The Rise Of Non-GAAP Metrics

CPA BC Education Foundation Symposium
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Anthony Scilipoti, FCPA, FCA, CPA (Illinois)
President & CEO

Outline

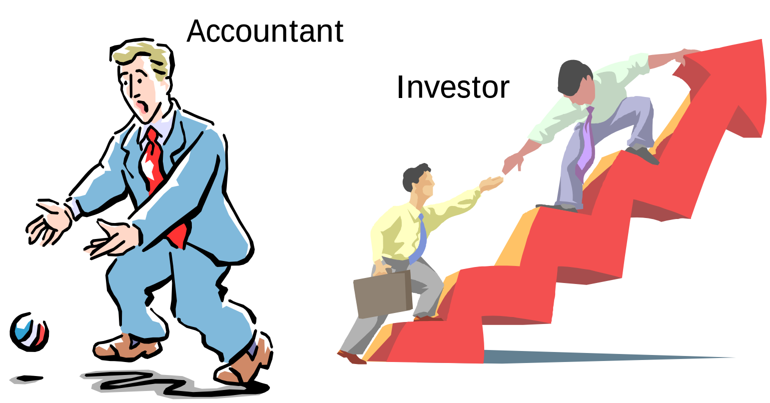
- Why Veritas
- The State of Non-GAAP
- Why Non-GAAP Is Important
- Uses/Usefulness of Non-GAAP
- Recommendations

Veritas

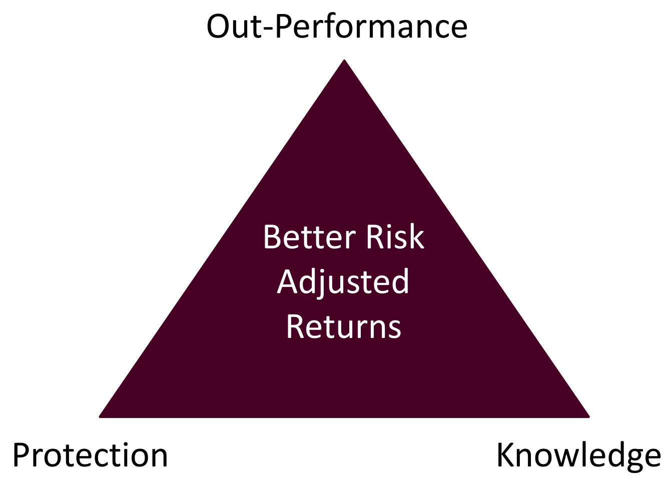
Independent
Employee owned
In-depth
Experienced

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

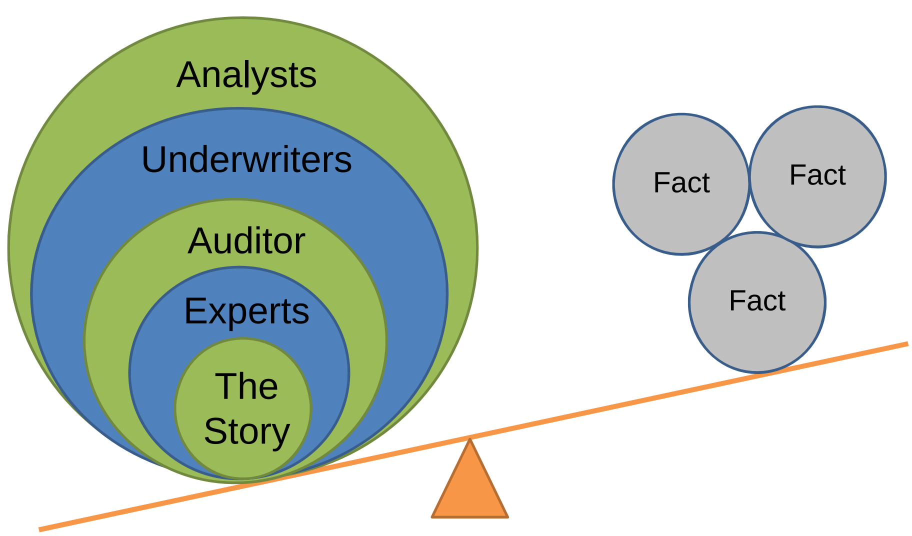
A Common Perception



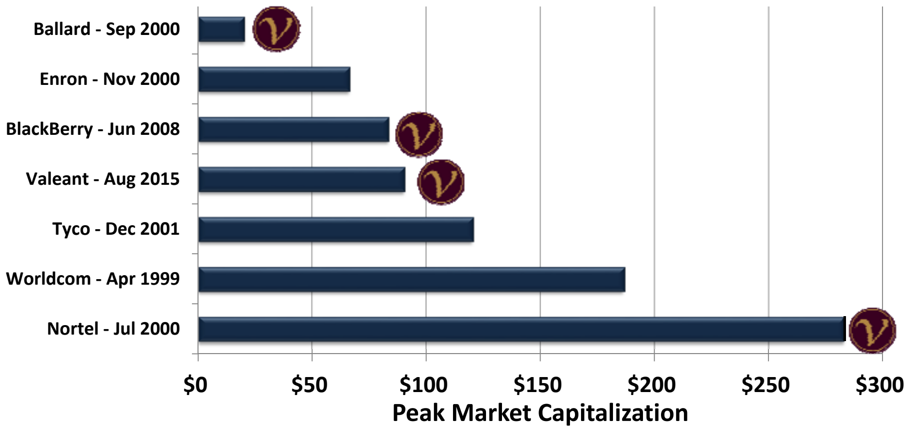
Why Veritas



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



Out-Performance: Infamous Blow-Ups



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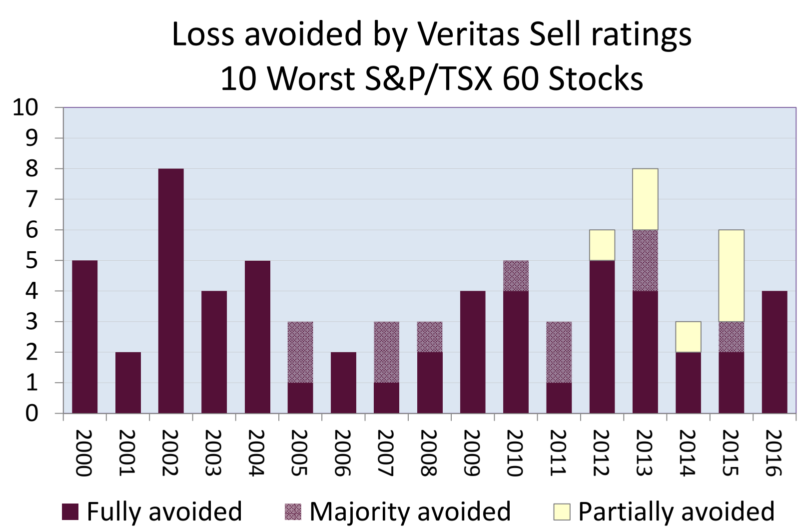
Capital Preservation



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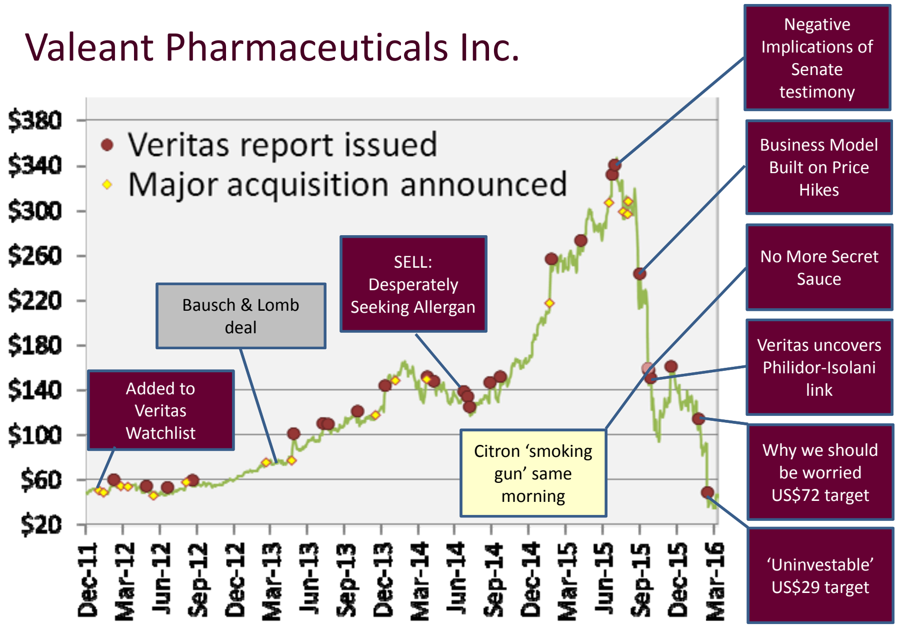
Valeant Pharmaceuticals Inc.

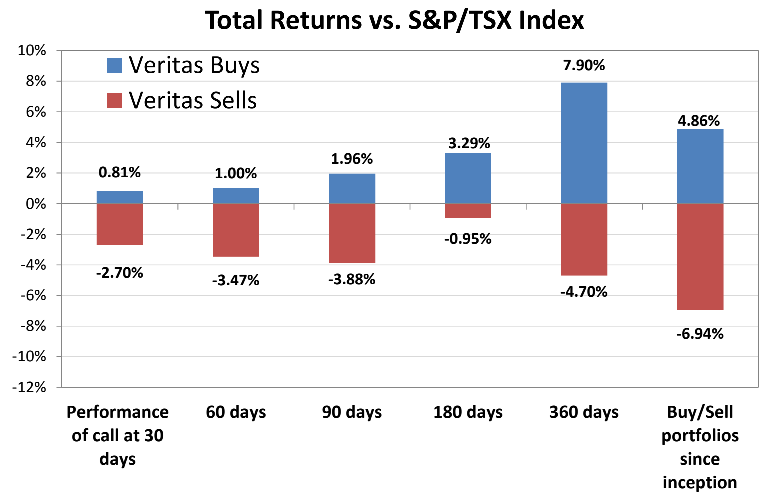


Yellow Pages – Caught by Competitive Threat

"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



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

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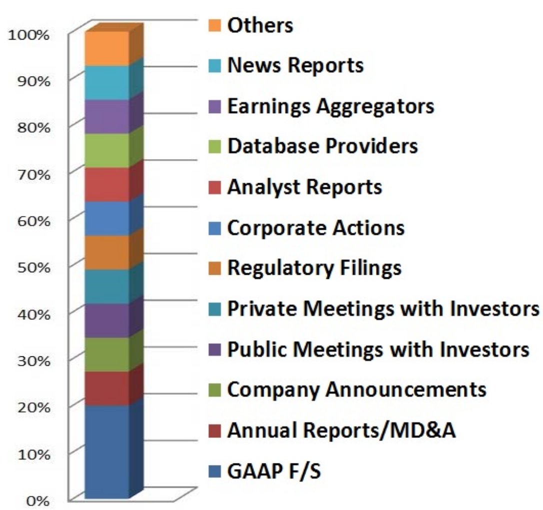
Sources of Information



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Understanding The GAAPs

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

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

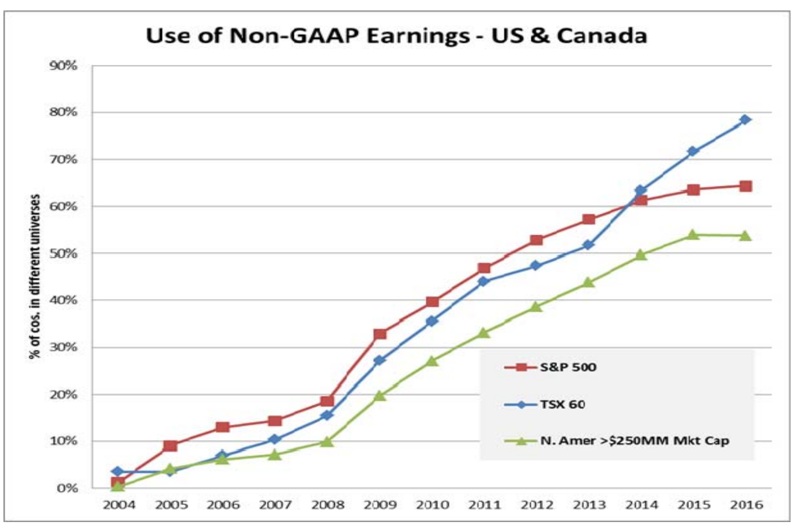
Most Used Financial Metrics for Investment Decisions:

EBITDA

Free Cash Flow

EPS

Current State Of Non-GAAP



Source: Bloomberg; Veritas Calculations

2015 Study: Adjustments are Upwardly Biased

	EBITDA		Net Income	
	Resource	Non-resource	Resource	Non-resource
% increase in adjusted metric vs GAAP	107%	9%	5788%	16%

Source: Bloomberg; Veritas Calculations; 2015 Filings

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

2015 Study: Non-GAAP Guidelines Need Enforcement

#	OSC Guideline	# of Issues
1	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.	2
2	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.	5
3	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.	2
4	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.	3
5	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.	14
6	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.	6
7	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.	0

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…

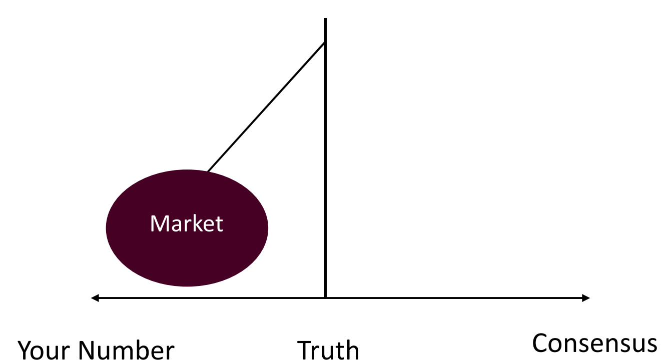
"The Market" Depends on a Belief System

Non-GAAP Matters Because…

GAAP	Non-GAAP
Audited	Non audited
Standards	Anything you want
Consistent	Change at will

- *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**?*

Veritas View On Earnings

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.***

Types of Adjustments

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)

	Q4-F10 through Q1-F15
Cash Earnigns - reported	8,237
Restructuring/integration costs	(1,602)
Cash Earnigns - adjusted	6,636
% impact on Cash Earnings	**24%**

Non-Recurring Expenses – Bell Canada

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

- 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?

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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.

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Asset Impairments

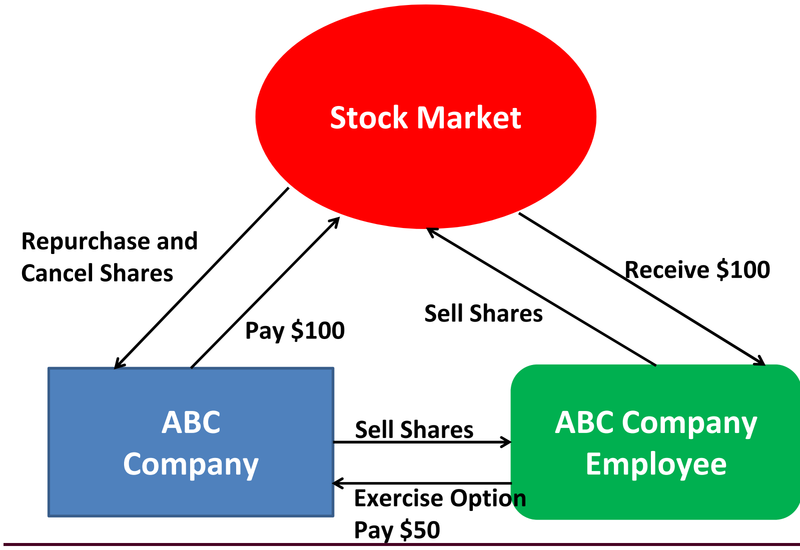
- Asset impairments represent real loss.
- Capital misallocation is a real business cost and can be incorporated into financial models.
- Investors can gauge the size of the impact by comparing the impairment to the current share price. Had the asset **not** been purchased, the company would have cash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

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



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

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

- 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

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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, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Selected Items)

	Year ended December 31, 2014	2013	2012
		(In thousands)	
Operating activities:			
Amortization of stock-based compensation	85,011	130,173	64,596
Net cash provided by operating activities from continuing operations	1,366,959	763,200	1,237,182
Financing activities:			
Proceeds from issuance of long-term debt, net of issuance costs	492,894	—	—
Purchases of treasury stock	(537,861)	(522,900)	(417,571)
Proceeds from issuance of treasury stock	20,404	25,273	—
Payment of dividends to stockholders	(84,697)	(75,760)	(130,423)
Proceeds from exercise of equity awards and employee stock purchase plan	108,121	56,836	241,193
Excess tax benefit on equity awards	58,156	39,606	41,100
Other, net	(8,868)	(15,571)	(7,086)
Net cash provided by (used in) financing activities from continuing operations	48,149	(492,516)	(272,787)

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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)

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

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

	SSSG explained?	Exclude remodeled/expanded stores?	Includes Digital sales?
Metro	×	- No explanation	N/A
Loblaw	✓	✓	N/A
Empire	✓	- No explanation	N/A
Canadian Tire	✓	✓	✓
Dollarama	✓	× - Include relocated/expanded stores open for 13 months.	N/A
Jean Coutu	✓	- No explanation	N/A
Hudson's Bay Co.	✓	× - remain in the comparable sales calculation	✓
Macy's	✓	× - remain in the comparable sales calculation	✓
Restaurant Brands	✓	- No explanation	N/A

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

Guidelines for AISC Calculation	Source	Expense Type
Cash Costs (on a sales basis)	Income Statement	Cash
+ Corporate G&A Costs (incl. share based comp)	Income Statement	Cash and Non-Cash
+ Reclamation & Remediation Accretion (operating sites)	Income Statement	Non-Cash
+ Exploration and Study Expense (sustaining)	Income Statement	Cash
+ Capitalized Exploration (sustaining)	Cash Flow Statement	Cash
+ Capitalized Stripping (sustaining)	Cash Flow Statement	Cash
+ Capital Expenditure (sustaining)	Cash Flow Statement	Cash
= All-In Sustaining Costs (AISC)		

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

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Results: Barrick, Newmont, Goldcorp Follow Agnico, IAMGOLD, Yamana Don't

Reported AISC and Impact of Adjustments in 2016

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

Source: Company Reports, Veritas estimates

Reported figures are not comparable without further adjustment.

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REITs AFFO: Capex - Maintenance vs. Growth

CAPREIT Page 45
2014 YE MD&A

($ Thousands, except per Unit amounts)

Year Ended December 31,		2014		2013
NFFO	$	183,353	$	159,375
Adjustments:				
Provision for Maintenance Property Capital Investments [1]		(15,466)		(15,097)
Amortization of Fair Value on Grant Date of Unit-based Compensation		4,347		2,525
AFFO	$	172,234	$	146,803
AFFO per Unit – Basic	$	1.574	$	1.438
AFFO per Unit – Diluted	$	1.551	$	1.419
Distributions Declared	$	131,044	$	119,256
AFFO Payout Ratio		76.1%		81.2%
Net Distributions Paid	$	87,051	$	88,265
Excess AFFO over Net Distributions Paid	$	85,183	$	58,538
Effective AFFO Payout Ratio		50.5%		60.1%

1 Based on an industry estimate of $450 per suite per year and the weighted average number of residential suites during the year (see Productive Capacity section).

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

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REITs AFFO: Capex - Maintenance vs. Growth

Property Capital Investments by Category

CAPREIT, 2014 YE MD&A Page 46

($ Thousands)

Year Ended December 31,	2014	%	2013	%
Building Improvements	$ 59,518	41.0	$ 80,728	51.2
Suite Improvements	33,613	23.1	31,659	20.1
Common Area	21,272	14.7	16,166	10.2
Energy-saving Initiatives	1,291	0.9	2,604	1.7
Equipment	11,625	8.0	10,139	6.4
Boilers and Elevators	15,408	10.6	14,549	9.2
Appliances	2,449	1.7	1,961	1.2
Total	$ 145,176	100.0	$ 157,806	100.0

2014 Veritas Estimated Maintenance Capex = $50,754

2013 Veritas Estimated Maintenance Capex = $42,815

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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?

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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.

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NON-GAAP Canada vs USA

Enforcement	OSC Staff Notice	SEC Rule
Introduced	2004	2004
Details	Identical	Identical

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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