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Minding the Gap

> *"Your investor relations folks, your CFO, they love the non-GAAP measures because they tell a better story."*
>
> *Mary Jo White, Chair*
> *Securities and Exchange Commission, March 2016*

In our analytical work of the companies we recommend, we pay a lot of attention to their earnings statements. What a company reports for its profits and losses -- and how it is reported -- says a great deal about the company, its management team and its prospects. Also, it can indicate how attractive the common shares are for current purchase.

But analyzing earnings can be challenging. There are a variety of accounting options available for reporting financial results. Some have the effect of making earnings appear weaker while others make earnings appear far stronger.

The most uniform option is known as Generally Accepted Accounting Principles, or "GAAP." These are the commonly accepted and widely used accounting standards required by government regulations for financial reporting. Because of the uniformity of GAAP accounting, a company's financial condition is easier to understand as are apples-to-apples comparisons to other companies.

But in addition to GAAP, alternative or non-GAAP measures also are permitted under government regulations. Increasingly, companies have been using non-GAAP figures and according to one study, last year about 25% of the financial reports filed with the Securities and Exchange Commission included non-GAAP earnings. More importantly, these earnings averaged some 50% higher than earnings under GAAP. Just a few years ago, the difference was about 20%.

A good illustration of this is the social media company Twitter. In its latest financial report, Twitter highlighted $550 million in non-GAAP earnings, or 40¢ a share. But the picture is very different on a GAAP basis: instead of making $550 million, Twitter lost $521 million. Instead of earning 40¢ a share, it lost 79¢ a share. An inattentive investor could end up paying for inflated earnings and growth, or worse, for earnings and growth that do not even exist. Such investments usually end up being deeply regretted.

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Non-GAAP measures have a variety of names, such as adjusted, pro-forma, operating and cash earnings. "EBITDA," or earnings before interest, taxes, depreciation and amortization, is another frequently used non-GAAP measure. All of these are basically tailor-made yardsticks that capture what management wants investors to focus on.

But how one company defines a non-GAAP measure may be different from another company's definition -- even though both are called the same thing. Adjusted earnings for one company is not necessarily calculated the same way that adjusted earnings is for another company, which presents unique analytical challenges.

And non-GAAP earnings measures frequently do not include items that have a real financial impact on the company. For example, the costs of laying-off employees, restructuring operations or acquiring another firm typically are not included in non-GAAP earnings. Other items not included could be gains and losses from investments as well as write-offs from expired patents or write-downs of acquired businesses that failed. One knowledgeable wag calls all non-GAAP measures "EBBS," or earnings before bad stuff.

The item most frequently excluded from non-GAAP earnings is stock options granted to employees. Some companies give employees, as part of their compensation, the option to purchase shares of the company's stock in the future at a set price. If the stock price rises before the options are exercised, the employee can buy the stock at the lower set price and then sell it at the higher current price.

Stock options became very popular during the 1990s in the booming technology industry. Employees were motivated by the possibility of becoming millionaires overnight -- which some did -- and managements liked them because they effectively reduced compensation costs and increased profits.

At first, there were no regulatory requirements to report the granting of stock options. As their use increased, regulators eventually required that they be disclosed in a footnote to the financial statements. Finally, about ten years ago companies were required to actually deduct the value of the granted stock options from their GAAP earnings.

For some companies, this is a big number. Salesforce.com, a cloud-based business development company, has annual stock-based compensation equal to about 9% of revenue. Over the last three years, excluding this amount turned its GAAP losses of more than $542 million into non-GAAP profits of over $1 billion.

Investors should understand how a company uses stock options. Rewarding employees with shares is not a benign event. When the options are exercised and new shares granted, the value of the existing shares becomes diluted. This weakens earnings per share growth and can potentially affect the price of the company's common shares.

Another item typically not included in non-GAAP earnings is foreign currency exchange. Last year, the U.S. dollar was particularly strong compared to other currencies around the world. A strong dollar affects the earnings of multi-national companies when the weaker foreign currencies are translated into U.S. dollars in the financial statements.

Under GAAP accounting, the effects of the currency conversion are included, thus a strong dollar will have a negative effect on a multi-national company's earnings. But on a non-GAAP basis, the earnings can be presented on a "constant currency basis," which reduces the impact and makes earnings appear to be relatively unaffected by foreign currency moves.

Of course, in years when the dollar is weaker compared to other currencies, the opposite occurs. That is, a multi-national company's earnings will get a tailwind boost from strong foreign currencies being converted into weaker U.S. dollars.

In our view, foreign currency exchange is a part of doing business overseas. In some years, currency swings will increase earnings and in others it will decrease it -- it is just a fact of investment life. Over time, such currency effects tend to net out to zero. Still, investors should understand the impact of foreign currencies on a company's earnings.

A third area where non-GAAP measures are prevalent is in initial public offerings or "IPOs." This is where companies sell their shares to investors for the first time and become publicly traded companies. In IPOs, the use of non-GAAP measures can be pushed to extreme levels.

The coupon company Groupon is an example. It went public in 2011 and in its IPO documents filed with the SEC, the company stated "We don't measure ourselves in conventional ways." It then introduced a new non-GAAP measure called "Adjusted Consolidated Segmented Operating Income" in which the cost of acquiring customers was not included in calculating the company's profits.

By using "Adjusted Consolidated Segmented Operating Income," Groupon's management was able to turn a loss of $420 million in 2010 into an "adjusted" profit of over $60 million. After reviewing the IPO documents and noticing that the entire business concept revolved around acquiring customers by offering them coupons, the SEC objected and forced management to abandon this particular non-GAAP measure.

Any analysis of a company's earnings basically boils down to the management team. A company's leaders set the tone at the top through the choices they make. These choices reverberate throughout the organization and include everything from how much to spend on research and development, which new products or services to develop and which new markets to enter, to how their financial results are presented to investors.

Some management teams are notorious for painting a rosy picture, even when their companies are facing serious challenges. Investors should beware of managements that consistently highlight non-GAAP measures in their financial reports while downplaying results under GAAP. In fact, after last year's increase in the use of non-GAAP measures, the SEC recently indicated it would be focusing on how companies are presenting their results to investors -- again.

However, management teams can be hard to analyze because their characteristics are mainly qualitative in nature. An investor can develop a "feel" for the management team, but it is usually after years of reading its Annual Letters to Shareholders, listening to its conference calls, participating in its presentations and discussions and carefully reviewing its financial statements and other corporate communications.

In our work, we strive to understand the differences between a company's GAAP and non-GAAP earnings. This is important in deciding whether or not to invest in the company. Since non-GAAP earnings are nearly always higher than the GAAP earnings, the resulting valuation could make its shares seem more attractive than they really are.

We tend to prefer using GAAP earnings in our analytical work because of the uniformity and conservatism underlying GAAP accounting principles. However, understanding a company's non-GAAP figures is important as it allows us to better assess managerial decision making and the company's corporate culture.

For example, one multi-national company restructured its operations every year for over a decade. In its earnings reports, management emphasized non-GAAP measures that did not include the costs of the restructurings, even though they occurred year after year. In addition, management made one misstep after another, further compounding its problems. But to the investing community, the company was able to give the impression of being proactive even though it was only reacting to prior bad decisions.

At the end of the day, all investors should "mind the gap" between GAAP and non-GAAP earnings. Paying attention to and discerning the differences in the way a company reports its earnings can go a long ways towards avoiding investment remorse.

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