Mind the GAAP

Many years ago, around the time Naas Botha made his NFL debut, the only earnings reported were "GAAP" numbers – that is those consistent with "generally accepted accounting practice". After these were released via newswire, investors had to wait a few days to receive the more detailed financial reports, by post. Those reports were sparse, when compared to today's standards. Over time, regulatory requirements have improved and the internet has made providing more information significantly cheaper than the paper and mail alternative, so companies are providing more information online.

GAAP is far from perfect; indeed, in some cases, it doesn't reflect economic reality. As buy-side investors became more sophisticated, they recognised many of these shortcomings and began to make their own adjustments to GAAP - to the extent there were unusual or non-recurring items, not representative of the underlying performance.

In response, companies began providing more granular information as regards any "Non-GAAP" adjustments they deemed worth disclosing. By way of example, a capital gain on the sale of a property must be booked as a GAAP profit, yet this would typically be a non-recurring event (for a company not engaged in the business of selling property), hence it would make sense to exclude such a number from earnings to get a more representative measure of earnings from continuing operations (referred to as either "adjusted earnings" or "non-GAAP earnings"). The distinction is not always so clear-cut. For example, if a company made a once-off large acquisition, they might split out (temporary) integration costs, extending over a few years. Whilst it makes sense to exclude (once-off) integration costs to get a representative measure of earnings, one needs to place reliance on the company's treatment. On the other hand, to the extent a company is a serial acquirer, then ongoing integration costs might be deemed to be recurring in nature.

What began as a practical exercise, initiated by (buy-side) investors in order to get a clean, representative Non-GAAP earnings number, has morphed in many cases into a fudge (to put it mildly) by a few unreliable companies, in many instances facilitated by sell-side brokers.

No issue is more contentious than stock-based compensation ("SBC") and in no other sector is the problem more endemic than in the technology sector.

SBC refers to remuneration paid to management teams either in stock or stock options. The awards of SBC are often contingent on achieving long-term corporate performance targets, which provides an incentive for management teams to grow earnings over the long-term and aligns their interests with shareholders. Unlike stock options, which gain value only if the company's stock price rises, restricted stock unit (RSU) awards represent an actual gift of shares. By contrast, stock options give holders the right to buy shares at a fixed price after a specific date.

The SBC controversy first came under the spotlight during the 1990's technology bubble, when there was a lot of competition from underwriters to publicly list ("IPO") fast growing, albeit unprofitable technology companies. In those days investment banks didn't always have Chinese walls between the broker research and IPO bankers. The big swinging bankers knew that if they could promise a tech CEO a higher IPO price, they were more likely to win underwriting business and generate higher fees (typically a percentage of proceeds). In many instances, unscrupulous bankers would incentivise research analysts, or apply pressure, to make questionable adjustments, so as to inflate Non-GAAP earnings. If they didn't do so, they would be at a competitive disadvantage and lose the business. Tech CEOs began to pay top tier employees big salaries, mostly in (inflated) stock, which for their part, allowed them to attract superior talent, buoying growth. The adjustment to GAAP was predicated on the basis that SBC is a "non-cash" expense, which is true, albeit a gross misrepresentation, since it ignores the dilutionary impact of not accounting for stock issued for free (RSU's) and share options (which have a value). Under the banker's crooked algorithm, if tech companies doubled or tripled the SBC, it would have no impact on "adjusted" earnings and cash flow. Reducing their reasoning to the absurd; even if the company's articles of association required that 100% of earnings (pre-SBC) be distributed as SBC to employees, precluding shareholders from ever sharing in earnings; it would have no impact on "adjusted" earnings. That is of course preposterous!

Mr Buffett of Berkshire Hathaway is probably the greatest investor alive today, so his view matters: "If stock options aren't a form of compensation, what are they? If compensation isn't an expense, what is it? And, if expenses shouldn't go into the calculation of earnings, where in the world do they go?". In his most recent annual report, Buffett noted that Berkshire Hathaway employees (and their subsidiaries) receive at least 20% of their compensation in stock, the caveat being that the stock granted is from Berkshire's existing issued shares, purchased with cash in the open market at the prevailing market price and expensed immediately (not issuing new stock for free or below market consideration and then not expensing it). His opinion; "if CEOs want to leave out [SBC] in reported earnings, they should be required to affirm to their owners one of two propositions: why items of value used to pay employees are not a cost, or why a payroll cost should be excluded when calculating earnings."

When evaluating a stock on the basis of a consensus price earnings multiple, you can't always rely on those ("non-GAAP") earnings estimates to be consistent, especially within the technology sector. By way of example, Microsoft and Apple fully expense SBC and we would highlight them as good proponents in this regard. Google and Facebook do not expense SBC, which is roughly 20% of earnings each. Therefore, their ("non-GAAP") earnings are inflated to that extent on an apples for apples basis (pun intended)! Twitter, we would highlight as a very bad culprit in this regard, having handed out SBC last year representing a scarcely believable 31% of revenue (and a multiple of their entire profit). Indeed the $682m of SBC in 2015 was by far the biggest factor in turning a $406m non-GAAP net profit into a $457m GAAP loss!

At Credo, we are bottom-up stock pickers. When determining the potential future returns to be gained by investing in a company, we pay careful attention to all adjustments to earnings, including SBC and anything which can dilute value for shareholders.

Important Notice

Data Source:

https://www.ft.com/content/858d9b62-eeef-11e6-ba01-119a44939bb6