

WHAT DO INVESTORS REALLY THINK ABOUT GAAP?



A new survey sparks discussion and insight about the emerging importance of non-GAAP reporting.

BY VICTORIA SIVRAIS

Generally Accepted Accounting Principles (GAAP) accounting, for all its good intentions, increasingly misses the mark for many investors, according to the results of a survey by Clermont Partners of active investment managers and a follow-on webinar on the topic.

In their bid to predict a company's future performance,

buy-side investors frequently turn to non-GAAP and intangible assets in their analyses. While many acknowledge a place for GAAP, nearly every analyst, according to the survey, puts their own spin on the numbers in their attempt to evaluate the true performance of a company and gain insight into the assets that drive a company's economic value-creation engine.

The Clermont Partners survey report, “More Active Investors Rely on Non-GAAP vs. GAAP Reporting in Analyzing Stocks,” was inspired by the book, *The End of Accounting and the Path Forward for Investors and Managers*, by professors Baruch Lev, Ph.D, and Feng Gu, Ph.D. In the book, Lev and Gu argue that GAAP reporting is no longer a useful tool to predict a company’s future performance, primarily because of the evolution of many industries away from asset-based models and the increasing complexity of Financial Accounting Standards Board (FASB) reporting rules, which often involve considerable estimation.

For example, Lev asserts:

- “GAAP-based earnings are deeply flawed measures of enterprise change, and therefore of little use to investors.” (IR Update, June/July 2017)
- “Earnings no longer move markets.” (IR Update, June/July 2017)
- “...in today’s economy you cannot succeed without innovation. And innovation is achieved by intangibles.” (CFO.com, October 20, 2016)

Respondents to the survey largely agree:

- 90 percent said they frequently make their own adjustments to GAAP results to get a more accurate picture of the company’s performance.
- 74 percent said they rely more on non-GAAP than GAAP reporting when analyzing a company’s performance and making buy or sell decisions on a stock.
- 47 percent disagreed that GAAP presentations accurately portray a company’s finances, compared with 36 percent who agree.
- 44 percent believe that non-GAAP measures have become more important over time.
- 64 percent said they view intangible assets as “important” to “absolutely critical” in their evaluation of a company.

A Discussion of Non-GAAP

Moderated by Clermont Partners’ Elizabeth Saunders, “The Rise of Non-GAAP” webinar posed these findings to a panel featuring:

- Baruch Lev, Ph.D, professor of accounting and finance, New York University Stern School of Business.

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- Elizabeth M. Lilly, founder and president, Crocus Hill Partners.

Lev noted that in writing their book, he and Gu examined hundreds of conference calls in five major sectors of the economy to fully understand what is important to investors. “We found that what matters most are strategic assets that create unique value for each company. For example, a product pipeline of a biotech company, or customer metrics for an internet services company.”

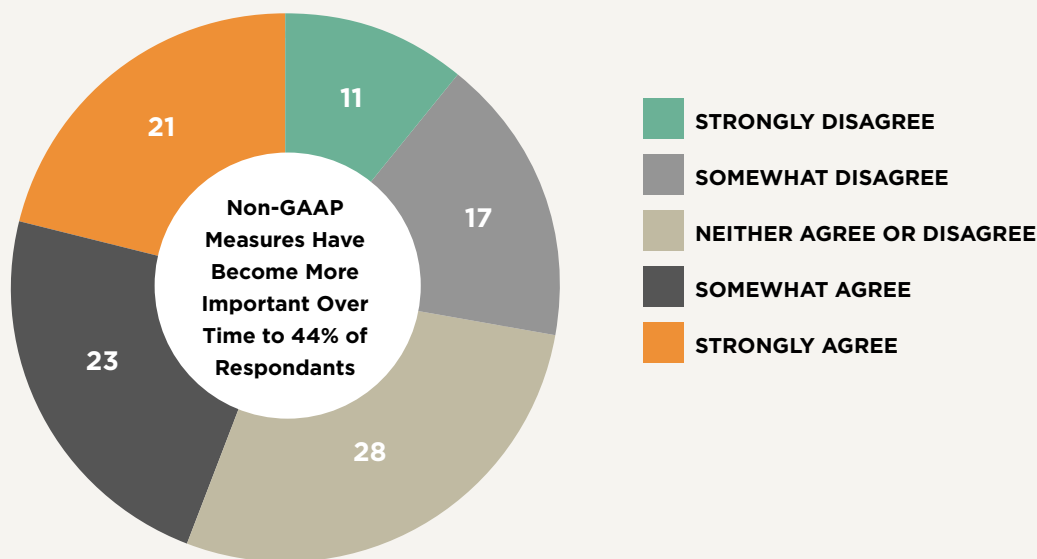
Their findings also show that GAAP-based information is fast losing its value to investors. “Thirty years ago, an investor’s perfect prediction of companies that beat or meet estimates would have gained an annualized 26-27 percent return above benchmark,” Lev noted. “Over time, those gains have all but disappeared. The conclusion is that earnings no longer reflect what they should reflect: value changes and growth prospects of companies.”

Corporate investment trends during the past 30 years support this observation. Lev cited one study of private sector companies that found a dramatic rise in *intangible* asset investment and a fall in *tangible* asset investment beginning in the mid-1980s. GAAP rules require, however, that intangibles such as investments in product

development must be expensed on the income statement, which puts pressure on profitability and the balance sheet, and thus contributes to the erosion of GAAP financials as a way to value companies. As an example, Lev noted that Tesla reports an accumulated loss of more than \$3 billion, but its huge market value means that investors completely ignore the financial reports.

GAMCO’s Marangi agreed, observing that the declining relevance of GAAP accounting has evolved over many decades, as the nature of the economy has changed and the financial sector has gotten larger and become more sophisticated. “When we look at a company, we ask: (1) What is the true cash flow power of a company today? (2) How fast will that cash flow grow? And (3) How predictable and how defensible is that cash flow? Those questions are primarily informed by non-GAAP measures, which are strategic assets, intangibles, hidden assets,

Q: To what extent do you agree with the following statement: "Over time, non-GAAP measures have become more important to me when evaluating a company's financial performance."



and non-financial metrics that I call key performance indicators, like subscribers, churn and customer trends.”

Marangi added, “As fundamental investors, we try to add value in looking at those non-GAAP measures. We have an acronym here [at GAMCO] called GAPIC, meaning Gather, Array, Project, Interpret, Communicate. That’s what the analysts are supposed to do.” He stressed that while analysts do their own work and make their own adjustments, they like to see transparency and consistency in reporting from different companies.

According to Lev, industries that do a good job in providing relevant information on strategic assets or non-financial information include pharma and biotech, which often report product pipeline data. Most media, telecom, and insurance companies also offer valuation tracking measures such as customer policy renewals, which are much more objective than customer satisfaction surveys. Marangi noted that disclosure in the media industry, particularly among the cable distributors, has gotten much better during the past decade. They provide some very useful key performance indicators, customer trends, churn, and average revenue per user.

Intangibles come in two forms, according to Marangi. The first type supports the sustainability of a company’s cash flow. Such assets include a strong brand that provides a moat, for example, that allows Mondelez to have pricing power over Oreos, or a loyal customer base that sustains revenues. Companies

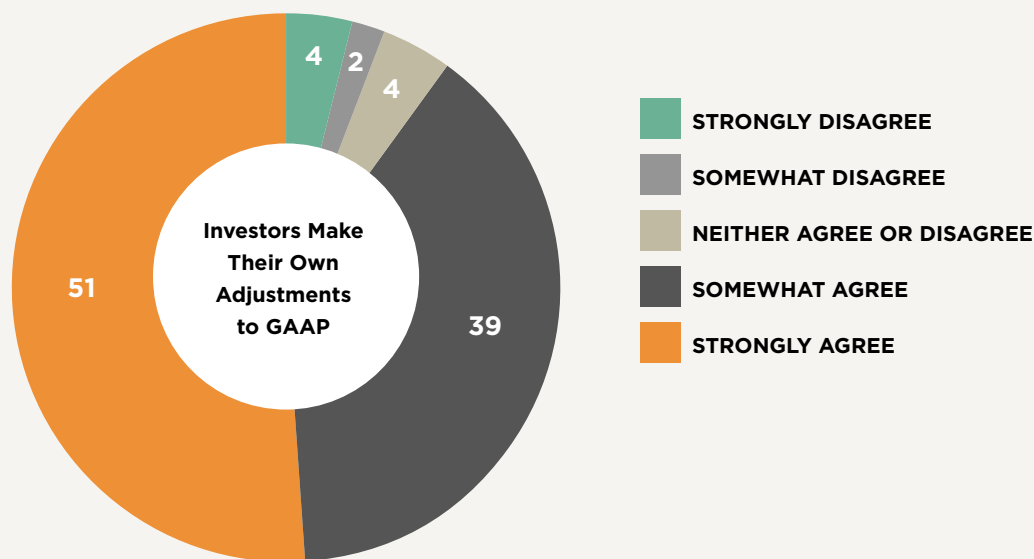
tend to do a better job of disclosing these types of intangibles. The second type is hidden assets that active investors spend a lot of time looking for, such as excess or under-utilized real estate, radio spectrum, and patents. They aren’t necessarily visible on the balance sheet, and companies don’t generally do a great job disclosing them.

Big data and artificial intelligence will likely change and accelerate the move away from GAAP accounting, Marangi said. With the flood of information becoming available, investors who are investing in solutions driven by big data and artificial intelligence could eventually know more about the state of a company’s business intra-quarter than the company itself. Some IROs and their management teams may need to step up their games to stay on top of the industry and company intelligence that is becoming available almost in real time.

GAAP still plays an important role, argues Lilly, by helping to keep managements honest in their non-GAAP presentations of financial performance. While investors make their own adjustments to companies’ GAAP financials, companies are increasingly presenting non-GAAP financials alongside the required GAAP information. A survey by Audit Analytics found that in Q4 2016, 96 percent of S&P 500 companies presented at least one non-GAAP metric, compared to a previous finding of 88 percent between July and September of 2015.

“Companies develop their non-GAAP figures, and they’re

Q: How much do you agree with the following statement: "I frequently make my own adjustments to a company's GAAP financials to get a more accurate picture of the company's performance."



not always forthright," Lilly noted. "One of the aspects of this that we find fascinating is that, ironically, the non-GAAP restatements are always higher than the GAAP, which is an interesting point. Rarely do you see companies taking their GAAP numbers and adjusting them, and the non-GAAP is lower. They're trying to portray their businesses in a better light. The more correlated the GAAP and the non-GAAP metrics are, the more comfortable we are. It's incumbent upon the analyst to do the math themselves and determine what's non-recurring, what's extraordinary and what's unextraordinary."

Stock-based compensation is a good example, she said. "Tech companies tend to take out stock-based compensation because it's not a direct cash payment, but it does involve an outlay of company shares and it's a transaction that dilutes ownership to other shareholders. Twitter is very famous for this. In 2015, they reported a \$520 million loss on a GAAP basis, but they said, 'Hey, what we really want you to focus on is that we reported a net \$277 million profit on a non-GAAP basis.' And yet, it excluded \$682 million in stock-based compensation."

Serial acquirers are another group to watch for potential abuses, she says. Companies that consistently buy smaller companies and exclude the acquisition-related costs can be problematic, she suggested, because acquisition costs are material expenses and revenues are included. "You never truly know or understand what the ongoing earnings of the

organization are because they're obfuscated by these charges, and you never really understand what the top-line growth is. We're very leery of serial acquirers, particularly because they don't deal with the accounting in a very clear and transparent way, and it's very hard to get at the real numbers."

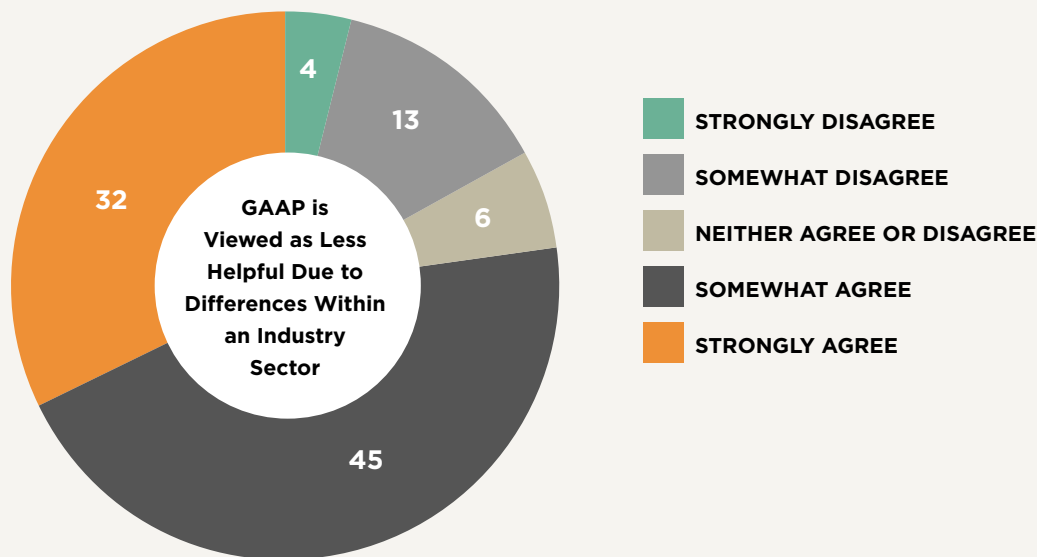
Show the organic growth, such as same-store sales, to provide the transparency investors want, Lilly recommended. If serial acquisitions are part of the company's ongoing business strategy, acquisition-related expenses are really a part of ongoing operations and should be viewed as part of the company's financial performance.

Intersection of Investor and SEC Demands

Ultimately, the greater reliance on non-GAAP measures has been motivated by investors' desire to uncover economic truth and improve their ability to forecast future performance. As the world changes, driven forward by transformative technologies and the value of intangible assets, GAAP-based accounting is losing favor and relevance with investors.

And yet, the U.S. Securities and Exchange Commission (SEC) has cracked down in recent years on perceived abuse of using non-GAAP financial measures. Since adopting Regulation G in 2002, which covers the use of non-GAAP measures in disclosure, the SEC has issued 40 Compliance & Disclosure Interpretations (CD&Is) on the issue. It brought its first action

Q: How much do you agree with the following statement: "There are significant differences among companies within a given industry sector, which make it less helpful to compare performance using solely GAAP measures."



against a company in 2009 and since 2016 has been increasingly assertive against companies' aggressive use of non-GAAP measures, according to Law 360.

With the rising use of non-GAAP measures, some companies may push the envelope in presenting their financial performance. According to the panelists, companies should work to present their financial performance with consistency and transparency. Sophisticated investors will make their own adjustments to the numbers to determine the underlying performance of the business. Providing insight into the intangible drivers of the business is essential as well.

Recommendations

IROs and their management teams should consider the following when disclosing financial performance and insight in their company:

- Be judicious in deciding what to include/not include with non-GAAP numbers. Management will be viewed as more credible if the presentation of positives and negatives is even handed. Consistency is key. For example, do not exclude one-time items one year, then include them the next year to present a more favorable comparison. This approach is also advisable from a compliance standpoint.
- If your non-GAAP measures provide a better fundamental understanding of the business, then make the case for them

when you report earnings, rather than simply leaving investors to interpret and calculate the numbers for themselves.

- Provide more alternative information to help supplement the financials. Make it easy for investors to digest and evaluate your company's current fundamentals and opportunities.
- When presenting a road map for future growth and shareholder value creation, include relevant non-financial performance milestones that support your growth plan.
- As you build engagement with current and prospective investors, ask them what metrics matter the most to them in their stock selection process. Consider evolving your reporting and messaging strategies to help accommodate their informational "wish list."
- Know what your channel is saying. Good investors will seek out information about your company from other sources, including channel partners, suppliers and customers. Keep these stakeholder audiences in the loop of publicly available information so they are able to respond effectively to investors' "channel check" questions. With the rise of big data and artificial intelligence, it will become even more essential to stay on top of this information to remain at least one step ahead of your investors. [IR](#)

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