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Investors, it's time to take action on the persistent and problematic use of non-GAAP measures

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When asked which type of wine he preferred to drink, Greek philosopher Diogenes replied, "That for which other people pay." The Canadian C-suite appears to have a similar feeling about the numbers they prefer to report.

Last year, we studied the widespread use of non-GAAP measures and the problems they present for users of financial statements. Unfortunately, our recent work shows that little progress has been made. Although many investors we've spoken to consider non-GAAP measures one of the biggest challenges they face, most companies have done very little to address their concerns.

This year, we again found that many S&P/TSX 60 companies remain offside guidelines from the Ontario Securities Commission in relation to reported non-GAAP measures. While some companies have improved, we still uncovered nearly the same number of violations as last year.

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For example, according to one guideline, companies are obliged to reconcile a given non-GAAP metric to the "most directly comparable" GAAP metric the first time it appears in a public filing. In other words, when "adjusted EBITDA" is first introduced in an annual report, the company needs to alert investors to the appropriate reconciliation and the page number where it can be found; not exactly a tough job. Still, many companies fail to fulfill even this basic requirement.

Reporting (and especially highlighting) non-GAAP metrics follows pretty simple logic (from the company's perspective): Non-GAAP "earnings" are consistently higher than GAAP earnings, and higher earnings typically beget higher valuations; higher valuations beget higher executive compensation. But can investors rely on valuations if they are based on non-GAAP numbers that are unaudited, do not follow standards and can be changed at management's whim? In other words, are those valuations "real"?

I learned long ago that perception is reality. And right now, it is easier to accept a market trading at 19.5 times (based on the S&P/TSX non-GAAP earnings-per-share number) than one trading at 25.2 times (based on the GAAP EPS number). Unfortunately, adjusting your metrics to justify where stocks are already trading is far easier than questioning valuations or the metrics themselves.

The influence of non-GAAP measures is not limited to company reporting; these metrics have now crossed over into management compensation schemes. Based on our analysis of the two largest categories of management compensation for S&P/TSX 60 companies, more than 40 per cent of short-term incentive plans and over 10 per cent of share-based plans are driven by non-GAAP metrics. Worse still is that, in many instances, the primary non-GAAP earnings measure promoted to investors does not match the one used in determining management's compensation. Consider that for a moment. Some companies use different non-GAAP performance measures to sway investors than they use to compensate their executives.

In his 2017 shareholder letter, Warren Buffett addressed management's use of non-GAAP measures, noting that management should: *"… in their commentary, describe unusual items – good or bad – which materially affected GAAP figures."* He also noted that: "management that regularly attempts to wave away very real costs by highlighting 'adjusted per-share earnings' makes us nervous." Mr. Buffett's conclusion on this matter, which matches our own, is that "bad behaviour is contagious."

In our experience, a common characteristic of financial frauds and spectacular investment blow-ups is that the tone at the top is pushed down to subordinates, saying we need to "make the numbers." Once that type of thinking invades a company, it is not long before "make the numbers" becomes "make up the numbers."

Ultimately the power rests in the hands of investors, who are the true owners of the businesses. Investors who find themselves on the receiving end of a muddle of obscure or intractable metrics need to take action. Reach out to your regulators and standard setters. Question your management teams. Let them know you are unhappy with this type of financial reporting.

Real change can only take place if investors make themselves heard. Until then, markets will continue to fall prey to managements' "stop-GAAP" measures and executives will continue to be rewarded by compensation plans that incentivize "making the numbers" at all costs.

Remember that, in the end, investors always end up paying for the drinks.