatively nascent reporting of customer metrics. In general, the survey found

[10] http://www.ifrs.org/-/media/feature/meetings/2017/november/iasb/wider-corporate-reporting/ap28a-wcr-mcps.pdf

a positive correlation between the extent of use and the perceived quality of reporting of individual metrics.

- ***Moderate to extensive use of financial, customer, and operational metrics*. Table 3** shows that most (12 of 17) of the financial and operating KPIs can be characterized as being applied “often” (average score can be approximated as 4) with the rest (5 of 17) being applied “sometimes” (average score can be approximated as 3).

- ***Poor to moderate quality of related reporting*. Table 4** shows that most (11 of 17) of the financial and operating KPIs are on average perceived as being of “moderate quality” (average score can be approximated as 3) with the rest (6 of 17) being of “poor quality” (average score can be approximated as 2). Also notable is that a significant number of respondents believe some of these metrics are unavailable for their purposes (e.g., 42% for customer satisfaction).

Table 3: Extent of use of financial and operational metrics

Metric	#	1	2	3	4	5	Av Score	Rank
Non-GAAP financial measures (e.g., EBITDA, free cash flow, core profit, etc.)	209	2%	3%	14%	28%	52%	4.25	1
Comparable or organic sales growth data (e.g., like for like or same-store sales, constant currency sales)	208	2%	4%	15%	35%	43%	4.12	2
Gross margin disaggregation (revenue mix & cost-of-sales mix breakdown)	208	1%	6%	13%	40%	39%	4.10	3
Market share	210	1%	4%	20%	40%	36%	4.05	4
Future revenue potential measures (e.g., contracted sales not yet recognized as revenue, order backlog)	209	2%	8%	25%	41%	24%	3.78	5
Capacity utilization measures	210	1%	6%	30%	40%	23%	3.77	6
Asset utilization (e.g., occupancy)	210	2%	7%	29%	36%	26%	3.77	7
Customer base (numbers, profile)	209	2%	6%	32%	37%	23%	3.72	8
New customers, subscribers	208	3%	9%	26%	39%	22%	3.68	9
Fixed versus variable cost analysis	207	2%	11%	29%	34%	24%	3.67	10
Customer retention rate (e.g., subscriber renewal rate, customer visits, footfall)	208	4%	7%	29%	39%	20%	3.65	11
Sales per unit (e.g., sales per square foot, sales per room)	209	4%	13%	32%	33%	17%	3.45	12
Sales conversion (average revenue per customer, cross-selling measures)	208	5%	15%	33%	31%	16%	3.39	13
Productivity ratios (e.g., employee productivity measures)	208	3%	15%	38%	29%	14%	3.37	14
Customer acquisition costs	210	4%	15%	37%	30%	14%	3.35	15
Customer satisfaction scores	210	9%	27%	39%	19%	7%	2.88	16

= Number of respondents; 1 = Never use; 2 = Rarely use; 3 = Sometimes use; 4 = Often use; 5 = Always use. Av Score = Average Score—the weighted average of percentage responses to rating 1 to 5.

- ***Inadequate reporting influences extent of use of information***. As reflected in **Table 5**, the relative rankings of the individual financial and operating metrics show a correlation between the availability and quality of information, and the extent of its usage.

- ***Concerns on KPIs echo those related to reporting of NGFMs***. Member comments show that investors have concerns on the incomplete, inconsistent, incomparable, and biased calculation of KPIs that are quite similar to the concerns related to the reporting of NGFMs.

Table 4: Perception of quality of financial and operational metrics

Financial and operational metrics	#	1	2	3	4	No opinion	Av Score	Rank
Non-GAAP financial measures (e.g., EBITDA, Free cash flow, Core Profit, etc.)	181	2%	12%	42%	36%	9%	3.23	1
Comparable or organic sales growth data (e.g., like for like or same-store sales, constant currency sales)	182	9%	7%	41%	35%	9%	3.11	2
Sales per unit (e.g., sales per square foot, sales per room)	182	10%	10%	41%	27%	12%	2.95	3
Market share	182	12%	15%	40%	27%	7%	2.87	4
Asset utilization (e.g., occupancy)	181	11%	17%	36%	27%	8%	2.87	5
Gross margin disaggregation (Revenue mix & cost of sales mix breakdown)	181	15%	13%	39%	24%	8%	2.78	6
Future revenue potential measures (e.g., contracted sales not yet recognized as revenue, order backlog)	179	9%	20%	46%	16%	8%	2.76	7
New customers, subscribers	182	12%	16%	45%	18%	8%	2.75	8
Capacity utilization measures	181	19%	15%	38%	20%	8%	2.64	9
Customer base (customer numbers, profile)	183	17%	22%	39%	15%	7%	2.55	10
Fixed versus variable cost analysis	181	28%	15%	33%	15%	8%	2.39	11
Productivity ratios (e.g., Employee productivity measures)	178	22%	21%	35%	10%	13%	2.37	12
Customer retention rate (e.g., subscriber renewal rate, customer visits, footfall)	182	26%	20%	34%	10%	10%	2.32	13
Sales conversion (Average revenue per customer, cross-selling)	182	25%	26%	29%	10%	10%	2.26	14
Customer acquisition costs	182	31%	26%	25%	5%	13%	2.05	15
Customer satisfaction scores	182	42%	26%	16%	4%	10%	1.81	16

= Number of respondents; 1 = Usually unavailable; 2 = Available and poor quality; 3 = Available and moderate quality; 4 = Available and high quality. Av Score = Average score, determined after excluding respondents with no opinion.

Table 5: Financial and operational metrics: Extent of use versus perception of reporting quality—rankings comparison

Other financial and operational metrics	Usage rank	Quality rank
Non-GAAP financial measures (e.g., EBITDA, Free cash flow, Core Profit, etc.)	1	1
Comparable or organic sales growth data (e.g., like for like or same-store sales, constant currency sales)	2	2
Gross margin disaggregation (Revenue mix & cost of sales mix breakdown)	3	7
Market share	4	5
Future revenue potential measures (e.g., contracted sales not yet recognized as revenue, order backlog)	5	8
Capacity utilization measures	6	10
Asset utilization (e.g., occupancy)	7	6
Customer base (numbers, profile)	8	11
New customers, subscribers	9	9
Fixed versus variable cost analysis	10	12
Customer retention rate (e.g., subscriber renewal rate, customer visits, footfall)	11	14
Other financial and operational metrics	12	4
Sales per unit (e.g., sales per square foot, sales per room)	13	3
Sales conversion (Average revenue per customer, cross-selling measures)	14	15
Productivity ratios (e.g., Employee productivity measures)	15	13
Customer acquisition costs	16	16
Customer satisfaction scores	17	17

CFA Institute Member Comments on Quality of Financial, Customer, and Operational KPIs

Poor Accessibility

> *Organic revenue growth is a metric I use heavily; however, oftentimes you really have to dig into the annual reports to find this. Frequently companies' management do not reveal organic growth on a divisional basis if it is poor, or indeed the implement rounding on the number. A tabulated format for this info is the ideal situation.*
>
> *Too much of this is inconsistent and not always available across most firms (i.e., available only for a subset).*

Lack of Comparability

> *Sales per square foot (sq ft) is not uniform across Real Estate Investment Trusts (REITS) and retailers - some split out large shops and small shops, some split out selling sq ft and total sq ft, occupancy also not uniform, rent per sq ft not uniform.*

Biased Calculation

> *Companies tend to fudge their organic / same-store revenue numbers. They also often choose inappropriate definitions for non-GAAP measures, for example excluding share-based payments, or restructuring costs which are actually ongoing. I've even seen efforts to rig cash flow numbers by excluding pension or other costs.*
>
> *I find that EBITDA, Free Cash Flow, and Operating Profit are measures that I use all the time. It is VERY disappointing that these are not defined by GAAP, and so every management selects its own definition to make its results look good.*
>
> *There is a lot of subjectivity in the exact calculation of many of these measures, which limits comparability.*
>
> *I've encountered two companies this year that have outright lied (in my opinion) about organic vs non-organic revenue growth. This has been a systemic issue with many acquisitive companies. It would be extremely helpful if there was a really simple requirement to have a breakdown of organic vs non-organic revenue growth in a more standardized forma… this would at least prevent the kind of outright lying (or intentional misleading) I have come across a number of times*.

3.2 RECOMMENDATIONS ON FINANCIAL, CUSTOMER, AND OPERATIONAL KPIs

Survey findings on the financial, customer, and operational KPIs support the following measures.

- ***Enhance regulatory guidance and scrutiny of financial, customer, and operational KPIs***. The development or strengthening of any existing guidance related to alternative performance measures reported outside the primary financial statements, including financial, customer, and operational KPIs, is needed to ensure greater transparency, consistent period-to-period definitions, and more comparable and reliable reporting of these measures.

  An idea that has gotten traction in several stakeholder conversations is the need for the three-year standstill requirements by securities regulators, whereby issuers have to stick to the same definition of individual metrics for a period of three years.

- ***Appropriate private-sector bodies should develop guidance that enhances comparability of KPIs***. There is a potential opportunity for a private-sector–driven industry/business model specific definition of relevant KPIs. It can be quite a balancing act between pursuing desirable comparability versus allowing companies discretion to "tell their story," bearing in mind that these KPIs are voluntary supplemental measures and are not meant to be mandatory standardized information. Examples of business model-relevant guidance that currently exists include the REIT sector definition of NGFMs and the gold mining sector definition of cash cost per ounce.
- ***Enhance related assurance requirements***. Existing assurance requirements need to be enhanced to increase the reliance that investors can place on these measures. Existing assurance requirements have a fairly low threshold of providing assurance–auditors only have to ascertain that there are no inconsistencies between the information within and outside the primary financial statements notwithstanding that the linkage between some of these KPIs and financial statement line items can, at face value, be indirect and difficult to readily ascertain. In other words, there is limited transparency and it is hard to discern how auditors ascertain the absence of inconsistencies.

4 INTELLECTUAL CAPITAL METRICS

In their 2016 textbook *The End of Accounting and the Path Forward for Investors and Managers*,[11] Lev Baruch and Feng Gu strongly advocate for the significant enhancement in the reporting of intangible assets (e.g., intellectual property rights, brands) as that would be aligned with the pattern of intangible assets increasingly becoming pervasive and being a core asset for modern economy companies. They observe that the rate of corporate investment in physical capital (tangible assets) fell by 35% from 1977 to 2012, whereas the rate of investment in intangibles increased by 60% during the same period. In effect, corporate investment in intangible assets has outstripped that made toward tangible assets.

[11] Lev Baruch, Feng Gu, *The End of Accounting and the Path Forward for Investors and Managers* (Hoboken, NJ: John Wiley & Sons, Inc., 2016).

4.1 MEMBER FEEDBACK ON INTELLECTUAL CAPITAL METRICS

The member survey findings on the usefulness and quality of intellectual capital metrics (**Tables 6**, **7**, and **8**) suggest that there is yet to be a widespread use of these metrics. Survey results show the following:

- ***Top three intellectual capital metrics***. Across a subset of 10 intellectual capital metrics, the top three most-used metrics are research and development expenditure as a percentage of sales, new product/research pipeline information, and intellectual property expiry exposure (revenue from products coming off patent in the next "x" years). As with the financial, customer, and operational metrics, the survey found a positive correlation between the extent of use and the perceived quality of reporting of individual metrics.
- ***Rare to moderate use of intellectual capital metrics***. **Table 6** shows that most (6 of 11) of the intellectual capital KPIs can be characterized as being on average applied "sometimes" (average score can be approximated as 3) with 4 of 11 being on average applied "rarely" (average score can be approximated as 2).
- ***Unavailable, poor quality of related reporting***. **Table 7** shows that most (9 of 11) of the intellectual capital KPIs are on average perceived as being either "unavailable" or of "poor quality" (average score can be approximated as 2) with the rest (2 of 11) being on average of "moderate quality" (average score can be approximated as 3).
- ***Inadequate reporting influences extent of use of information***. As reflected in **Table 8**, the relative rankings of the individual intellectual capital KPIs show a correlation between the availability and quality of information, and the extent of usage.
- ***Questionable intangibles valuation could affect usefulness of related disclosures***. Intellectual capital disclosures are meant to convey the future cash-generating potential of related assets and where available, the standalone/realizable values of individual assets. That said, skepticism by investors regarding the economic relevance of any standalone valuation of intellectual capital assets (e.g., brand values) could influence the usefulness of such disclosures as reflected in the member comment below:

The valuation of intellectual capital is closely associated with the earnings or cash flows generated by that intellectual capital. It is rarely the case the intellectual capital has separable realizable value apart from these cash flows.

Table 6: Extent of use of intellectual capital metrics

Intellectual capital metrics	#	1	2	3	4	5	Av Score	Rank
Research and development (R&D) expenditure ratios (e.g., R&D/Sales)	161	7%	11%	28%	35%	19%	3.50	1
New product/research pipeline information	162	10%	10%	38%	38%	5%	3.18	2
Intellectual property expiry exposure - revenue from products coming off patent in the next "X" years.	159	14%	21%	41%	17%	7%	2.81	3
New product ratios (sales of products launched within recent X years/total sales)	161	15%	27%	32%	20%	6%	2.76	4
Details, indicators of the value of intellectual property owned (patents, trademarks, licenses, franchises, copyrights, and concessions)	160	11%	30%	38%	16%	6%	2.76	5
Number and revenue/EBIT derived from patents with economically meaningful remaining terms	159	19%	27%	31%	18%	4%	2.60	6
Human capital profile (e.g., expert staff headcount, disaggregation by key functional areas)	161	20%	30%	30%	17%	2%	2.50	7
Brand valuation measures	159	21%	28%	36%	12%	3%	2.47	8
Other intellectual capital metrics	60	43%	10%	33%	5%	8%	2.25	9
Brand perception scores (e.g., net promoter scores)	162	28%	32%	28%	10%	1%	2.23	10
Training expenditure per employee	160	44%	32%	19%	4%	1%	1.87	11

= Number of respondents; 1 = Never use; 2 = Rarely use; 3 = Sometimes use; 4 = Often use; 5 = Always use. Av Score = Average Score—the weighted average of percentage responses to rating 1 to 5.

Table 7: Perception of quality of intellectual capital reporting

Intellectual capital metrics	#	1	2	3	4	No Opinion	Av Score	Rank
Research and development (R&D) expenditure ratios (e.g., R&D/Sales)	156	10%	12%	33%	35%	10%	3.05	1
New product/research pipeline information	155	15%	23%	43%	9%	10%	2.51	2
Intellectual property (IP) expiry exposure—revenue from products coming off patent in the next "X" years.	154	27%	18%	29%	11%	15%	2.27	3
New product ratios (sales of products launched within recent X years/total sales)	155	29%	15%	29%	10%	16%	2.25	4
Details, indicators of the value of intellectual property owned (patents, trademarks, licenses, franchises, copyrights, and concessions)	154	28%	23%	25%	11%	13%	2.22	5
Number and revenue/EBIT derived from patents with economically meaningful remaining terms	155	32%	18%	25%	8%	16%	2.12	6
Human capital (e.g., expert staff headcount, disaggregation by key functional areas)	154	34%	19%	25%	5%	16%	2.01	7
Other intellectual capital metrics	115	30%	11%	18%	4%	37%	1.96	8
Brand perception scores (e.g., net promoter scores)	156	46%	19%	16%	3%	17%	1.71	9
Brand valuation measures	154	53%	18%	13%	3%	14%	1.62	10
Training expenditure per employee	156	54%	11%	17%	2%	17%	1.60	11

- Number of respondents; 1 = Usually unavailable; 2 = Available and poor quality; 3 = available and moderate quality; 4 = Available and high quality. Av Score = Average score determined after excluding respondents with no opinion.

Table 8: Intellectual capital metrics: Extent of use versus perception of reporting quality—rankings comparison

Intellectual capital metrics	Usage rank	Quality rank
Research and development (R&D) expenditure ratios (e.g., R&D/Sales)	1	1
New product/research pipeline information	2	2
Intellectual property expiry exposure - revenue from products coming off patent in the next "X" years	3	3
New product ratios (sales of products launched within recent X years/total sales)	4	4
Details, indicators of the value of intellectual property owned (patents, trademarks, licenses, franchises, copyrights, and concessions)	5	5
Number and revenue/EBIT derived from patents with economically meaningful remaining terms	6	6
Human capital profile (e.g., expert staff headcount, disaggregation by key functional areas)	7	7
Brand valuation measures	8	10
Other intellectual capital metrics	9	8
Brand perception scores (e.g., net promoter scores)	10	9
Training expenditure per employee	11	11

4.2 RECOMMENDATIONS ON INTELLECTUAL CAPITAL METRICS

Notwithstanding the increasing relevance of intellectual capital assets as highlighted by Baruch and Gu (2016), the current poor state of the reporting of these assets contributes to the limited use of this information by investors. Hence, we recommend the following:

- ***Enhance authoritative intellectual capital reporting guidance***. Various publications (*2016 KPMG Room for Improvement*; *2016 WICI Intangibles Reporting Framework*; *2007 CFA Institute Comprehensive Business Reporting Model*; *2014 UK FRC Report on Investor Perspectives on Intangible Assets and Their Amortisation*; *The End of Accounting and the Path Forward for Investors and Man*agers) offer specific proposals that could guide the development of comprehensive and useful intellectual capital disclosures. These proposals should be incorporated into authoritative guidance from either the accounting standard setters (e.g., IASB management commentary practice statement) or from securities regulators guidance.

- ***The IIRC should heighten focus on intellectual and human capital reporting***. The IIRC should champion and encourage the curation of intellectual capital metrics in a similar fashion to what it has done for some of the other capitals within the integrated reporting framework (natural and social). In other words, the IIRC has been highly visible in its support, promotion and coordination of sustainability/ESG reporting initiatives and it should do the same for intellectual and human capital reporting initiatives.

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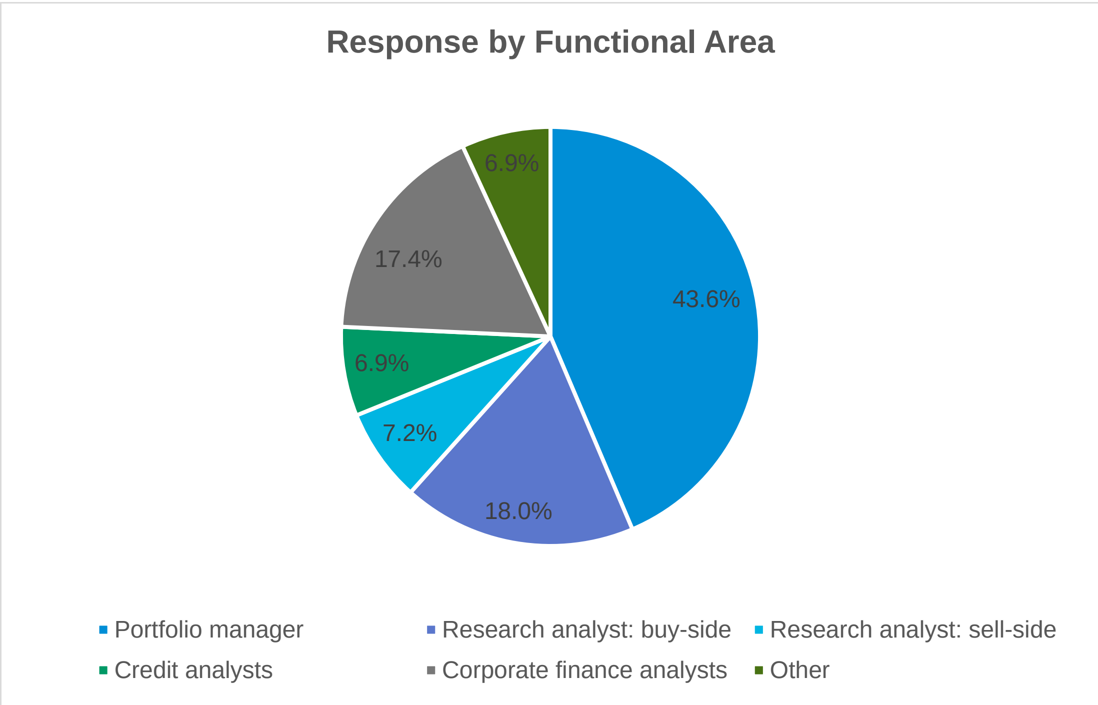
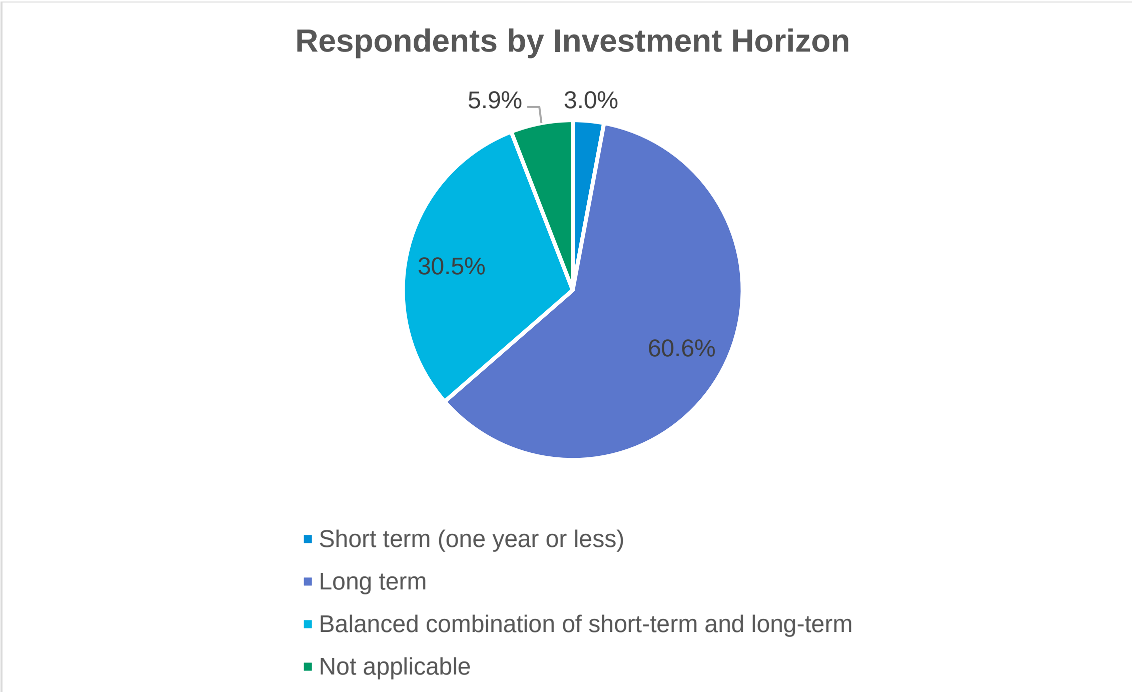
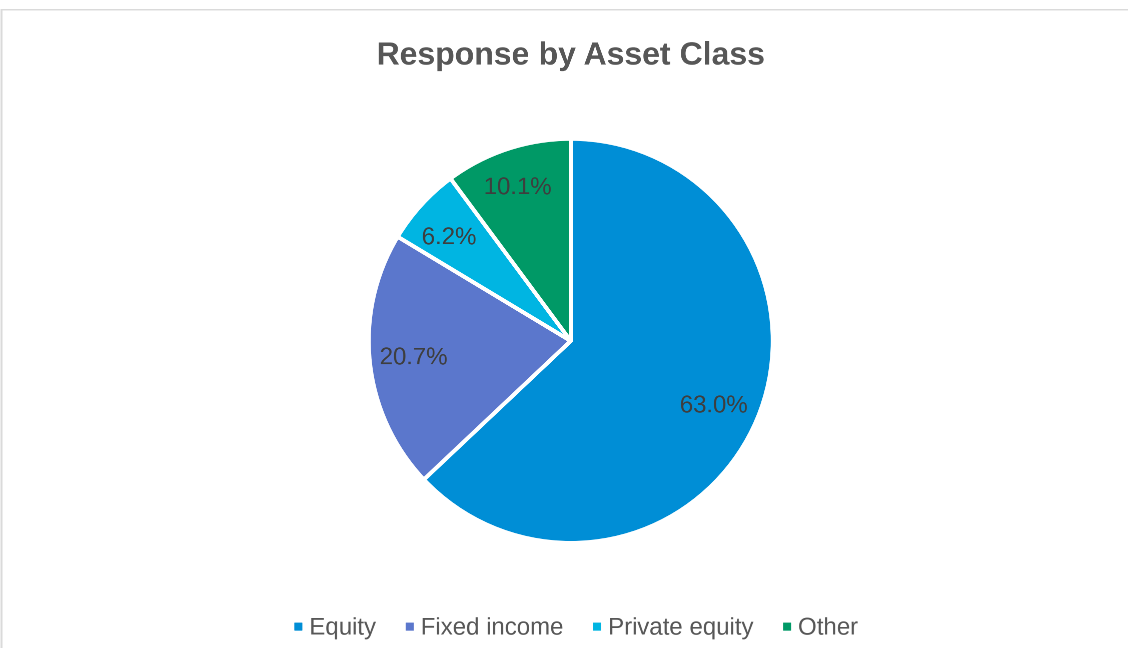
5 APPENDIX:

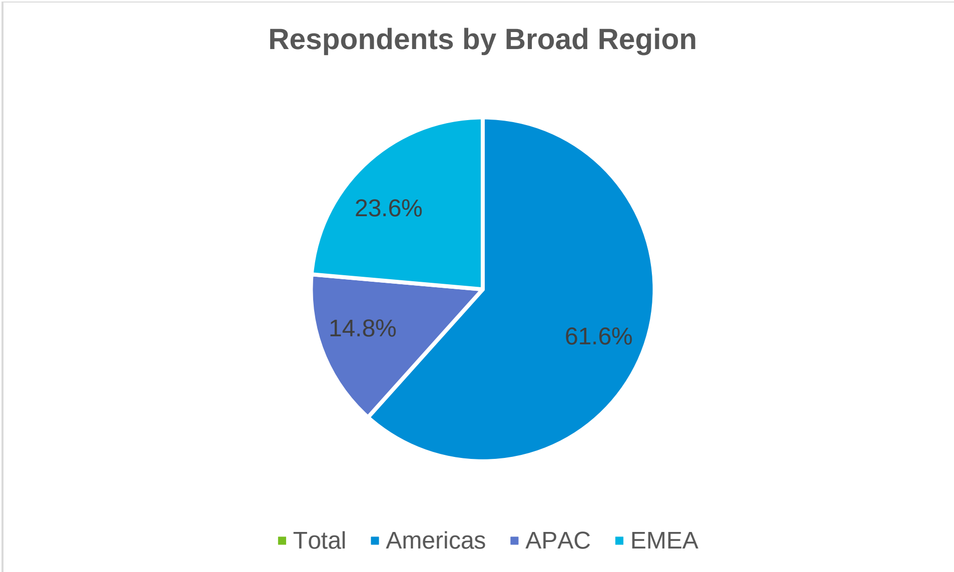
2017 CFA INSTITUTE CORPORATE REPORTING SURVEY PROFILE

The survey administered in August 2017 was primarily targeted at buy-side portfolio managers and research analysts, sell-side analysts, credit analysts, and corporate financial analysts. The survey had 305 initial respondents representing a response rate of 1.4 percent. Response rates to the detailed questions ranged from 154 to 250 resulting in a margin of error ranging from 6.2 to 7.9%. Below is a breakdown of respondents by functional area, investment horizon, asset class, and broad region.




Respondents by Investment Horizon
5.9%
3.0%
30.5%
60.6%
Short term (one year or less)
Long term
Balanced combination of short-term and long-term
Not applicable


Response by Asset Class
10.1%
6.2%
20.7%
63.0%
Equity
Fixed income
Private equity
Other


Respondents by Broad Region
23.6%
14.8%
61.6%
Total
Americas
APAC
EMEA