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Investors need to stop blindly believing in the financial metrics of TSX stocks

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According to Bloomberg, the S&P/TSX index is trading at 22.7 times trailing earnings. But what if you knew that the majority of the figures used to calculate that metric were each company's own creation, were not audited, and might not be comparable?

Now what if you knew that the same index was trading at 48.9 times earnings using the figures that were produced according to the appropriate accounting rules and independently audited?

Clearly, many investors want to believe that the lower price-to-earnings metric is true. Unfortunately, what we have learned in the stock market and in life is that truth is a popularity contest. And non-GAAP measures are popular.

The root of the problem lies in an age-old accounting issue called the "expectations gap": Auditors and accountants provide historical information based on generally accepted accounting principles (GAAP) that is designed to be both consistent and verifiable. Investors, on the other hand, want to know what will happen tomorrow. Adjustments help to bridge the gap and thus non-GAAP measures are born. Unfortunately, what may have started with good intentions has had a number of potentially unintended consequences.

Our study reveals that all but one company in the S&P/TSX 60 (an index of Canada's largest and most liquid companies) present some form of adjusted number in their regulatory filings. Our survey of Canada's largest money managers finds that non-GAAP measures are relied upon most when making investment decisions. And our discussions with financial executives tell us that investors demand them.

Blame human nature. As humans, we look for shortcuts, conform to what the majority is doing and seek out positive reinforcement. For many investors, coming to quick investment decisions is more often rewarded than missing out, making it easier for managers to convince themselves that a stock is trading at 10 times earnings, rather than 20 times. So why read a 100-plus page regulatory filing to confirm a different answer? Using the non-GAAP figure is so much easier – management prepared it; the regulatory filings highlighted its importance; analysts repeated it; journalists commented on it; your colleagues accept it; therefore, it must be true.

Of course, similar to the results I would receive if I asked my 11-year-old daughter to prepare her own report card, more than 80 per cent of all adjustments used to calculate non-GAAP measures are upwardly biased, many materially so.

There are issues with, among other things, nomenclature, comparability, consistency and calculation. Non-GAAP measures are given attractive names that include the words "cash" or "normalized." Companies within the same industry will use different calculations to arrive at non-GAAP metrics that have the same name – EBITDA or adjusted earnings. Some companies change their calculation methodologies as frequently as each quarter. And the most common adjustments used are carefully labelled as "non-cash." As billionaire investor Warren Buffett teaches: cash flow is king, so what could be wrong?

The problem is, if any expenses are “non-cash,” then what exactly are accountants counting and management teams spending? The reporting of expenses is merely a timing issue – virtually all expenses are either cash spent some time in the past, cash spent in the current period or cash to be spent in the future.

How can excluding costs associated with a patent or royalty that has a finite life (called “depreciation” or “amortization”) but including the associated revenue be considered the truth? How can excluding the costs associated with closing a facility or paying employee severance (often labelled “restructuring” or “non-recurring”), be considered anything but cash, especially when such costs are reported in consecutive periods? And finally, the next time a management team argues that stock-based compensation expenses should be excluded from earnings, ask them what would happen to employee retention if they no longer paid stock-based compensation?

The last time we had a preponderance of non-GAAP measures was in the dot-com bubble of the early 2000s. Investors sought non-GAAP measures to justify companies without earnings or cash flow. The pain that was subsequently felt by equity markets was only surpassed by the recent financial crisis.

Ultimately, we are not calling for non-GAAP measures to be banned. In fact, forms of non-GAAP measures have been around since the beginning of time and serve a purpose. Instead, we are calling for all stakeholders to pay greater attention to the issue. Securities regulators and auditors must enforce compliance with issued guidelines. Management teams must be more transparent. And investors need to stop believing blindly.

Before accepting any financial metric – GAAP or non-GAAP – investors should at least consider three items: the business facts surrounding its presentation, the accounting conventions used in its calculation, and the preparer’s objectives.

Which brings us back to my original question: If everyone believes that the market is trading at 22.7 times earnings, does that mean that it is? Like all truths, they are real so long as everyone believes.

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