THE RISE OF NON-GAAP MEASURES IN ANNUAL REPORTS: THE ROLE OF CORPORATE GOVERNANCE

Nom: ADJAOUD
Prénom: FODIL
University of Ottawa
Telfer School of Management
55 Laurier East, Ottawa, Ontario, Canada
Adjaoud@telfer.uottawa.ca
613-562-5800

Abstract. We documented the non-Generally Accepted Accounting (non-GAAP) measures used by Canadian firms listed on Toronto Stock Exchange. Striking results emerge: Non-GAAP measures show a significantly improved performance and firms using only GAAP measures are disappearing. The use of non-GAAP seems to be impacted by the poor quality of corporate governance.

Key words: Non-GAAP measures, performance, governance.
Mots clés : Mesures non comptables, performance, gouvernance.

THE RISE OF NON-GAAP MEASURES IN ANNUAL REPORTS: THE ROLE OF CORPORATE GOVERNANCE

I. OBJECTIVES OF OUR STUDY

In recent years, there is a trend that firms include in their annual reports a series of non- GAAP measures. However, the topic does not seem to attract a high attention from academia and research communities and thus has not been seriously documented.

These new measures aim to add information to investors helping them to make better decision regarding the performance and cash flows generated by the firm. Managers pretend that reporting non-GAAP measures provides relevant information about corporate performance to the market participants. Opponents of non-GAAP metrics suggest that firms disclose them in an opportunistic purpose, to alter user's judgment about their financial performance.

We can argue that corporate governance plays a significant role in the use of non-GAAP measures. The research hypothesis is when the quality of corporate governance is high; the propensity to use non-GAAP measure is low.

Using a sample of Canadian firms we identified the proportion of users, which metrics are in use and their frequency. We compared Canadian firms listed in USA markets to learn whether the legislation impacts the use (or not) of Non-GAAP measures. Then we relate the measures to the quality of corporate governance as measured by Globe & Mail Index.

II. LITERATURE REVIEW

The empirical papers on non-GAAP have taken two different streams of research.

The first stream has the value relevance of accounting numbers as background (Baruch, 1989). Hirshleifer and Teoh (2003) have demonstrated non-GAAP measures assure that stock prices reflect in a more accurate manner fundamental value. Bradshaw and Sloan (2002) shows that non-GAAP are a better determinant of stock prices than GAAP numbers. Bhattacharya et al. (2003) revealed that non-GAAP numbers as being more informative that GAAP measures regarding share prices, and thus are more relevant to investors. However, Francis et al. (2003) concluded that non-GAAP measures are not superior to GAAP measures in explaining stock returns.

The second set of research papers reported results based on surveys of potential users of accounting information in their decision process. A Price Waterhouse Coopers (2016) survey revealed that 50% of investors found non-GAAP useful for analysis. CFA Society of UK (2015) reported results showing that 61 % of investors apply non-GAAP measures in their decision. Some other studies (Curtis et al. (2014)) have shown that firms use non-GAAP to evaluate the performance of their managers or to determine their compensation (Black et al., 2009).

The literature review revealed that no single study considered the role of corporate governance on the use of non-GAAP measures. Our study will fill in the gap. We intend to collect data on non-GAAP measures in an IFRS basis of accounting. We use a sample of Canadian firms to document the non-GAAP measures, their frequency and numbers. We test whether the basis of accounting (IFRS and GAAP) affects the use of non-GAAP measures by comparing a sample of US-interlisted Canadian firms and pure Canadian firms. Finally, we relate the use of non-GAAP measures to the quality of corporate governance. This index is published annually by the Canadian newspapers Globe and Mail (McFarland, 2002).

III. METHODOLOGY AND SAMPLE SELECTION

We surveyed the 2015 annual reports of 232 Canadian firms included in the The S&P/TSX Composite Index. The non-GAAP measures are listed in a separate section of the Management Discussion and Analysis (MD&A) of the annual report and labelled "non-GAAP measures and main Key Performance Indicators (KPI)" and are not part of the regular financial statements. For the majority of firms, the non-GAAP measures are spread in different parts of the annual report and require a meticulous reading to be found. When the corporation did not mention, in a specific manner, that the measure is non-GAAP, we classified it as such, if the word "adjusted" is used.

According to Canadian legislation, reporting non-GAAP measures should obey to some clearly stated rules: the firm should define the measure, explain its relevance and its usefulness to investors. The firm should also provide quantitative reconciliation with most comparable GAAP measure (CSA staff notice 52-306). In this study however we report only measures related to the last two categories. A measure is classified non-GAAP when it is qualified as such or a reference to non-GAAP section is made by the issuer.

The governance quality is based on the governance index published annually by G&M Business report. We used the index for year 2015.

IV. OUR FINDINGS

Only 6 % of firms fall in the category 0 non-GAAP measures. The large majority, approximately, 94 %, indicate 1 or more non-GAAP measures in their annual report. The results also show that almost 60 % of the sample has at least 3 non-GAAP measures, with 14 % having 6 non-GAAP measures and more. For the whole sample, it appears that, on average, Canadian firms mention 3.62 non-GAAP measures in their annual report, with a high standard deviation.

Canadian firms listed on US markets have a higher number of non-GAAP compared to firms listed only on TSX, with 3.64 and 3.60, respectively. The most popular non-GAAP measure seems to be "adjusted earnings per share" with the highest adoption rate (43 %) among Canadian firms and in comparison to all the non-GAAP measures. Other non-GAAP measures are also used such as Cash flows, EBITDA, EBIT and ratios with a lower portion of firms adopting them.

There is a huge diversity in non-GAAP measures used by Canadian firms in their names and also in the way they are defined. Even when the name is similar, the calculation could be different because the adjustments made are not the same nor standardized.
The results also show that non-GAAP earnings are higher that GAAP earnings and this difference is significantly impacted by the quality of corporate governance. Indeed we revealed that higher the governance index, lower is the difference between GAAP and non-GAAP

earnings per share. This result leads to the interpretation that when corporate governance is weak, non-GAAP measures are adopted against the owners' benefits.

Managers think these adjusted measures are better tools to assessing the performance of the company. Some empirical papers so far seem to agree with this interpretation, and some express serious concerns (Marques, 2006). Our results seem to confirm the latter interpretation.

V. CONCLUDING REMARKS

We documented the non-GAAP measures cited by a sample of Canadian firms in their 2015 annual report. Striking results emerge. First, firms using only GAAP measures to characterise their performance, financial situation or cash flow situation are disappearing. Second, the vast majority of firms use around 3 non-GAAP measures, with an average approaching four. We did not find any significant difference between firms listed on either US markets of TSX. There is a large diversity in the non-GAAP measures used, some firms using even a very large number.

However, seven non-GAAP measures seem to be popular among Canadian firms. The majority are centered on adjusted earnings such as EBITDA, adjusted EBITDA and adjusted Earnings per share. However, the measure "adjusted EPS" seems to be among the most popular non-GAAP measures in Canada. In most cases, compared to GAAP measures, the non-GAAP measures show a rosy firm performance.

It seems to be a significant correlation between the use of non-GAAP measures and the quality of corporate governance, reinforcing the idea that the rise of the Non-GAAP measures by managers is not always in the investor's best interest.
Our study has many contributions. It sheds more light on the current status of non-GAAP measures by Canadian firms. By doing so, we open the door for future research in the area of non-GAAP.

REFERENCES

Baruch, L. (1989). "On the Usefulness of Earnings and Earnings Research: Lessons and Directions from Two Decades of Empirical Research". *Journal of Accounting Research, vol.* 27, 153-192.

Bhattacharya, N., E. Black, T. Christensen, and C. Larson. (2003). "Assessing the Relative Informativeness and Permanence of Pro Forma Earnings and GAAP Operating Earnings." *Journal of Accounting and Economics*, vol. 36, no. 1–3: 285–319.

Black, D. and T. Christensen. (2009). "US Managers' Use of 'Pro Forma' Adjustments to Meet Strategic Earnings Targets." *Journal of Business Finance & Accounting*, vol. 36, no. 3–4 (April/May): 297–326.

Bradshaw M. T., and R.G. Sloan. (2002). GAAP versus the street: An empirical assessment of two alternative definitions of earnings. *Journal of Accounting Research*, 40, 41-66

CFA institute. (2015). "Bridging the Gap: Ensuring Effective Non-GAAP and Performance Reporting". *CFA Institute (October).*

CFA institute, (2015). "Investor Uses, Expectations, and Concerns on Non-GAAP Financial Measures". *CFA Institute (October).*

Curtis, A.B., S.E. McVay, and B.C. Whipple. (2014). "The Disclosure of Non-GAAP Earnings in the Presence of Transitory Gains." *Accounting Review*, vol. 89, no. 3: 933–958.

Francis, J., K. Schipper, and L. Vincent. (2003). "The Relative and Incremental Explanatory Power of Earnings and Alternative (to Earnings) Performance Measures for Returns", *Contemporary Accounting Research*, Vol. 20, No. 1, pp. 109–47.

Hirshleifer, D., and S. H. Teoh. (2003). "Limited attention, information disclosure, and financial reporting". *Journal of Accounting and Economics* 36: 337–386.

McFarland, J. (2002). "How ROB Created The Rating System", *The Globe and Mail,* Monday October 7.

Price Waterhouse Coopers. (2016). "An Alternative Picture of Performance: Alternative Performance Measure Reporting Practices in FTSE 100 Companies". (www.pwc.co.uk/services/audit-assurance/ insights/alternative-performance-measure-reporting-practices-in-ftse-100.html).