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Investors are still getting a distorted view of TSX stocks' financials - and regulators are promising to act

Ontario Securities Commission logo

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Canadian companies are hooked on their own, rosier versions of their earnings performance. And Canadian securities regulators are going to crack down.

Cameron McInnis, chief accountant at the Ontario Securities Commission, tells The Globe and Mail his agency will combine with other provincial regulators to publish formal rules next spring on how companies use what are known as "non-GAAP financial measures," which are results not calculated in accordance with generally accepted accounting principles.

The move indicates that regulators are becoming more concerned about the way public companies are emphasizing to investors the results calculated using their own measures of financial performance at the expense of those based on standard accounting measures. By writing new rules about this, provincial regulators will gain new tools to crack down on companies that take the practice too far. This will also put Canada's regulatory efforts on this issue on par with the United States, where the Securities and Exchange Commission has been using its formal rules to go after companies in enforcement actions, with financial and other penalties.

"It's important [that companies] provide this information in a way that is not misleading to investors," Mr. McInnis said in a written statement. "Given the increased use of non-GAAP measures and the problem areas that we continue to find, we believe it is appropriate to move this guidance into a rule."

The CSA's move comes as *Veritas Investment Research*, a Toronto firm, has completed its second study of the use of non-GAAP measures among large Canadian public companies and found an increase in 2016 from the year before. Companies still may be violating existing OSC guidance, *Veritas* finds.

The *Veritas* study also found that many companies are using one non-GAAP measure to present to investors and a different one to calculate management's annual bonuses and other lucrative compensation awards.

Veritas reviewed Bloomberg data taken from regulatory filings of the S&P/TSX 60 and found that 70 per cent used a non-GAAP measure of net income in their securities filings in 2015, and nearly 80 per cent did so in 2016. Those levels exceed those of the companies in the United States' S&P 500, per the Bloomberg data, *Veritas* has found.

Typically, the companies exclude restructuring costs, stock payments to executives and writeoffs from deals that went badly on the premise that they are either "non-cash" items, or are "unusual" and don't reflect the company's normal performance. But the vast majority of adjustments increase earnings, not decrease them. As one hedge-fund manager told The Globe last year: "Management isn't going to adjust numbers to make them selves look bad."

Investors buy stocks to lay claim to a company's earnings, now and in the future. If the companies can persuade investors and analysts that their earnings are higher than what they would be if they used the GAAP accounting rules, their stock prices will follow.

Neither U.S. nor Canadian regulators prevent companies from making these adjustments. But they are fighting to make sure companies do not emphasize those results over the ones calculated with tried-and-true measures, and also that investors know exactly how they are calculated. In its 2016 report, highlighted in The Globe, *Veritas* explicitly recommended "the OSC should formalize its guidance as a regulation to be more comparable to the SEC."

Veritas believes widespread failures in Canada in non-GAAP disclosure merit the change. Among the S&P/TSX 60, *Veritas* identified 31 potential violations of CSA guidelines in both 2015 and 2016. Some companies had multiple violations, so 21 companies had issues in 2015, and 20 in 2016, in *Veritas'* view. (The OSC takes an outsized role in Canadian securities regulation because of the TSX, but the CSA must craft rules so they will apply nationwide.)

The biggest problems over compliance with the CSA guidelines: *Veritas* believes 10 companies of the 60 did not present the GAAP measure with as much or more prominence than the non-GAAP measure derived from it. Another 14 companies did not provide a clear reconciliation between the non-GAAP measure and GAAP measure – in the form of a table that explains the differences – that they would point to when the non-GAAP measure first appears in the results report.

In *Veritas'* view, Metro Inc. had both these problems in 2016, as well as failing to state explicitly that its non-GAAP measure is not directly comparable to that of another company. Metro had three potential issues with the disclosure guidance, making it the most problematic S&P/TSX company, in *Veritas'* view.

Veritas analyst *Taso Georgopoulos*, the author of that report, says the problem comes because Metro believe its primary profit measure, "operating income before depreciation and amortization and associate's earnings," conforms to the International Financial Reporting Standards, while *Veritas* does not. Metro would not comment for this story.

Metro's measure came in at $236.1-million for the fourth quarter, versus $150.2-million of net income as calculated under IFRS.

As part of *Veritas'* new report, the firm examined the proxy circulars of the S&P/TSX 60 companies and found an extensive use of non-GAAP measures.

For both short-term incentive plans and share-based award plans, *Veritas* found that the non-GAAP metrics companies used were frequently different than those emphasized to investors in quarterly earnings announcements. *Veritas* believes only 12 of 28 share-based award plans that use a non-GAAP measure

use the key non-GAAP earnings measure that management presents to investors. For short-term incentive plans, just 31 of 48 used the same measure for both purposes.

*For a detailed breakdown by **Veritas** of how disclosures stack up for all TSX 60 stocks, go to tgam.ca/nongaap*