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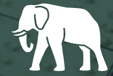

Stewart Investors

Why accounting choices matter

Commuters on the London Underground would be familiar with the warning to "mind the gap". The investment industry is in dire need of a similar warning but with an extra A – "Mind the GAAP". GAAP refers to Generally Accepted Accounting Principles.

The aim of GAAP is to help management teams present the affairs of a business in a fair and transparent manner. These accounting principles should make the value of a dollar earned in one company comparable to another. However, in our view GAAP and its global counterparts are also arming management teams with the tools to paint a vague and sometimes distorted picture of reality. We have always believed cash flows provide a better lens to understand the health of any business. However, analysing broader accounts gives us important clues about the quality of management. At the other end of these accounts is a manager painting a picture for investors to observe and interpret.

> "Art is not what you see but what you make others see."
>
> Edgar Degas

Accounting distortions often happen under the guise of being transparent. For example, in order to be clearer and more comparable across borders, there is a rising trend, particularly in the US, to report two sets of accounts – one based on US GAAP and the other non-GAAP. Firstly, it is a strange concept to digest that a company could have two very different profit numbers. Secondly, the difference between these numbers continues to widen raising more questions than the intended transparency seeks to answer. It is akin to producing two versions of the Mona Lisa using different painting techniques and brushes. And, as they age, these paintings begin to look increasingly different. So which one is the real painting or which set of accounts is the more accurate representation of the business?

Ansys* is a world-leading software simulation provider and has been publishing GAAP and non-GAAP statements for many years. Non-GAAP operating profits and net profits are higher than GAAP numbers by 56%, and 43% respectively in 2021[1]. And this disparity has been rising over the years. In 2016, non-GAAP operating profits and net profits were only 23% and 21% higher than GAAP accounts[2]. As per company disclosures, non-GAAP results exclude stock-based compensation, payroll taxes related to stock-based compensation, amortisation of acquired intangibles, transaction expenses related to mergers and acquisitions and adjustments for the income tax effect of the excluded items. To our simple minds, all of the above are regular expenses which should be accounted for. It is our firm belief that such accounting choices do not accurately represent the financial health of the business.

Management at Ansys advocates the virtues of transparency as the basis for reporting non-GAAP numbers. But annual report disclosures state that non-GAAP financial measures are used to evaluate management performance, allocate resources, set targets, and, most importantly, determine management compensation. There is danger in this approach that goes well beyond the stated aims of transparency. Being measured on non-GAAP metrics means there is potential that management teams ignore the actual costs of doing business, take excessive risks and are not held financially

> "I never paint dreams or nightmares. I paint my own reality."
>
> Frida Kahlo

accountable for the negative consequences of their decisions. The increasing gulf between the two sets of accounts, alongside a rapid increase in stock-based compensation, suggests a financial engineering flywheel could be at work.

The longer this continues the larger the risks become. We have observed over many years that the aggressive use of options as a compensation tool impacts culture and incentivises poor behaviour. For example, KLA Corporation*, which makes technologies that enable metrology, advanced inspection and computational analysis in the electronics industry, engaged in generous options issuance and used aggressive accounting practices leading up to 2006. An investigation by the SEC[3] forced KLA to restate its accounts and replace its senior leadership. The restatements wiped out a material portion of equity that had been patiently built over decades. KLA had to spend many valuable years rebuilding its trust with employees, customers and shareholders.

Accounting is about choices, and understanding these choices helps us build a better picture of financial and management quality. And history continues to serve as an important lens through which to interpret these accounting portraits. Irrational and aggressive accounting practices are neither unusual nor recent. In a time of generally rising share prices, we believe management teams are emboldened and encouraged to employ such practices. The rewards encourage them to persist with these practices. It becomes a self-fulfilling prophecy. However, when share prices fall or when growth starts slowing, the accounting shenanigans become clearer and attract attention. This time should not be any different.

> "Art is a lie that makes us realise truth."
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> Pablo Picasso

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[1] Source: Ansys 2021 Annual Report

[2] Source: Ansys 2016 Annual Report

[3] Source: US Securities and Exchange Commission

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