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THE NUMBERS GAME

In an attempt to burnish their image with investors and drive stock prices higher, companies are offering up a host of gerrymandered measures to make their costs appear lower, and their profitability higher. The use of these customized earnings measures that do not adhere to generally accepted accounting principles is growing in Canada, posing a quandary for both regulators and the investors they're charged to protect.

Imagine, if you will, something terrible: A fire begins in your home and rages, uncontrolled. No one is hurt, thankfully, because you're away from the house at the time. But the structure is ruined and, financially, you've just taken a huge blow – because you failed to renew your home insurance policy.

You are devastated. But your accountant advises you not to worry. After all, the destruction of your house is merely a non-cash loss.

The example may seem extreme, but the accountant's words are not unlike the message being offered to shareholders by many large public companies in Canada when they report sales and profits each quarter. In an attempt to burnish their image with investors and drive their stock prices higher, companies are offering up a host of gerrymandered measures to make their costs appear lower, to ignore real losses, and to make their profitability seem higher.

Restructuring costs, stock payments to executives, writeoffs from deals that went badly – all of these are being removed by corporate accountants who use "adjusted" measures of earnings. Company management justifies hiding some of these costs because, just like an uninsured house that burns down, they do not involve an immediate outflow of cash.

But the effect is often to deceive investors and to make many Toronto Stock Exchange-listed companies look healthier than they really are. Sometimes, the adjustments change the entire picture of a company's profitability. In the first quarter this year, for instance, BlackBerry Ltd. presented a number to investors that showed it broke even. But that figure excluded a litany of costs, including share payments to staff, some administrative costs, and writedowns of royalty agreements that were no longer as valuable as the company first thought.

The real bottom line for BlackBerry? Not break even. A loss of $670-million (U.S.). (BlackBerry tells investors it believes that presenting its earnings this way "enables it and its shareholders to better assess the company's operating performance … and improves the comparability of the information presented.")

The use by companies of customized earnings measures, called "non-GAAP" because they do not adhere to generally accepted accounting principles, is growing in Canada, as more companies cast aside tried-and-true accounting conventions. According to a new report from Veritas Investment Research Corp. provided exclusively to The Globe and Mail, 70 per cent of the members of the S&P/TSX 60 stock index of large public companies used some form of non-GAAP metric in their results as compiled by Bloomberg. In the United States, 63 per cent of companies in the Standard & Poor's 500 do so.

In 2004, just a handful of companies in the S&P/TSX 60 used non-GAAP measures somewhere in their annual reports. Today, 59 do. The only exception: Imperial Oil Ltd.

The majority of the accounting adjustments by TSX companies – at least 80 per cent – served to put a positive spin on the numbers, mostly by boosting measures of profitability. "Management isn't going to adjust numbers to make themselves look bad," says Jerome Hass, a partner at Lightwater Partners Ltd., a Toronto-based hedge fund.

And, in Veritas's view, about 35 per cent of the members of the S&P/TSX 60 may not be following the guidelines of Canadian securities regulators about how they should present financial numbers. For example, the Canadian Securities Administrators calls on companies to present their GAAP earnings figures with at least as much prominence as their non-GAAP measures – something a number of companies seem to be failing to do.

The new report from Veritas presents a quandary for both Canadian regulators and the investors they're charged to protect. In the United States, the Securities and Exchange Commission is cracking down on abuses in non-GAAP reporting. In Canada, securities commissions have been more lax, offering "guidance" instead of firm rules, reminding companies of what to do – and weighing whether more action is needed.

In the meantime, investors must navigate an ocean of conflicting and contradictory measures that typically serve to inflate companies' earnings – and, as a result, the stocks' valuation. After all, investors are paying for companies' earnings, now and in the future. And if the companies can convince investors and analysts that their earnings are higher than what accounting rules require, their stock prices will follow – at least for a while. "Valuations are attached to inflated earnings, so valuations are higher than average investors believe them to be," Mr. Hass says.

"This is the root of all evil, the current No. 1 problem in financial reporting," says Anthony Scilipoti, Veritas's chief executive officer and a co-author of the report. "The regulators, investors, the auditors – this is a challenge for everyone involved. … It's gotten out of control, and investors can't assess what the truth is."

The use of non-GAAP measures is not brand new. The trend began in earnest during the technology-driven stock market boom of the late 1990s. The bursting of the bubble, as well as the Enron and WorldCom accounting scandals that followed, brought greater scrutiny to the use of "pro forma" earnings, or what has also been called "earnings before bad stuff."

While the SEC took action against companies for abuses in earnings announcements – the first major case, in 2002, was against Trump Hotels & Casino Resorts Inc. – the Sarbanes-Oxley Act in the U.S. later that year codified their regulation. Rather than ban the use of these measures, however, the United States allowed them, as long as certain rules were followed.

Chief among them was the regulation that the GAAP measure be at least as prominent as the non-GAAP measure, as well as the rule that companies must provide a clear explanation of how they calculated the latter. (This is known as a reconciliation.) Canadian regulators' guidance is markedly similar.

Once companies received the blessing of regulators to use their own accounting metrics, however, the predictable happened: More and more companies used them, and used them to exclude more and more expenses.

In a study published earlier this year, Jack Ciesielski of the Analyst's Accounting Observer found that 401 members of S&P 500 firms were reporting earnings on a non-GAAP basis; of those, just 269 were using such figures in 2009.

All told, the 380 firms that also existed in 2009 collectively reported $804-billion in non-GAAP income in 2015. But using standard accounting rules, the real profit figure was $562-billion.

For investors, the difference is a significant one. While the companies' customized measures allowed them to show a gain in profits of 6.6 per cent last year, their net income, if measured conventionally, actually fell by 10.9 per cent over the same period. "Call it 'Wonder Bread,'" Mr. Ciesielski says. "The firms make their bread, but you should wonder how."

With files from Tim Shufelt

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