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More Active Investors Rely on Non-GAAP vs. GAAP Reporting in Analyzing Stocks

Executive Summary

- Based on a proprietary survey of active investors, and inspired by the book, "The End of Accounting," by Baruch Lev and Feng Gu, Clermont Partners conducted a survey to reveal how active (not passive) investors factor GAAP and non-GAAP reporting, intangible assets and non-financial metrics into their stock selection process.

- The survey found that almost three-quarters (74%) of respondents rely on non-GAAP reporting more than GAAP in evaluating a company's performance. Forty-four percent of respondents believe that non-GAAP measures have become more important over time.

- While non-GAAP and GAAP measures each have their fans (as one might guess), it was notable that most respondents will frequently create their own adjustments to a company's GAAP results based on what they believe is relevant in evaluating performance.

- Intangible assets and non-financial metrics are considered important factors in evaluating stocks for many of the respondents.

- This project seemed to hit a nerve, as we were surprised by the number of write-in comments participants provided along with their responses to the survey questions. These opinions provide insightful views into how investors think about company-provided and SEC-mandated metrics.

Section 1:
Introduction, Key Observations & Takeaways

A tidal wave of fresh thinking and advocacy for change hit the accounting world with *The End of Accounting*, a book published in June 2016 by professors Baruch Lev of New York University's Stern School of Business and Feng Gu of the University of Buffalo School of Management.

Among its many tenets, the book champions major changes in the reporting process to help investors better understand the true drivers of a company's value. Why? Because Mr. Lev's and Mr. Gu's deep-dive research strongly suggests that GAAP reporting over the years now misses the mark as a useful tool, primarily due to the evolving nature of many industries and the increasing complexity of FASB reporting rules.

Some of Mr. Lev's quotes include:

> "GAAP-based earnings are deeply flawed measures of enterprise change, and therefore of little use to investors." [i]

> "Earnings no longer move markets." [ii]

> "…in today's economy you cannot succeed without innovation. And innovation is achieved by intangibles." [iii]

Inspired by Mr. Lev's thought-provoking ideas, we wanted to add to the discussion with our own capital markets research. We decided to ask investors how GAAP and non-GAAP measures, intangible assets and non-financial metrics factor into their stock selection process.

We conducted a survey of active (not passive) investors, who were diversified across industry focus and investment styles. Fifty-six investors participated in the 14-question survey. We were impressed by the number of write-in comments, which provided excellent color to the quantitative data.

This report provides (1) key observations and quotes from respondents, (2) the survey questions, results and write-in comments for each, and (3) recommendations for CFOs and IROs based on the information.

Key Observations and Quotes from Respondents

- Almost three-quarters (74%) of respondents rely upon non-GAAP more than GAAP reporting in evaluating a company's performance. Forty-four percent of respondents believe that non-GAAP measures have become more important over time.

  "I completely ignore GAAP. Did I always? I don't think so– I think this has been a newer phenomenon."

  "GAAP means nothing to me."

- Unfavorable GAAP sentiment indirectly supports non-GAAP:

  "GAAP is rarely comparable and doesn't show us the underlying trends in the business."

  "There are always non-recurring adjustments that should be eliminated to get a clear picture of a company's performance that can be compared to others'."

- The choice between using GAAP versus non-GAAP is not always clear cut. Some said it depends on the industry, the company and what's being excluded from GAAP.

  "I'll take non-GAAP more seriously if I trust the management team."

  "I'm in energy and industrials, and traditional GAAP works especially well for those industries. Maybe if you're looking at something with IP, non-GAAP might be more helpful."

- Even though non-GAAP is preferred, there is skepticism around how it's used:

  "Non-GAAP is like a presentation of a company's 'best self.'"

  "Some charges truly are one-time, often including legal settlements, debt refinancing, and merger costs. But it's definitely abused."

- Fans of GAAP said:

  "The longer I do this, the greater my appreciation for GAAP with small adjustments."

  "Exceptions to every rule, but GAAP presentation is a better reflection of the true fundamentals on an ongoing basis."

- The survey revealed that many investors rely upon their own put-and-take calculations to analyze a company's financials.

  "We have full teams of people that do only this."

  "I've been doing this for over 20 years."

- Some examples of adjustments include:

  - Back out non-recurring charges from GAAP, such as plant closures.

  - Leave in shareholder base compensation as a real expense.

- Investors rely on a wide range of non-GAAP metrics to evaluate companies. Of these, cash flow and free cash flow are considered very important, along with EBITDA and adjusted EBITDA, and adjusted net income or adjusted EPS.

- The evaluation of intangible assets is important to nearly two-thirds of respondents.

  "This is what separates good managers from great ones – those who take the time to do intangible asset valuation."

  "This is the way we assess future valuation potential."

- More than one-third of respondents place a strong weight on non-financial metrics or characteristics when making stock buy and sell decisions.

  "We are constantly on the phone trying to get industry trends/ customer trends and anything that will help. Companies don't provide us enough of this information - we have to get it ourselves."

  "It's really a blend – 'non-financial' metrics influence financial metrics, which to me means there are no non-financial metrics."

Takeaways for Company Management Teams & IROs

- Be judicious in deciding what to include/not include with non-GAAP numbers. Management will be viewed as more credible if the presentation of positives and negatives is even handed. Consistency is key. For example, do not exclude one-time items one year, then include them the following year to present a more favorable comparison.

- If your non-GAAP measures provide a better fundamental understanding of the business, then make the case for why this is true when you report earnings, rather than simply leaving investors to interpret and calculate for themselves.

- Provide more alternative information to help supplement the financials. Make it easy for investors to digest and evaluate your company's current fundamentals and opportunities.

- When presenting a road map for future growth and shareholder value creation, include relevant non-financial performance milestones that support your growth plan.

- As you build engagement with current and prospective investors, ask them what metrics matter the most in their stock selection process. Consider evolving your reporting and messaging strategies to help accommodate their informational "wish list."

- Know what your channel is saying. Good investors will seek out information about your company from other sources, including channel partners, suppliers and customers. Keep these stakeholder audiences in the loop of publicly available information so they are able to respond effectively to investors' "channel check" questions.

Section 2:

Survey Questions, Results and Comments

Demographics

This section provides the demographic background of survey participants.

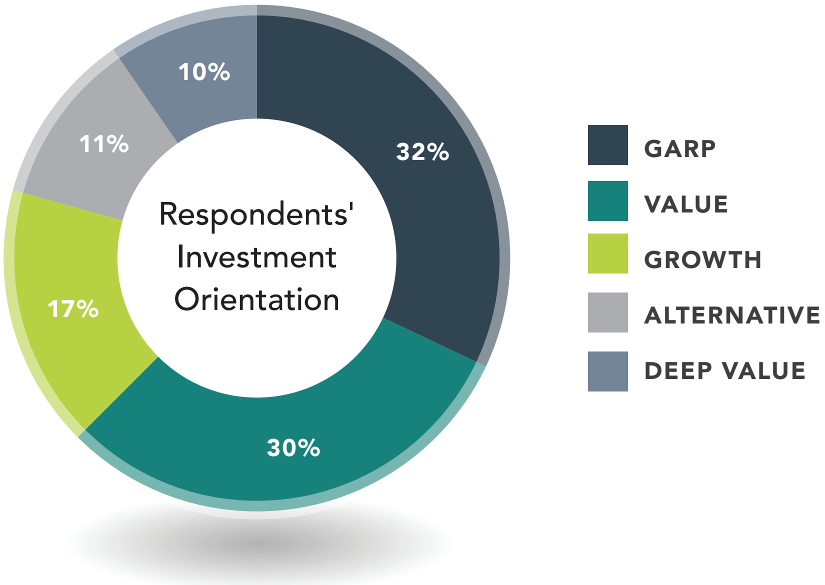
1 Industry orientation of survey participants was diversified, with strong representation in industrials/manufacturing (22 respondents), consumer discretionary (17 respondents), software (14 respondents), technology hardware (14 respondents), and healthcare (12 respondents). Several participants indicated that they are generalists.

Q: *What sectors / industries are most represented by the companies you analyze? Check all that apply.*

Sectors Analyzed by Respondents

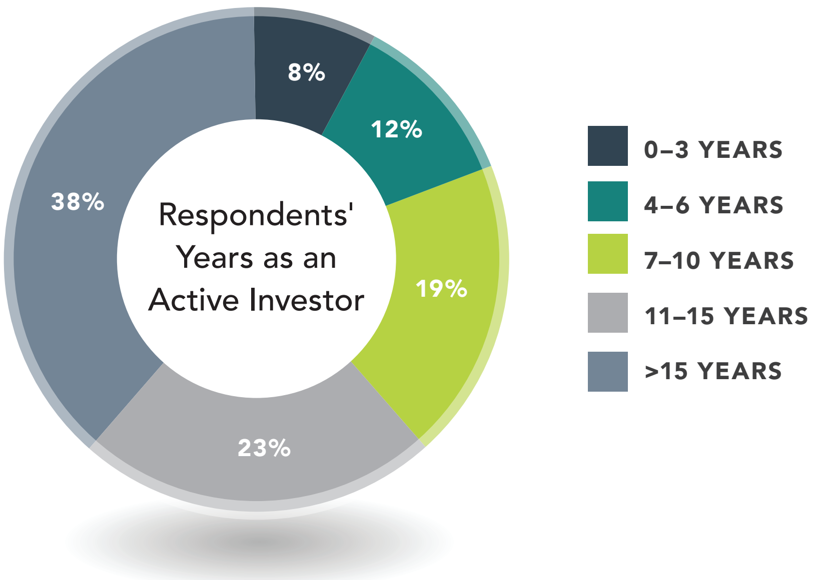
2 Survey respondents were considered "active" (vs. "passive") investors, with 32% representing a GARP investment style, followed by Value at 30%.

Q: *What is your active (not passive) investment orientation?*



3 The majority of respondents (61%) had 11+ years' experience as an active investor, with 38% indicating more than 15 years' experience.

Q: *How many years have you been an active-oriented (not passive) buy-side investor?*

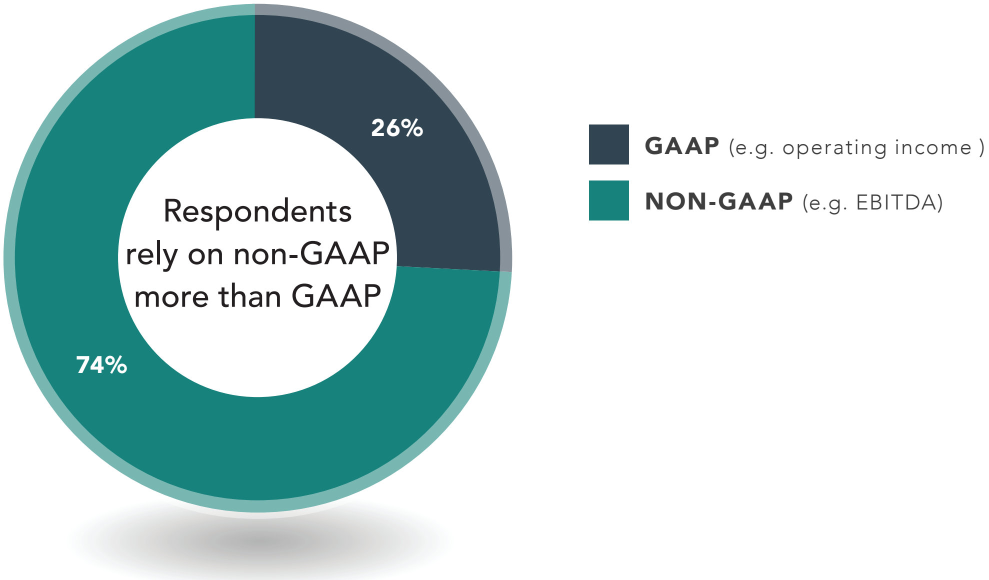


Questions and Responses

This section features the survey questions, consolidated responses and write-in commentary from participants.

1 Nearly three-quarters of respondents (74%) revealed that they rely on non-GAAP more than GAAP reporting.

Q: *When analyzing a company's performance and making a buy or sell decision on a stock, which accounting reporting methodology do you rely upon the most?*



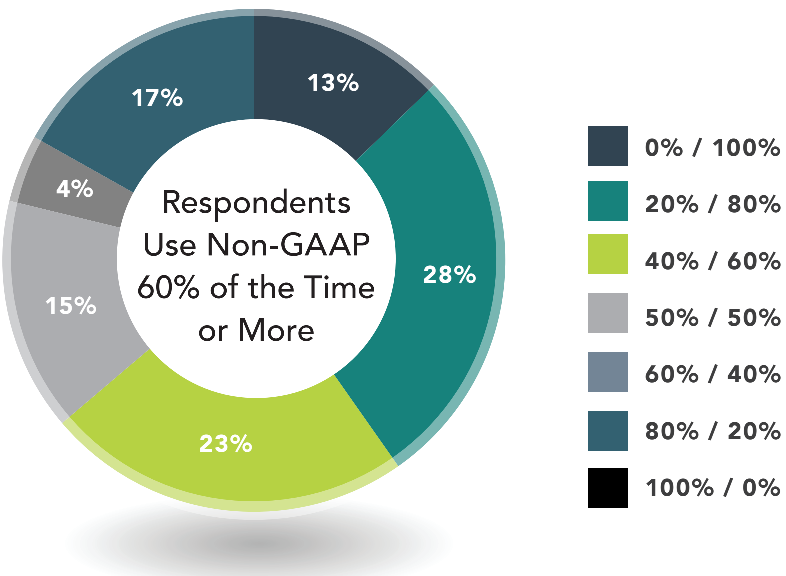
Comments included:

- GAAP is rarely comparable and doesn't show us the underlying trends in the business.
- GAAP means nothing to me.
- We look at GAAP. But for growth companies there are always adjustments that make sense.
- We look at both and blend together. We take GAAP and then back out truly non-recurring charges with adjustments to reflect reality.
- I start with GAAP and make small adjustments. I'll ignore amortization of acquired intangibles if the company is good at R&D and buys long-lived assets. I'll normalize the tax rate. I might look at maintenance capex instead of depreciation. I always leave SBC (stock-based compensation) in as a real expense.
- We tend to work off GAAP, but part of the process is deconstructing their earnings. We're really just trying to get down to a free cash flow analysis anytime we look at earnings – that's what I really care about. We will ultimately get to a non-GAAP number, but we're going to get to the one we want, not the one the company is reporting. It does depend too on the company and industry. I'll take non-GAAP more seriously if I trust the management team.

- We look mostly at EBITDA. I don't like the trend towards Cash EPS (excluding amortization and numerous other charges).
- We tend to focus on adjusted EPS.
- We use NAV, which is based on cash NOI.
- Cash flow is the most important metric.
- Generally we care about cash flow multiples such as EBITDA.
- Cash flow is all that matters.
- It depends on the company. It's always helpful to see expenses that are one-time in nature, although we don't always agree with management's characterization of them, and we oftentimes adjust their non-GAAP numbers.
- A large and persistent divergence between the two is a HUGE warning sign.
- Tech companies and internet platforms tend to have a lot of noise in their GAAP numbers.

2 Non-GAAP is relied on more than GAAP reporting, as almost two-thirds (64%) of respondents indicated they use non-GAAP 60% of the time or more when analyzing stocks as compared to GAAP. No participants responded that they use GAAP 100% of the time.

Q: *To the closest ratio possible, to what extent of the time do you use GAAP vs. non-GAAP accounting when analyzing stocks (e.g., % GAAP / % non-GAAP)?*

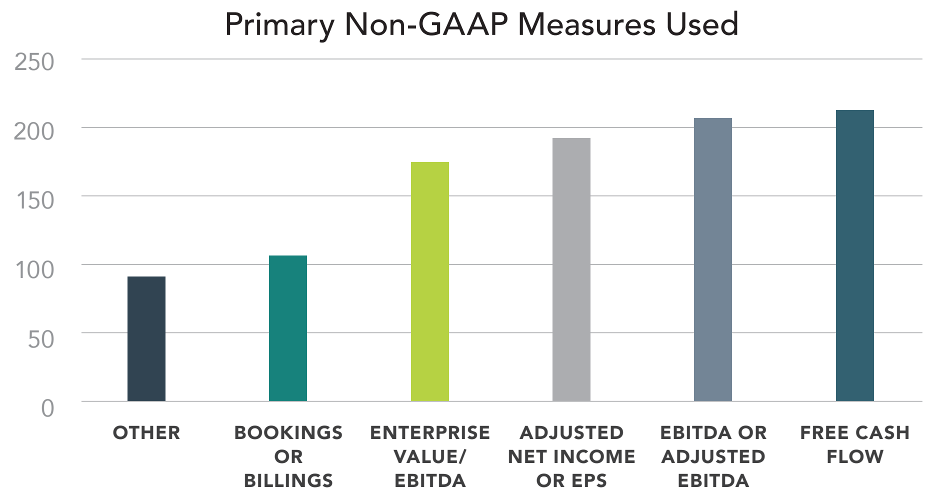


Comments included:

- There are always non-recurring adjustments that should be eliminated to get a clear picture of a company's performance that can be compared to others'.
- We only use GAAP for mega-caps that will never be acquired.
- We do not like the use of standard items - like pension investments, back into non-GAAP.
- It varies.
- More like 92% / 8%.
- Again, GAAP means nothing to me.

3 The primary non-GAAP measures respondents most prefer are free cash flow, EBITDA or adjusted EBITDA, and adjusted net income or adjusted EPS.

Q: *In general, please rank order the following primary non-GAAP measures you use most when evaluating a company. 1=highest rank and 6=lowest rank*

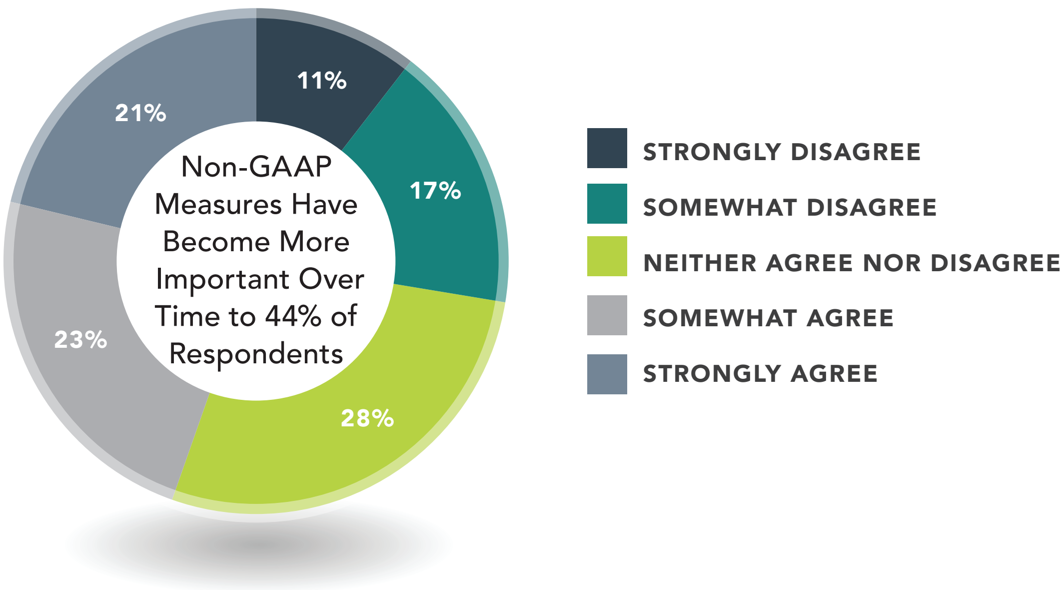


Respondents indicated they use the following other non-GAAP measures:

- ROE [return on equity] / ROIC [return on invested capital]
- Price to net assets and price to sales are more common than any of these listed.
- EV [enterprise value] to NOPAT [net operating profit after tax] is better for me than EV/EBITDA [enterprise value divided by earnings before interest, taxes, depreciation and amortization]. Also, with FCF [free cash flow], I'll make adjustments such as (1) don't put a multiple on the cash avoided via SBC [stock based compensation], (2) only put low multiples on growth in float, (3) assume international income gets taxed at some point.
- FCF/EV.
- EBITDAR [earnings before interest, taxes, depreciation, amortization and rent/ restructuring costs] - in the case of airlines.
- I like to look at operating income but add or subtract any one-time items above that line (i.e., inventory write off).
- I'm an old P/E [price to earnings] guy, so I look at adjusted EPS most of all.
- P/E ratio, relative P/E.
- We use EBITDA for established companies and maybe a price/sales multiple for smaller, not-yet-profitable companies. Cash EPS (excluding amortization and other charges) is being adopted by many companies and we have some issues with that.
- Adjusted cash flow.

4 Forty-four percent of respondents agreed that, over time, non-GAAP measures have become more important in evaluating a company's financial performance, while 28% disagreed and the remaining 28% neither agreed nor disagreed.

Q: *To what extent do you agree with the following statement: "Over time, non-GAAP measures have become more important to me when evaluating a company's financial performance."*

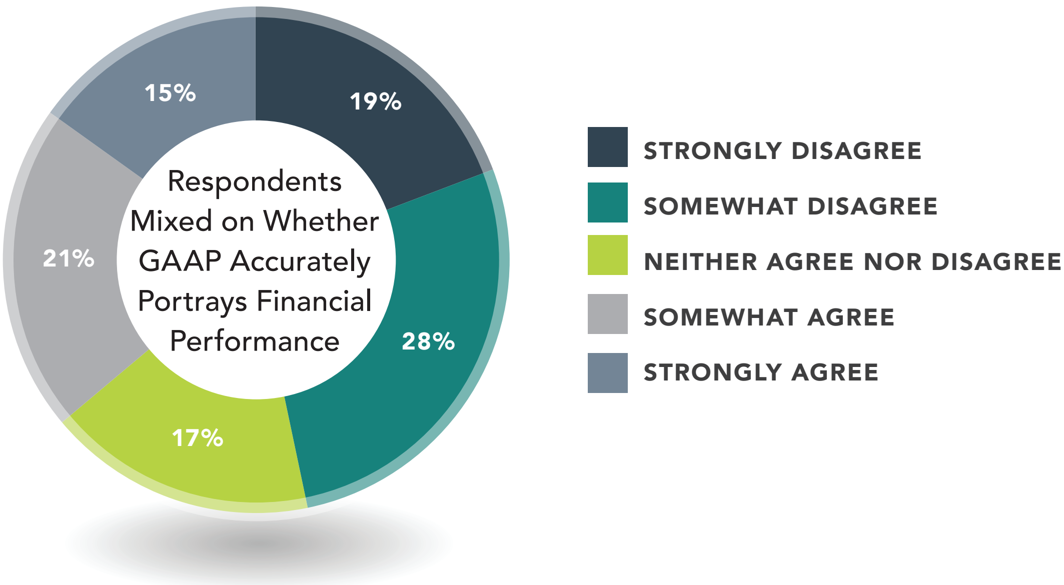


Comments included:

- I completely ignore GAAP. Did I always? I don't think so – I think this has been a newer phenomenon.
- I think most people would strongly agree with this statement but for me - I've always blended the two.
- It really depends on the industry and the company. With industrial stocks, if a company is going through a transition and has several one-time charges, non-GAAP results might be more pertinent to investors versus GAAP results.
- As long as tech companies don't have linear growth patterns, GAAP won't be helpful.
- I prefer GAAP, but oftentimes GAAP does not truly reflect a company's financial performance. So, I look at non-GAAP only as an alternative.
- I'm in energy and industrials, and traditional GAAP works especially well for those industries. Maybe if you're looking at something with IP, non-GAAP might be more helpful.
- EBITDA has always been fine, Cash EPS is a bit suspect.
- Cash matters.

5 While respondents tend to favor non-GAAP, they were more divided as to whether GAAP accurately portrays a company's performance. Thirty-six percent of respondents agreed that GAAP paints a true picture of a company's finances, while 47% disagreed and 17% were in the middle.

Q: *How much do you agree with the following statement: "GAAP presentations of financial statements provide an accurate picture of a company's financial performance and condition."*

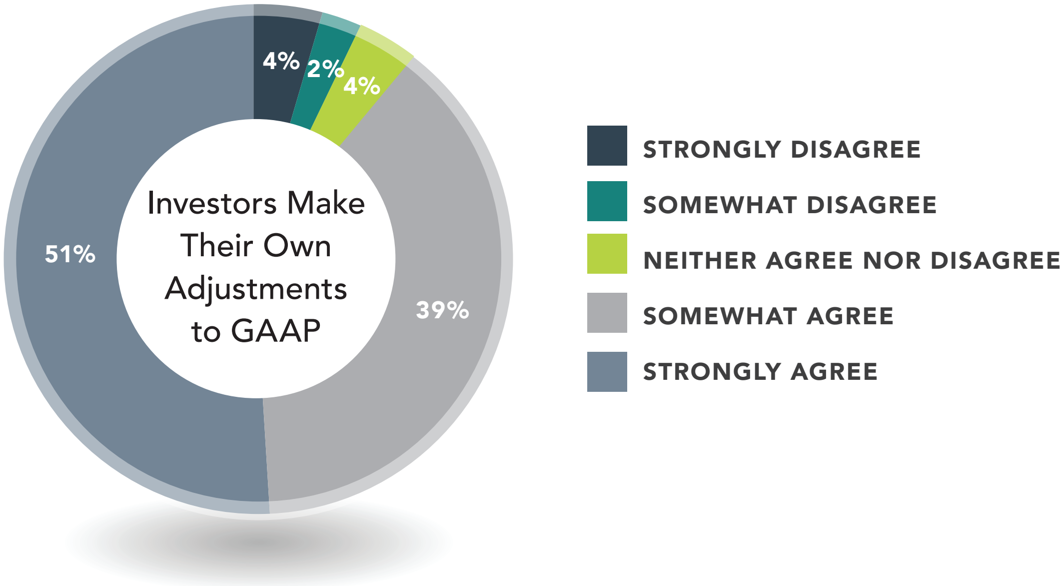


Comments included:

- It really depends on the company, the industry, and the exclusions from GAAP.
- GAAP is more consistent, and I'm probably going to arrive at my own non-GAAP number anyway.
- GAAP doesn't always provide an accurate picture.
- GAAP numbers just don't portray an accurate picture. They are not able to comp well versus the companies or their peers.
- Too many non-cash items are included in a REIT's FFO so we prefer non-GAAP metrics.
- Non-GAAP is like a presentation of a company's "best self."
- Some charges truly are one-time, often including legal settlements, debt refinancing, and merger costs. But it's definitely abused.
- If a company is not consolidating facilities or spinning off businesses, GAAP results are more pertinent.
- Somewhat strongly agree – exceptions to every rule, but GAAP presentation is better reflection of the true fundamentals on an ongoing basis.
- The longer I do this, the greater my appreciation is for GAAP, with small adjustments.

6 A whopping 90% of respondents carve out their own view of a company's financials to some degree by making adjustments to GAAP numbers. Survey results suggest very few – only 6% – look at GAAP numbers "as is."

Q: *How much do you agree with the following statement: "I frequently make my own adjustments to a company's GAAP financials to get a more accurate picture of the company's performance."*

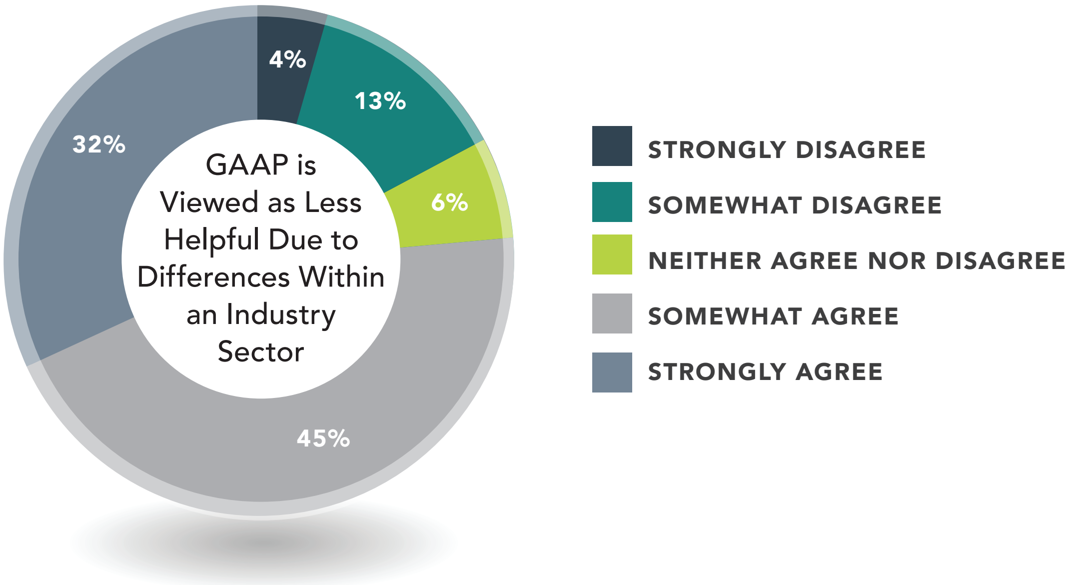


Comments included:

- We have full teams of people that do only this.
- I've been doing this for over 20 years.
- I refuse to exclude some items, like stock compensation or other ongoing expenses.
- One-off charges such as plant closures can make GAAP results misleading. I usually adjust for such events.
- I make nips and tucks to appropriately address one-time items.
- Serial restructures shouldn't get a free pass, but there are some truly one-time items.
- I'll only make the adjustments if the company doesn't. But if the company does, that makes life a lot easier for me.

7 When it comes to evaluating companies within a given industry sector, more than three-quarters of respondents (77%) agree that GAAP is less helpful as the sole means of comparison due to individual company differences.

Q: *How much do you agree with the following statement: "There are significant differences among companies within a given industry sector, which make it less helpful to compare performance using solely GAAP measures."*

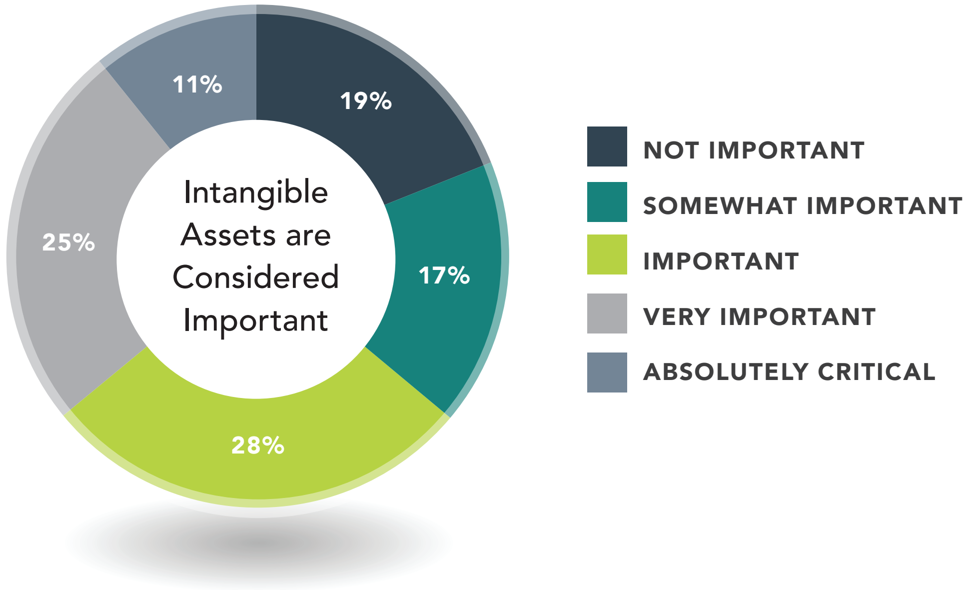


Comments included:

- GAAP measures are just not helpful anymore. The trends aren't helpful.
- I disagree only because I don't think there are that many differences between companies within given industry sectors. But, I also wouldn't use GAAP anyhow.
- In the tech sector, smaller startup companies may reward their employees with options. As a result, relying solely on GAAP results may be misleading.
- Large acquisitions and the resulting depreciation and amortization are perhaps the largest differences between companies within a sector. But there are some legitimate accounting differences or other practices, too
- Sure, you have to get to apples-to-apples, but ignoring SBC and Depreciation makes no intellectual sense.
- While some REITs have changed their definition of FFO/AFFO from the official NAREIT version, they are comparable for the most part.
- Amortization of goodwill can make earnings look much lower than FCF.
- There are significant differences which is why EBITDA is a horrible metric - GAAP with adjustments is the best way to compare.

8 Nearly two-thirds (64%) of respondents said they view intangible assets as 'important' to 'absolutely critical' in their evaluation of a company. Nineteen percent said intangible assets are not important.

Q: *How important are a company's intangible assets in your evaluation of a company? Examples include intellectual property, such as patents, trademarks, copyrights and business methodologies; goodwill; brand recognition; skilled work force; and organizational designs and processes.*

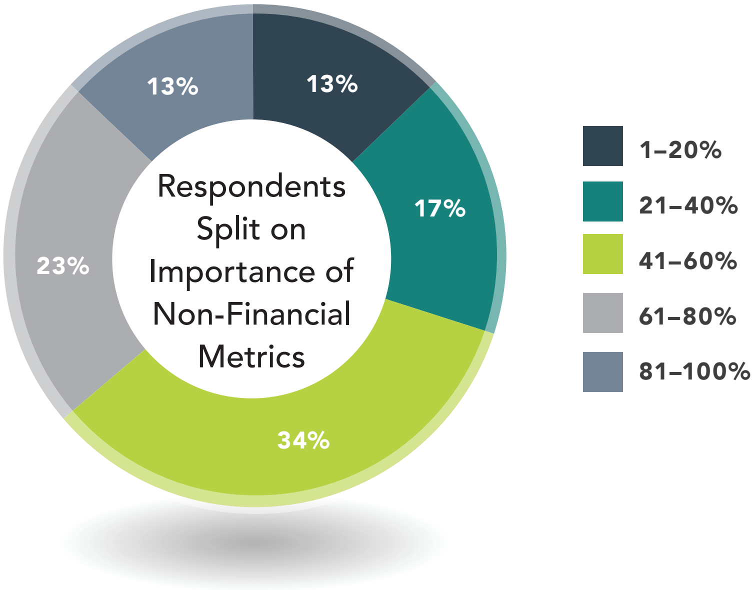


Comments included:

- This is what separates good managers from great ones – those who take the time to do intangible asset valuation.
- This is the way we assess future valuation potential.
- As an industrials analyst, I find intangibles the line item in which the M&A sins of Christmas past hide.
- As we move away from a manufacturing economy, this becomes critical.
- Factors such as those mentioned above do impact a company's results...meaning a motivated workforce that is treated properly by a company can outperform versus a competitor who does not values such items as much.
- We only value tangible assets.
- Never think about them.

9 The emphasis placed on non-financial metrics or characteristics was mixed. Respondents were roughly divided into thirds, with 30% of respondents indicating they place 40% or less weight on these metrics, while 34% of respondents were in the middle at between 41% and 60% weight, and 36% of respondents place a strong weight of 61% or greater on these metrics when they make buy and sell decisions on stocks.

Q: *How much weight do you put on non-financial metrics or characteristics when making buy and sell decisions on stocks? Examples include industry trend information, sales pipeline, customer satisfaction, total addressable market, operational metrics, and new customer adoption rates.*



Comments included:

- This is the edge for growth investors. Identifying the right factors and studying them closely.
- It’s really a blend - "non-financial" metrics influence financial metrics, which to me means there are no non-financial metrics.
- We are constantly on the phone trying to get industry trends/customer trends and anything that will help. Companies don't provide us enough of this information - we have to get it ourselves.
- As long-term growth investors, we value not only near-term growth (i.e., 6-12 months) but the durability of growth. Some of the items above are more important than others, but in totality the "non-financial" metrics/characteristics address the durability of growth and, ultimately, the sustainability/expansion of earnings multiple.
- If I am investing in a software company, customer satisfaction is significantly important.

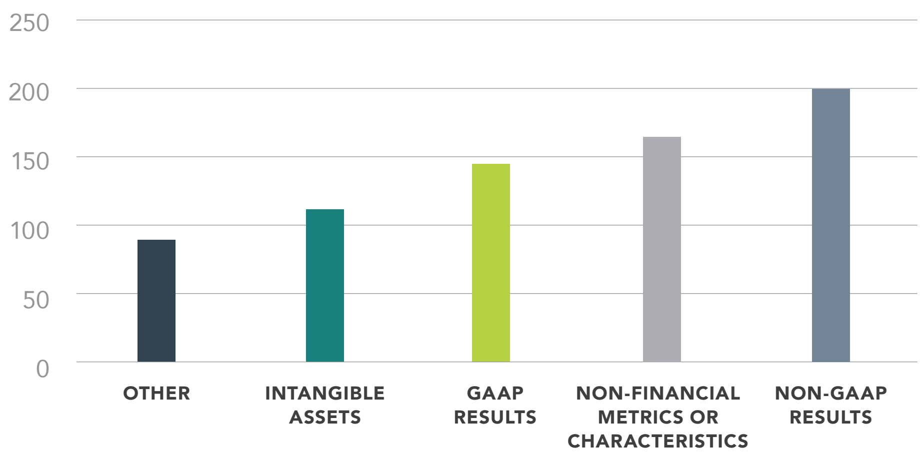
- We want to see growing end markets, a full pipeline of next generation products, a talented management team.
- You can't evaluate a company in a vacuum or at a place in time. You have to look at the larger picture and the issues that will impact future growth.
- It's all about sustainable competitive advantage.
- They're important, especially when looking at trends, but I can't think of an example where I've ever made any decision based on it. I'd say it's rarely going to be the defining factor in a buy/sell decision. What I care about is cash. Cash flow is king.

10 Non-GAAP results received the highest number of votes as the most important metric used in making a stock selection, followed by non-financial metrics or characteristics, and then GAAP results.

The most frequently mentioned "other" factor was quality of management. Additional write-in considerations included adjusted net asset value, industry outlook, uses of cash, takeover targets, sales ratios and valuation metrics.

Q: *In general, please rank the order of importance of the following in making a stock selection. 1 = most important and 5 = least important.*

Non-GAAP Results Considered the Most Important Metric in Making a Stock Selection



11 **Q:** *Is there anything else you would like to add?*

- Half of our firm is very focused on old style GAAP measures. The give and take between the non-GAAP and the GAAP discussion is a really important one for our firm. We don't use either exclusively - but we analyze both.
- Companies should always include non-GAAP in the discussions. The new SEC rules just don't make sense to us - we go right for non-GAAP.
- We just need to follow if and when the company will generate free cash flow. Cash does not lie.

[i] *The End of Accounting* by Al Rickard, CAE, National Investor Relations Institute (NIRI) IR Update, June/July 2017
[ii] Ibid
[iii] *The End of Accounting?* by David M. Katz, CFO.com, October 20, 2016

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