The Rise Of Non-GAAP Metrics

Outline

• Why Veritas

• The State of Non-GAAP

• Why Non-GAAP Is Important

• Uses/Usefulness of Non-GAAP

• Recommendations
Veritas

Independent
Employee owned
In-depth
Experienced

We tell the truth,
not what management or
the market wants to hear.

A Common Perception

Accountant
Investor
Why Veritas

Out-Performance

Better Risk Adjusted Returns

Protection Knowledge

Out-Performance: Don’t Get Caught In The Noise

Analysts

Underwriters

Auditor

Experts

The Story

Fact

Fact

Fact
Out-Performance: Infamous Blow-Ups

- Ballard - Sep 2000
- Enron - Nov 2000
- BlackBerry - Jun 2008
- Valeant - Aug 2015
- Tyco - Dec 2001
- Worldcom - Apr 1999
- Nortel - Jul 2000

Peak Market Capitalization

$0 $50 $100 $150 $200 $250 $300

Capital Preservation

Loss avoided by Veritas Sell ratings
10 Worst S&P/TSX 60 Stocks

Fully avoided
Majority avoided
Partially avoided
Veritas report issued
Major acquisition announced

Bausch & Lomb deal

Citron ‘smoking gun’ same morning

Added to Veritas Watchlist

Valeant Pharmaceuticals Inc.

Negative Implications of Senate testimony
Business Model Built on Price Hikes
No More Secret Sauce
Veritas uncovers Philidor-Isolani link
Why we should be worried US$72 target
‘Uninvestable’ US$29 target

Yellow Pages – Caught by Competitive Threat

Sell: 07/05
We firmly believe that those investors that sell their YPG units now will reap the rewards of their decision at leisure, while others that hang on for more gains might find the exit door shut in the face of a stampede a year or two down the road

“I mean, 11 out of 12 analysts that cover us have ‘buy’ recommendations.”
Marc Tellier
CEO, Yellow Pages Income Fund- September 2005
Buy & Sell Only

Total Returns vs. S&P/TSX Index

- Veritas Buys
- Veritas Sells

Performance of call at 30 days 60 days 90 days 180 days 360 days Buy/Sell portfolios since inception

Veritas Performance: March 25, 1999 to December 31, 2016

Recent Study: Is the Audit Losing Relevance?

- CFA Society Toronto, AASB, AcSB and CPAB partnered together to solicit input from investors and financial analysts
- Surveyed institutional investors representing $3+ trillion &
- Major sell-side research firms and credit rating agencies
Key Messages

• The Audit is **Highly Relevant** (unanimous agreement)

• But, detailed knowledge about the Audit scope, Audit process, and Accountabilities is **low**

• Investors use a wide variety of information to make their decisions (including a variety of data aggregators)

• While audited GAAP financials are fundamental, investment decisions are increasingly based on **unaudited information**

Sources of Information

- Others
- News Reports
- Earnings Aggregators
- Database Providers
- Analyst Reports
- Corporate Actions
- Regulatory Filings
- Private Meetings with Investors
- Public Meetings with Investors
- Company Announcements
- Annual Reports/MD&A
- GAAP F/S
Understanding The GAAPs

<table>
<thead>
<tr>
<th>Information</th>
<th>Examples</th>
<th>Standard/Policy Set by</th>
<th>Verification</th>
</tr>
</thead>
<tbody>
<tr>
<td>GAAP Financial KPI</td>
<td>EPS</td>
<td>GAAP [NI 52-109]</td>
<td>External Audit</td>
</tr>
<tr>
<td>Non-GAAP Financial KPI</td>
<td>Pro-Forma EPS, Adj, EBITDA, Free Cash Flow</td>
<td>Securities Regulators [Staff Notice 52-306]</td>
<td>Audit Committee; Auditor Review - &quot;not inconsistent&quot; with GAAP F/S</td>
</tr>
<tr>
<td>Other Financial KPI</td>
<td>ARPU, SSS, Sales/sqft</td>
<td>Management</td>
<td>As above</td>
</tr>
<tr>
<td>Operating KPI</td>
<td>Churn, Barrels, Subscribers, Customer Sat</td>
<td>Management</td>
<td>As above</td>
</tr>
</tbody>
</table>

Users Value

- Dialogue with the standard setters
- **Reliability** of key non-GAAP financial information & KPIs
- **Consistent** use & calculation of KPIs
- **Comparable** definitions of KPIs within a sector
- **Greater Transparency**:
  - Disclose which KPIs are most relevant (incl. mgmt compensation)
  - Disclose definition & calculation of KPIs
  - Identify any changes in KPI definitions
- **Accuracy** trumps **Timeliness**
- Users believe the enhancements in these areas would outweigh any incremental cost
2013 Buy-Side Study: Veritas/PWC

Most Used Financial Metrics for Investment Decisions:

EBITDA

Free Cash Flow

EPS

Current State Of Non-GAAP

Source: Bloomberg; Veritas Calculations
2015 Study: Adjustments are Upwardly Biased

• Over 80% of adjustments are favourable.
• Non-GAAP and GAAP earnings difference is material.
• If the ‘earnings’ are inflated...what about valuations.

<table>
<thead>
<tr>
<th>% increase in adjusted metric vs GAAP</th>
<th>EBITDA</th>
<th>Net Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Resource</td>
<td>Non-resource</td>
<td>Resource</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>107%</td>
<td>9%</td>
<td>5788%</td>
</tr>
</tbody>
</table>

Source: Bloomberg; Veritas Calculations; 2015 Filings

2015 Study: Non-GAAP Guidelines Need Enforcement

<table>
<thead>
<tr>
<th>#</th>
<th>OSC Guideline</th>
<th># of Issues</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>State explicitly that the non-GAAP financial measure does not have any standardized meaning under the issuer’s GAAP and therefore may not be comparable to similar measure presented by other issuers.</td>
<td>2</td>
</tr>
<tr>
<td>2</td>
<td>Name the non-GAAP financial measure in a way that distinguishes it from disclosure items specified, defined or determined under an issuer’s GAAP and in a way that is not misleading.</td>
<td>5</td>
</tr>
<tr>
<td>3</td>
<td>Explain why the non-GAAP financial measure provides useful information to investors and the additional purposes, if any, for which management uses the non-GAAP financial measure.</td>
<td>2</td>
</tr>
<tr>
<td>4</td>
<td>Present with equal or greater prominence to that of the non-GAAP financial measure, the most directly comparable measure specified, defined or determined under the issuer’s GAAP presented in its financial statements.</td>
<td>3</td>
</tr>
<tr>
<td>5</td>
<td>Provide a clear quantitative reconciliation from the non-GAAP financial measure to the most directly comparable measure determined under the issuer’s GAAP and presented in its financial statements, referencing to the reconciliation when the non-GAAP financial measure first appears in the document.</td>
<td>14</td>
</tr>
<tr>
<td>6</td>
<td>Ensure that the non-GAAP financial measure does not describe adjustments as non-recurring, infrequent or unusual, when a similar loss or gain is reasonably likely to occur within the next two years or occurred during the prior two years.</td>
<td>6</td>
</tr>
<tr>
<td>7</td>
<td>Present the non-GAAP financial measure on a consistent basis from period to period; however, where an issue changes the composition of the non-GAAP financial measure, explain the reason for the change and restate any comparative period presented.</td>
<td>0</td>
</tr>
</tbody>
</table>

Source: Bloomberg; Veritas Calculations; 2015 Filings

~35% of TSX 60 members have potential non-GAAP regulatory concerns based on current guidelines.
Most Used Non-GAAP Metrics

• EBITDA & derivatives EBIT etc.
• Adjusted Net Income or similar
• Free Cash Flow

Non-GAAP Matters Because...

“The Market” Depends on a Belief System
Non-GAAP Matters Because...

<table>
<thead>
<tr>
<th>GAAP</th>
<th>Non-GAAP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Audited</td>
<td>Non audited</td>
</tr>
<tr>
<td>Standards</td>
<td>Anything you want</td>
</tr>
<tr>
<td>Consistent</td>
<td>Change at will</td>
</tr>
</tbody>
</table>

- *Bridge the gap between past and future*
- *Aggressive non-GAAP metrics are a symptom of underlying operating issues*

The Range of Truth

What does the Market believe?
What is GAAP?

- Revenue
- Receivables
- Cost of Sales
- Inventory

What is Non-GAAP?

- EBITDA
- “Adjusted” EBITDA
- “Cash” EBITDA – Free Cash Flow
- “Normalized” EBITDA
What About...

- Same Store Sales Growth
- Average Revenue Per Unit
- All In Sustaining Costs
- Revenue Per Truck

Who “Uses” GAAP?

- Auditors
- Preparers
- Regulators....
  - Management?
  - Users?
Non-GAAP Humour

If you call a dog’s tail a leg, how many legs would the dog have?

Non-GAAP – Key Question

How much is a company **earning**?
The goal of accounting for earnings is to represent, as best as practicable, the excess of revenues earned over expenses incurred, during a specific period, including all resources management has used in that period.
Non-Cash Expenses

- Virtually all expenses are cash. The difference is usually timing.

- Examples of common ‘non-cash’ expenses:
  - **Amortization/Depreciation**: Cash now - expensed later
  - **Payroll**: Cash now – expense now
  - **Deferred taxes**: Expense now – cash later

- If management claims an expense is non-cash, what exactly is management spending and what are the accountants counting?

### Restructuring Charges

**VRX – What to consider**

- Frequency: VRX reported restructuring costs in each quarter since Q4-F10
- Business Performance: Organic erosion meant these costs are necessary sustain the operations

The Impact of Restructuring Costs on Cash Earnings

*(Amounts in millions of US dollars)*

<table>
<thead>
<tr>
<th></th>
<th>Q4-F10 through Q1-F15</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash Earnings - reported</td>
<td>8,237</td>
</tr>
<tr>
<td>Restructuring/integration costs</td>
<td>(1,602)</td>
</tr>
<tr>
<td>Cash Earnings - adjusted</td>
<td>6,636</td>
</tr>
<tr>
<td>% impact on Cash Earnings</td>
<td>24%</td>
</tr>
</tbody>
</table>
Non-Recurring Expenses – Bell Canada

<table>
<thead>
<tr>
<th></th>
<th>F11</th>
<th>F12</th>
<th>F13</th>
<th>F14</th>
<th>F15</th>
</tr>
</thead>
<tbody>
<tr>
<td>EBITDA, adjusted</td>
<td>7,629</td>
<td>7,888</td>
<td>8,089</td>
<td>8,303</td>
<td>8,551</td>
</tr>
<tr>
<td>Adjustments:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Severance, acquisition and other costs</td>
<td>(409)</td>
<td>(133)</td>
<td>(406)</td>
<td>(216)</td>
<td>(446)</td>
</tr>
<tr>
<td>Depreciation</td>
<td>(2,538)</td>
<td>(2,678)</td>
<td>(2,734)</td>
<td>(2,880)</td>
<td>(2,890)</td>
</tr>
<tr>
<td>Amortization</td>
<td>(723)</td>
<td>(714)</td>
<td>(646)</td>
<td>(572)</td>
<td>(530)</td>
</tr>
<tr>
<td>Interest Expense</td>
<td>(853)</td>
<td>(865)</td>
<td>(931)</td>
<td>(929)</td>
<td>(909)</td>
</tr>
<tr>
<td>Interest on post-employment benefit obligations</td>
<td>(973)</td>
<td>(131)</td>
<td>(150)</td>
<td>(101)</td>
<td>(110)</td>
</tr>
<tr>
<td>Expected return on post-employment benefit plan asset</td>
<td>1,032</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Other expense (income)</td>
<td>129</td>
<td>269</td>
<td>-6</td>
<td>42</td>
<td>(12)</td>
</tr>
<tr>
<td>Income taxes</td>
<td>(720)</td>
<td>(760)</td>
<td>(828)</td>
<td>(929)</td>
<td>(924)</td>
</tr>
<tr>
<td>Total adjustments</td>
<td>-5,055</td>
<td>-5,012</td>
<td>-5,701</td>
<td>-5,585</td>
<td>-5,821</td>
</tr>
<tr>
<td>Net income, reported</td>
<td>2,574</td>
<td>2,876</td>
<td>2,388</td>
<td>2,718</td>
<td>2,730</td>
</tr>
</tbody>
</table>

- BCE states “We use adjusted EBITDA and adjusted EBITDA margin to evaluate the performance of our businesses as they reflect their ongoing profitability.”
- If a company incurs an expense every year for 5 years, isn’t that part of ‘ongoing profitability’?
- Part of the severance costs are for the wireline business, which is declining. How are restructuring costs for a declining business not part of ongoing operations?

Non-Recurring Expenses – Investor Considerations

1. Is the same or similar expense likely to recur within 2 years? If yes, don’t adjust.
2. Has the same or similar expense been incurred in the most recent 2 years? If yes, don’t adjust.
3. Does the expense relate to otherwise normal business activity even if the expense happens infrequently? If yes, don’t adjust.
4. Does it appear that management is proposing an adjustment for a business expense simply because it is unusually large in the current period? If yes, don’t adjust.
5. Does it relate to an event where real business value has be lost (i.e. loss of patent, impairment of asset, etc)? If yes, an adjustment may be appropriate, however investors need to also consider where to capture the loss in their assessment of value.
6. Was the expenditure a result of actions within management’s control? If yes, don’t adjust.
Asset Impairments

- Asset impairments represent real loss.
- Capital misallocation is a real business cost and can be incorporated into financial models.
- Investors can gauge the size of the impact by comparing the impairment to the current share price. Had the asset not been purchased, the company would have cash on hand and be worth more today.

- **Kinross Red Back example:**
  - Kinross bought Red Back in 2010 and subsequently wrote down ~US$7.5B of a ~US$8.7B acquisition.
  - Current market capitalization of Kinross: ~US$5.2B

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Asset Impairments – Valuation Considerations

- Should investors build capital misallocation costs into their valuation? Things to consider:
  1. Are the people who approved the asset acquisition still in place?
  2. Do the people who approved the asset acquisition have a track record of asset impairments?
  3. Has the company produced returns on equity/capital, using GAAP net income (which incorporates the cost of asset impairments), which are above the investors’ hurdle rate, cumulatively over the last 10 years? How do those returns compare to peers?
  4. Has management addressed the impairment with shareholders directly and taken ownership of the decision or do they couch it in the language of non-cash, non-recurring, etc?
  5. Is the impairment due to volatile economics of the industry, and therefore potentially temporary in nature? (e.g. commodity businesses)?
  6. Has the company changed its processes related to investment projects?
Share Based Awards – The Economics

Stock Market

- Repurchase and Cancel Shares → Pay $100
- Sell Shares
- Receive $100

ABC Company

ABC Company Employee

- Sell Shares
- Exercise Option → Pay $50

Share Based Awards - Non-Cash Fallacy

- **Question for management:** If you had to replace your entire stock compensation scheme with cash, how much would it cost the company?
Share Based Awards - RBC Example
The Disconnect Between Accounting and “Real” Cost

<table>
<thead>
<tr>
<th></th>
<th>F13</th>
<th>F14</th>
<th>F15</th>
</tr>
</thead>
<tbody>
<tr>
<td># of options exercised (‘000) (A)</td>
<td>2,528</td>
<td>2,723</td>
<td>1,190</td>
</tr>
<tr>
<td>Weighted average share price @ exercise (B)</td>
<td>63.17</td>
<td>74.27</td>
<td>76.87</td>
</tr>
<tr>
<td>Weighted average exercise price (C)</td>
<td>42.22</td>
<td>49.03</td>
<td>46.44</td>
</tr>
<tr>
<td>Net profit per share (C - B = D)</td>
<td>20.95</td>
<td>25.24</td>
<td>30.43</td>
</tr>
<tr>
<td>Total compensation earned by employees ($'000) (A x D)</td>
<td>52,962</td>
<td>68,729</td>
<td>36,212</td>
</tr>
<tr>
<td>Stock option expense per income statement ($'000)</td>
<td>7,000</td>
<td>7,000</td>
<td>6,000</td>
</tr>
</tbody>
</table>

- The discrepancy is due to:
  - Black-Scholes model is probability weighted therefore the accounting expense considers the potential for options to expire worthless
  - Timing difference between when options are expensed (vesting period) and when employees can exercise the options (exercise period)

- RBC does not exclude stock comp from adjusted earnings and provides robust disclosure

Expedia: How to Factor Stock-based Compensation

- Operating cash flow excludes share based compensation because it is non-cash
- The real cost is buried in financing cash flow
Expedia: Measuring Stock Based Comp

- Expedia excludes share based comp from its key metrics

What’s the cost of stock based compensation?
(Amounts in thousands of US dollars)

<table>
<thead>
<tr>
<th></th>
<th>2014</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>FCF (CFO - capex)</td>
<td>1,038,572</td>
<td>454,619</td>
</tr>
<tr>
<td>Stock based compensation - accounting expense</td>
<td>(85,011)</td>
<td>(130,173)</td>
</tr>
<tr>
<td>Intrinsic value of share based comp, net of tax benefit</td>
<td>(153,459)</td>
<td>(98,093)</td>
</tr>
<tr>
<td>FCF - adjusted if used accounting expense</td>
<td>-8%</td>
<td>-29%</td>
</tr>
<tr>
<td>FCF - adjusted if used intrinsic value</td>
<td>-15%</td>
<td>-22%</td>
</tr>
</tbody>
</table>

NON-Non-GAAP Measures
Retailers: Same-Store-Sales Growth (SSSG)

- Used to measure sales growth generated by a company’s existing store network, open for one-year

<table>
<thead>
<tr>
<th>Retailer</th>
<th>SSSG explained?</th>
<th>Exclude remodeled/expanded stores?</th>
<th>Includes Digital sales?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Metro</td>
<td>✔</td>
<td>- No explanation</td>
<td>N/A</td>
</tr>
<tr>
<td>Loblaw</td>
<td>✔</td>
<td></td>
<td>N/A</td>
</tr>
<tr>
<td>Empire</td>
<td>✔</td>
<td>- No explanation</td>
<td>N/A</td>
</tr>
<tr>
<td>Canadian Tire</td>
<td>✔</td>
<td></td>
<td>✔</td>
</tr>
<tr>
<td>Dollarama</td>
<td>✔</td>
<td>- Include relocated/expanded stores open for 13 months.</td>
<td>N/A</td>
</tr>
<tr>
<td>Jean Coutu</td>
<td>✔</td>
<td>- No explanation</td>
<td>N/A</td>
</tr>
<tr>
<td>Hudson’s Bay Co.</td>
<td>✔</td>
<td></td>
<td>✔</td>
</tr>
<tr>
<td>Macy’s</td>
<td>✔</td>
<td>- remain in the comparable sales calculation</td>
<td>✔</td>
</tr>
<tr>
<td>Restaurant Brands</td>
<td>✔</td>
<td>- No explanation</td>
<td>N/A</td>
</tr>
</tbody>
</table>

Source: Company Annual reports.

Clear Explanation? Remodeled Stores. Digital Sales?

Gold Miners: All-In Sustaining Cost (AISC)

- Costs required to “sustain” current operating production plan
- World Gold Council provided a guideline in 2013

<table>
<thead>
<tr>
<th>Guidelines for AISC Calculation</th>
<th>Source</th>
<th>Expense Type</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash Costs (on a sales basis)</td>
<td>Income Statement</td>
<td>Cash</td>
</tr>
<tr>
<td>+ Corporate G&amp;A Costs (incl. share based comp)</td>
<td>Income Statement</td>
<td>Cash and Non-Cash</td>
</tr>
<tr>
<td>+ Reclamation &amp; Remediation Accretion (operating sites)</td>
<td>Income Statement</td>
<td>Non-Cash</td>
</tr>
<tr>
<td>+ Exploration and Study Expense (sustaining)</td>
<td>Income Statement</td>
<td>Cash</td>
</tr>
<tr>
<td>+ Capitalized Exploration (sustaining)</td>
<td>Cash Flow Statement</td>
<td>Cash</td>
</tr>
<tr>
<td>+ Capitalized Stripping (sustaining)</td>
<td>Cash Flow Statement</td>
<td>Cash</td>
</tr>
<tr>
<td>= All-In Sustaining Costs (AISC)</td>
<td>Cash Flow Statement</td>
<td>Cash</td>
</tr>
</tbody>
</table>

Source: WGC, Veritas

An incomplete picture since AISC excludes taxes and financing costs
Gold Miners: AISC - Exclusions and Adjustments

- **Production vs. Sales**: Show AISC/oz on ounces produced instead of ounces sold as per guideline
- **Inventory Adjustments**: Including them to reduce costs
- **Processing Costs**: Treatment and Refining Costs excluded
- **G&A Adjustments**: Share-based compensation excluded
- **Exploration**: Brown-field exploration costs excluded
- **Other**: Development costs due to geological and technical issues excluded

To make comparisons we need to know what costs companies exclude

<table>
<thead>
<tr>
<th>AISC</th>
<th>Adjustment</th>
<th>2016 AISC Reported ($/oz)</th>
<th>Impact of Adjustment ($/oz)</th>
<th>% Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>AEM</td>
<td>Ounces produced, Excludes Project and Exploration Expense</td>
<td>820</td>
<td>82</td>
<td>10%</td>
</tr>
<tr>
<td>IAG</td>
<td>Excludes Westwood Restructuring cost for one year</td>
<td>1,057</td>
<td>33</td>
<td>3%</td>
</tr>
<tr>
<td>AUY</td>
<td>Ounces produced, Excludes stock based compensation and other undisclosed items, reclamation amortization</td>
<td>911</td>
<td>35</td>
<td>4%</td>
</tr>
</tbody>
</table>

Source: Company Reports, Veritas estimates

Reported figures are not comparable without further adjustment.
REITs AFFO: Capex - Maintenance vs. Growth

Provision as a % of Actual Maintenance-related Capex
2014: 30%
2013: 35%

Property Capital Investments by Category

2014 Veritas Estimated Maintenance Capex = $50,754
2013 Veritas Estimated Maintenance Capex = $42,815
Evaluating Non-GAAP Metrics

- Understand the metric used by the market and how it is calculated
- Is there anything abnormal/different from peers?
- Has the calculation changed?
- Do the adjustments make common business sense?
- Is compensation or covenants tied to the market’s metric?
- What will move the market’s belief to your number?

Advise For Users

- Don’t blindly accept non-GAAP metrics
- If an adjustment doesn’t make common business sense, don’t use it!
- Scrutinize adjustments based on management objectives.
- Compare valuation/performance metrics using both GAAP and non-GAAP measures.
NON-GAAP Canada vs USA

<table>
<thead>
<tr>
<th>Enforcement</th>
<th>OSC Staff Notice</th>
<th>SEC Rule</th>
</tr>
</thead>
<tbody>
<tr>
<td>Introduced</td>
<td>2004</td>
<td>2004</td>
</tr>
<tr>
<td>Details</td>
<td>Identical</td>
<td>Identical</td>
</tr>
</tbody>
</table>

Non-GAAP Recommendations to Regulators

• Issue a regulation
• Nomenclature must be labeled “Adjusted” unless as calculated
• All inputs reconciling to GAAP figures must be provided
• Strong regulatory enforcement for non-compliance
• Audit compliance with regulatory standards
A Word On How Audit Can Help

- Improve image of assurance
- Clearly label what is audited in financial filings
- Expand assurance services
- Compliance with Non-GAAP Regulatory Standards (OSC)
- Compliance with compensation programs

Questions
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