THE GLOBE AND MAIL

September 25, 2017

How Valeant's financial reporting may still echo the bad old days

Valeant Pharmaceuticals chief executive Joseph Papa takes questions from shareholders at the company's annual meeting in Laval, Que., on Tuesday, June 14, 2016.

RYAN REMIORZ/THE CANADIAN PRESS

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Early this year, Valeant Pharmaceuticals International Inc. referred to itself as "the new Valeant" in investor presentations, a turn of phrase that was met by skepticism from some quarters, as the company's financial results continued to seem troubled.

There's been more enthusiasm since, and the shares have rallied from lows, albeit nowhere near the highs of the old Valeant. There is building enthusiasm for the leadership of chief executive officer Joseph Papa and a potential turnaround.

We'll set that question aside for today, however, and ask this instead: Is the company's financial reporting better under Mr. Papa than under his once-vaunted, now-exiled predecessor Michael Pearson? And in one complicated but important way, the answer seems to be "no."

The devilish details come in how Valeant calculates its preferred earnings measure, "adjusted EBITDA," which takes earnings before interest, taxes, depreciation and amortization – itself not a figure calculated under generally accepted accounting principles – and, yes, adjusts it further.

Under Mr. Pearson, the company used something called "cash earnings," until the U.S. Securities and Exchange Commission helpfully told Valeant that the concept could mislead investors. Now, Valeant has a new metric, and an explanation of its non-GAAP calculations that takes up seven pages of its quarterly earnings release.

Included in the descriptions is this: Valeant's adjusted EBITDA "no longer includes adjustments for foreign exchange gain/loss arising from intercompany transactions." These are transactions among various Valeant subsidiaries and entities (despite the prefix "inter," as opposed to "intra.")

Now, in adjusting EBITDA, "no longer includes adjustments for" means that that particular item is now *included* in the final metric. And as it happens, the foreign exchange gain/loss has been, for the first two quarters of 2017, a gain – meaning Valeant's decision is boosting its preferred earnings measure.

By how much? For now, we can tell. Its "foreign exchange and other" line item was $68-million (U.S.) in the first half of 2017. The company confirms that for the first two quarters, it's solely composed of these gains on intercompany transfers.

It's not much, certainly, compared with $1.8-billion in adjusted EBITDA. But when we look at Valeant's net income, calculated per U.S. generally accepted accounting principles, the forex gains contribute almost 20 cents a share, on a pretax basis, to Valeant's earnings per share of $1.68 in the first half of the year. (Valeant, never a big taxpayer thanks to its Canadian domicile, now reports an income-tax credit on its financial statements thanks to operating losses).

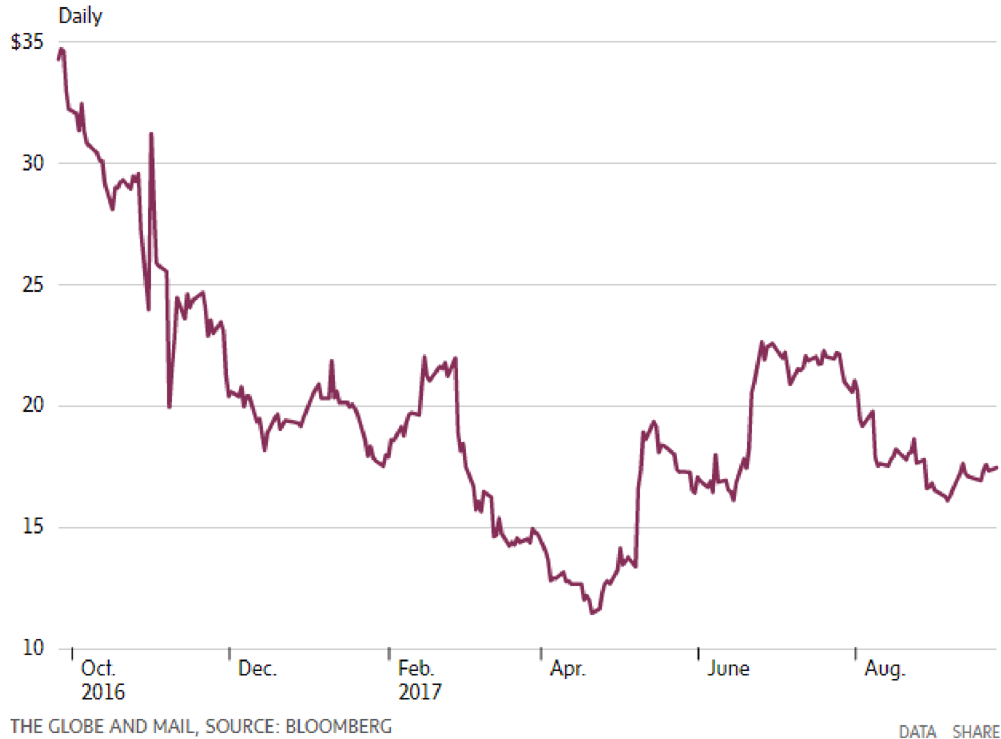
Valeant used to include the benefits of intercompany foreign exchange in its "cash earnings," but stopped in 2012. Now, in 2017, it has resumed the practice, albeit in a new form. Count me among the lingering skeptics: I asked Valeant whether it was now including foreign exchange gains in adjusted EBITDA because it's a positive, and the company is forecasting it will make that preferred earnings number larger, and was excluding it when it made the non-GAAP earnings measure worse.

This conclusion, says Valeant spokewoman Lainie Keller, "is incorrect. The company has no way of predicting foreign exchange moves so any suggestion that the company changed the methodology to improve our financial results is incorrect. As a result of the new methodologies, the company may see a positive impact or negative impact from foreign exchange on our quarterly financial results."

She also says "these new methodologies to calculate non-GAAP measures, including excluding foreign exchange gain/loss adjustments, better reflect the underlying business of the company, reflecting increased transparency and putting us in line with peers in our industry."

Analyst ***Dimitry Khmelnitsky*** of ***Veritas Investment Research***, one of Valeant's early critics, wrote in May: "We see no reason why these gains should be included in adjusted EBITDA, especially given their inherent volatility and their intercompany nature." He also noted that the move away from them in 2012 came after ***Veritas*** criticized the quality of the company's non-GAAP metrics. In the second quarter, he says, a $38-million foreign exchange gain contributed mightily to the company's $40-million "beat" to analyst earnings expectations.

The company isn't using the phrase "the new Valeant" quite as often these days, although it firmly believes it's distancing itself from the "legacy" Valeant under Mr. Pearson and, Ms. Keller says, "is committed to transparency." Indeed, investors who have dug through the company's announcement will find that it's made this particular accounting change, although it requires a bit of analysis and math to see the impact. At that point, investors can then come to their own conclusions on how much new Valeant differs from the old.



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