les affaires

Rough Translation of an Article published December 7, 2019

Investors: Pay Attention to Financial Reporting Practices

Two important criteria in my investment decisions are the quality of the management team and the sustainability of competitive advantages. In my opinion, these are the two factors that will have the greatest impact on long-term success. This is important because we are looking for companies that we can keep in our portfolio for a very long time.

One aspect of leadership quality is the ability to create a winning corporate culture. Evaluating culture involves judgments on intangible aspects, but some more tangible elements can sometimes help. Executive compensation is one of them. In this text, I will briefly address three others: accounting choices under GAAP, adjusted profits, as well as choices in business success metrics and their communication to investors.

Accounting under GAAP

The way in which GAAP figures are presented gives us clues to a company's culture, looking at whether management is more of the "promotional" type, stretching numbers to show better results, or if it is conservative and consistent from one period to another. Many revenue, expense, asset and liability entries involve subjective judgments, estimates and projections. Assessing management's accounting choices requires the investor thoroughly read the notes to financial statements. With practice, investors end up being able to identify companies that communicate clearly and simply, do not hide critical factors in the notes to their financial statements and have the long-term interest of their shareholders at heart.

"Adjusted Profits"

"Adjusted" profits is the new standard for judging profitability and is often used as a basis for valuation. The purpose of adjustments is to give a better idea of the real dynamics of a business that GAAP cannot always reveal. However, there is no uniform definition of these adjustments which are at each management's discretion, and this makes comparisons even more difficult between companies and for the same company from one period to another. The most common technique of adjustment is to exclude "extraordinary" or “one-time” expenses and to add certain anticipated cost reductions to present a higher underlying profitability. The "red flag" investors should pay attention to

is whether the management of a listed company is encouraged to "stretch" the numbers to influence the market price of its shares upwards before exercising their stock options.

Business Success Metrics and their Communication

Leaders make choices to measure success. Companies that put forward targets for revenue and earnings before interest, taxes, depreciation and amortization (EBITDA) and pay bonuses or issue options to their executives if they hit those targets often make me raise a red flag. In general, in addition to being a highly malleable number at management's discretion, the use of "adjusted" EBITDA as a measure of success has significant limitations[i]:

1. In addition to interest and tax payments which EBITDA aims to subtract, it does not include capital expenditures required to continue to operate or to grow the business, the cost of acquisitions, nor does it reflect the efficiency of working capital management;
2. EBITDA does not reflect business risk, partially represented by operating leverage (weight of fixed costs).

Overall, a good measure of success should reflect what truly remains to common shareholders after all expenses, including capital expenditures, and it should consider the cost and the return on capital. Without going into details on types of businesses and industries, I generally like to see free cash flow and return on invested capital targets.

Beyond the numbers, I like to hear about strategic assets and how they are deployed and reinforced, and business risks and how they are reduced, as this is indicative of a long-term vision; as is a discussion about improving the company's position vis-à-vis its customers and suppliers with the goal of increasing pricing power and reducing structural input costs. It is business strategy that will help me evaluate the source and long-term viability of future profits. Finally, I look at whether management is disciplined in the allocation of excess capital. Is management patient enough to wait for a good price for acquisitions or for the repurchase of company shares, or is it in a hurry show growth regardless of the cost of this growth, or to show share count reduction regardless of its cost?

In short, is management more motivated by short-term profits and the temporary rise in share price than by the long-term health of the company? It is rarely black or white, but rather a question of degree, and consistency of the emphasis. Human nature being what it is, management compensation structure is important to create incentives to a long-term vision and disincentives to aggressive accounting and shareholder communication.

---

[i] Michael J. Mauboussin, *What Does an EV/EBITDA Multiple Mean?* Blue Mountain Investment Research, Sept. 2018