Non-GAAP Reporting and Capital Markets: Reliable and Relevant?

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Non-GAAP:
The New Reporting Paradigm!

Non-GAAP metrics are upwardly biased, not comparable, differ materially from GAAP: For 80%+ of TSX 60 firms, non-GAAP metric > GAAP metric.

A greater proportion of TSX 60 firms present non-GAAP net income in regulatory filings than S&P 500 firms: (70% vs. 63%).

Approximately 35% of the TSX 60's members have potential regulatory concerns related to their non-GAAP presentation.

Non-GAAP metrics matter for valuation, not just accounting: Virtually all companies in the TSX 60 are using some form of non-GAAP earnings metric.

(Performance Measurement: The Rise of Non-GAAP Metrics. Accounting Alert. Veritas Investment Research, September 8, 2016)

Reporting that Markets Find Relevant (US Evidence)

- Market participants find non-GAAP information relevant to decision making;
- Earnings items of a non-gaap nature (core earnings or headline earnings) are assigned greater value by the stock market than indicators according to GAAP.

Non-GAAP and Governance (US Evidence)

Pre Regulation G:

- Investors were misled by non-GAAP information for firms with weak governance.

Post Regulation G:

- No evidence of such behavior (after 2002).

Firm-level governance is important in ensuring quality non-GAAP reporting, even in a context of strong country-level governance.
(Jennings and Marques, 2011)

Non-GAAP and Governance (US Evidence)

In U.S. setting, board independence enhances the quality of non-GAAP reporting:

- Less adjustments and exclusions in determining non-GAAP measures

Frankel et al. (2011)

Situation in Canada
(Cormier, Lapointe-Antunes, Magnan, 2011)

Income Trust Era – The Age of Distributable Cash

- Value relevant;
- Dominates GAAP earnings as an input to valution;
- Subject to extensive smoothing by management, with capex the focus of attention;
- Governance matters, for the better or for the worse.

Situation in Canada (Cormier, Demaria, Magnan, 2017)

- EBITDA reporting is associated with greater analyst following and with less information asymmetry;
- EBITDA reporting enhances the positive relationship between earnings and stock pricing as well as future cash flows;
- Corporate governance substitutes for EBITDA reporting for stock markets. Hence, <u>EBITDA helps market participants to better assess earnings valuation when a firm's governance is weak</u>.

Situation in Canada (Cormier, Demaria, Magnan, 2017)

- Inversely, when governance is strong, releasing EBITDA information has a much smaller impact on the earnings-stock price relation.

- However, results show an increase in bid/ask spread for firms releasing only an adjusted EBITDA.

Situation in Europe – France (Cormier, Demaria, 2014)

- Independence of AC members = low propensity to disseminate non-GAAP information. opportunistically.
- High Sensitivity of Executive Compensation to Stock Market Fluctuations = More Non-GAAP Measures.

Situation in Europe – France (Cormier, Demaria, 2014)

- Positive impact of non-GAAP on market valuation and reduction of information asymmetry.
- Beyond a certain threshold, an increasing number of non-GAAP measures would result in increasing information asymmetry.

Takeaways

- While EBITDA numbers are biased upward, potentially inconsistent over time and not clearly comparable, markets appear to take them in strides.
- EBITDA numbers appear useful to market participants, especially when a firm's governance is weak.
- A clear 'Line of sight' into their measurement enhances the non-GAAP measures relevance.
- Regulators should be cautious when considering the imposition of further restrictions upon non-GAAP reporting.