CLAY TOKENS

The Uniform Accounting Monthly Report | May 31, 2021

Deficiencies in GAAP/IFRS vis-a-vis Uniform Accounting

Presented to the UAFRS Advisory Council

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Warren Buffett – the World's Greatest Investor – Is No Fan of GAAP

When Warren Buffett talks, his comments are worth listening to. If you were not already aware, Buffett has said a great deal about problematic accounting standards.

Arguably the world's most famous and most successful investor, Buffett has earned the moniker "Oracle of Omaha" due to his sage advice and seemingly unrivaled investment acumen. Each year, tens of thousands of his disciples flock to the small Nebraskan city to hear his thoughts on the stock market, investing, and the performance of the firm he Chairs, Berkshire Hathaway.

With the pandemic restrictions in place, the last two meetings have been virtual.

Would it surprise the Financial Accounting Standards Board that in three of the past four Berkshire Hathaway shareholders meetings, Buffett began his address by railing on the deficiencies in current accounting standards?

Within the first ten minutes of each of these annual meetings, Buffett has expressed great displeasure with GAAP, and specifically the mark-to-market accounting rules introduced in 2018.

The new standards require firms to adjust the value of their equity securities, whether they sell them or not, to reflect their current market values, or what the company would get for that asset at the given point in time.

The problem is that asset values of publicly traded equities can be notoriously volatile. They fluctuate widely from year to year, and even from week to week. Over the past 20 years, the entire market, as represented by the S&P 500 Index, has fallen as much as 38% and risen as high as 30% in a year. Individual securities and certain groups of stocks can swing even more sharply in either direction in short periods.

However, decades of market history have shown that large indexes of stocks, held over a few years, prove to have very little downside.

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In other words, over the last 150 or more years, try finding a period of time where the stock market was down. It's very, very difficult. Statistically, one could say that the market is almost never down, so long as it's given ten years or more as a measurement period.

The accounting rules present an earnings number that assumes that securities would be sold on the date of any given reporting period. The very short-term fluctuations of the stock market are recorded as a current term gain or loss, despite those securities not being sold.

Until 2018, unrealized gains and losses made adjustments to a company's net worth but did not run through traditional earnings.

When this accounting change was implemented, Buffett warned that the new accounting standards, not economic reality,

> *"would produce some very unusual effects from quarter to quarter….[in the] net earnings figure".*

And he was right. Even just first quarter earnings for Berkshire Hathaway have swung from a $1 billion dollar loss to a $21 billion dollar gain, to nearly a $50 billion dollar loss in 2020, and then a stellar recovery into 2021's first quarter of $11 billion.

Berkshire's first quarter earnings fluctuate as much as $60 billion to $70 billion dollars per year, up and down, having nothing to do with the operations of the firm.

Compare that against something as simple as operating earnings, without even adjusting for the 130 adjustments necessary under Uniform accounting. A very stable firm emerges, with earnings of approximately $5 billion moving to $7 billion over that time frame.

The as-reported earnings number is less than useless for the users of financial statements. A very stable business can appear unbelievably volatile—when it is not. See the table below.

BRK.A - Berkshire Hathaway Inc.	2018 Q1	2019 Q1	2020 Q1	2021 Q1
Operating earnings	$ 5,288	$ 5,555	$ 5,871	$ 7,018
Investment and derivative gains (losses)	$ (6,426)	$ 16,106	$ (55,617)	$ 4,693
Net earnings (loss)	$ (1,138)	$ 21,661	$ (49,746)	$ 11,711

**in USD millions*

Meanwhile, the stock price of Berkshire Hathaway has traded with a beta of less than one over the last five years while the stock rose more than double from $216,000 per share to about $440,000 per share in the same timeframe.

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Despite the giant swings in as-reported earnings, the stock market has rewarded the company with a very stable, rising stock price. Over five incredibly volatile years of as-reported GAAP earnings, Berkshire Hathaway has beaten the overall stock market handily, and with less volatility.

The swings of tens of billions dollars in as-reported earnings are due almost entirely to the faulty accounting of investment and derivatives gains—or in other words, mark-to-market accounting.

As Buffett states, due in part to the recent changes,

> *"the bottom line figures are .... totally capricious" and "have absolutely no predictive value or analytical value on a quarterly basis or an annual basis."*

The accounting rules make it nearly impossible to compare firms against each other or over time, even if otherwise nearly identical in their business activities.

Accounting standards are supposed to be designed to make financial statements relevant to the users of financial statements. This very notable user, Buffett, finds as-reported earnings to be wholly irrelevant.

Berkshire Hathaway is just one in a long line of firms, from various sectors, where as-reported earnings do not represent economic reality due to this particular accounting issue.

This month we highlight three well-known companies that have made significant stock investments historically, wherein mark-to-market accounting significantly limits the reliability of earnings.

- Berkshire Hathaway, with its diversified holdings across sectors
- Constellation Brands, with its sizeable investment in Canopy Growth
- Coca-Cola, with investments in Monster Beverage as well as multiple publicly traded bottlers

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In the pages and charts below, we show the difference between as-reported GAAP earnings and UAFRS-computed Uniform Earnings. In addition, we show the difference between as-reported GAAP Assets and UAFRS-based Assets.

While all of the 130+ adjustments have been applied, we hone in on how long-term investments and equity income, in particular, can create material deviations from economic reality.

In each case shown below, it's quite obvious the stock market does not and has not valued firms on GAAP earnings. These examples highlight just how bad the as-reported numbers are, from a database of more than 32,000 companies wherein Uniform Accounting and GAAP Accounting differences are shown.

The report name "Clay Tokens" comes from the earliest known form of accounting and bookkeeping and a foundation for tracking the earliest debits and credits. In this regard, Uniform Accounting is an attempt to get financial statements back to the foundations of the purpose of accounting… to be useful to the users of the accounting information. Clay Tokens is produced monthly by Valens Research on behalf of and for the UAFRS Advisory Council for Uniform Adjusted Financial Reporting Standards.

BRK.A – Berkshire Hathaway

Following the change in mark-to-market rules, BRK.A's earnings power has remained fairly stable, fading slightly as its asset growth has slightly outpaced earnings growth (Exhibit 1a)

Similar to this UAFRS-based earnings trend, the firm saw fairly tame stock market movement over the course of two years, excluding volatility driven by pandemic-related disruptions

Meanwhile, GAAP earnings have fluctuated wildly over this period, rising from immaterial levels to corporate averages, before collapsing back towards cost-of-capital levels, misleading investors into incorrectly believing the firm has erratic operating performance

From the initiation of the mark-to-market rules in 2018 through the end of 2020, BRK.A shares remained generally flat, ranging from $300,000-$340,000 levels, excluding periods of pandemic-related volatility (Exhibit 1b). That said, according to the market, BRK.A appeared to be a firm experiencing wild swings in profitability, and not one with generally stable asset growth and profitability trends that would warrant this stock market performance.

However, using Uniform Accounting, we can identify distortions such as a firm's earnings being misstated due to the mistreatment of the firm's extensive list of long-term equity investments and their associated mark-to-market equity income and equity investment income adjustments.

According to as-reported metrics, BRK.A saw its ROA spike from just 1% in 2018 to 9% in 2019, before crumbling once more in 2020. Meanwhile, UAFRS-adjusted metrics paint a significantly different picture of BRK.A, where Uniform ROA faded slightly over the same timeframe, remaining near cost-of-capital levels as asset growth slightly outpaced earnings expansion, suggesting the firm's stable stock price performance may have been justified (Exhibit 1c).

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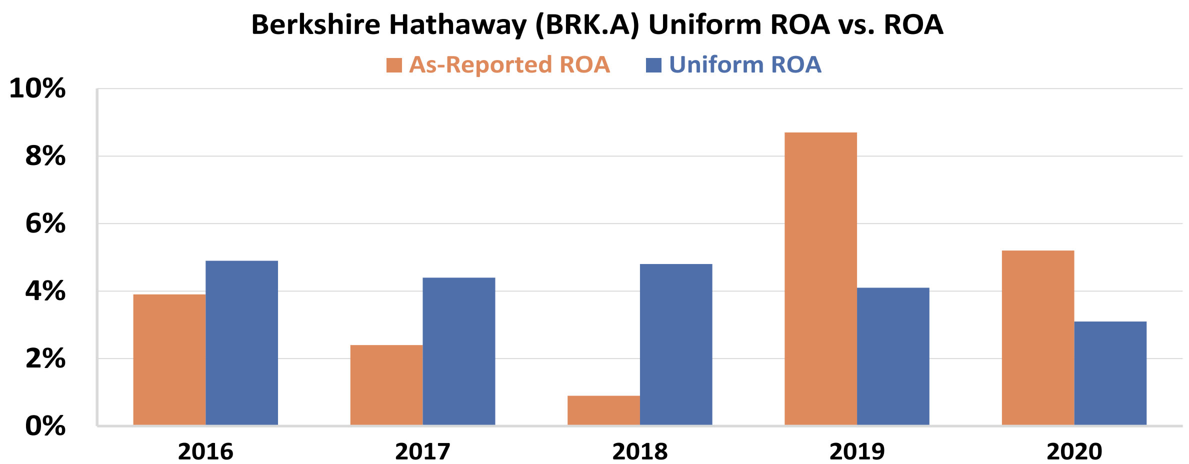
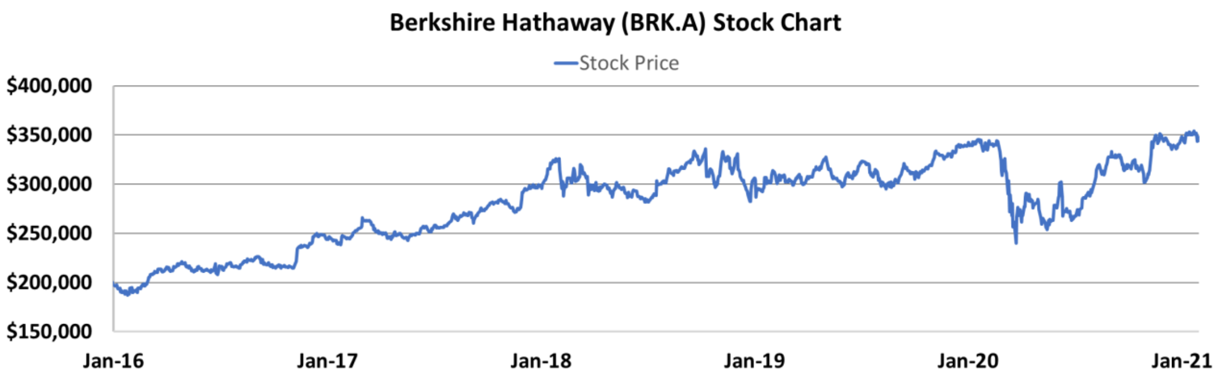
Deficiencies in GAAP/IFRS vis-a-vis Uniform Accounting

Exhibit 1a



Source: UAFRS, CapitalIQ

Exhibit 1b



Source: CapitalIQ

Exhibit 1c

BRK.A - Berkshire Hathaway Inc.	2016	2017	2018	2019	2020
Long-term investments	174,798.0	212,917.0	209,980.0	284,217.0	318,883.0
Equity income/(loss) from Affiliates	1,109.0	3,014.0	2,167.0	1,176.0	726.0
Equity investment income	(7,553.0)	(1,410.0)	22,455.0	(72,607.0)	(40,746.0)
Uniform earnings	21,857.4	25,138.8	27,486.2	27,699.6	22,933.1
Net income	24,074.0	44,940.0	4,021.0	81,417.0	42,521.0
% Variance	10.1%	78.8%	-85.4%	193.9%	85.4%
Uniform net assets	441,829.0	565,420.4	566,957.9	683,124.4	746,987.9
Total assets	620,854.0	702,095.0	707,794.0	817,729.0	873,729.0
% Variance	40.5%	24.2%	24.8%	19.7%	17.0%
Uniform ROA	4.9%	4.4%	4.8%	4.1%	3.1%
ROA	3.9%	2.4%	0.9%	8.7%	5.2%
Uniform ROA vs ROA - Variance	1.0%	2.0%	3.9%	-4.6%	-2.1%

**in USD millions*

STZ – Constellation Brands

Prior to the pandemic, STZ's Uniform earning power had remained robust and steadily improved over the past 4 years (Exhibit 2a)

Meanwhile, from 2017-2020, the firm's stock price seemed to move in line with Uniform-calculated earnings, with a material increase over that time period

Meanwhile, GAAP earnings had been deteriorating over the same time period, failing to explain the firm's stock price movements. Clearly, these standards are in total dislocation from the economic reality of the firm's strong performance.

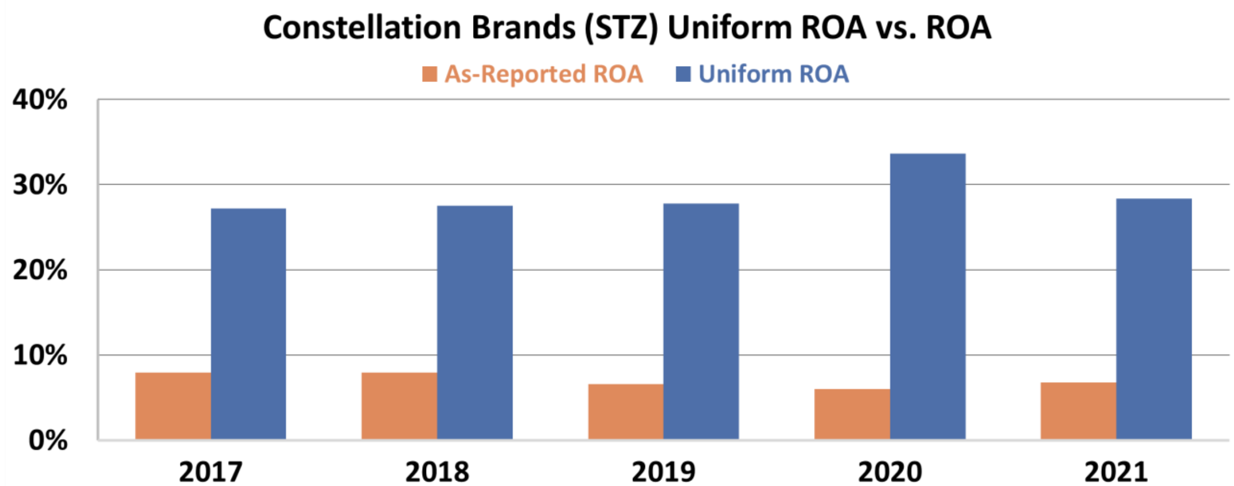
From 2017 up through the start of the pandemic, STZ shares saw a material price appreciation, rising from approximately $150/share to over $200/share, an approximately 40% increase (Exhibit 2b). That said, according to the market, STZ appeared to be a firm with declining profitability approaching cost-of capital levels, and not one with strong and improving fundamentals that would justify the company's stock performance.

However, using Uniform Accounting, we can identify distortions such as a firm's earnings being misstated due to the mistreatment of the firm's long-term equity investment in cannabis company, Canopy Growth, and its associated mark-to-market equity income adjustments.

According to as-reported metrics, STZ saw its as-reported ROA decline from 8% in 2017 to just 6% in 2020, approaching cost-of-capital levels. Meanwhile, UAFRS-adjusted metrics paint a significantly different picture of STZ, where Uniform ROA expanded steadily from 27% to 34% over the same timeframe, justifying the firm's stock price appreciation (Exhibit 2c).

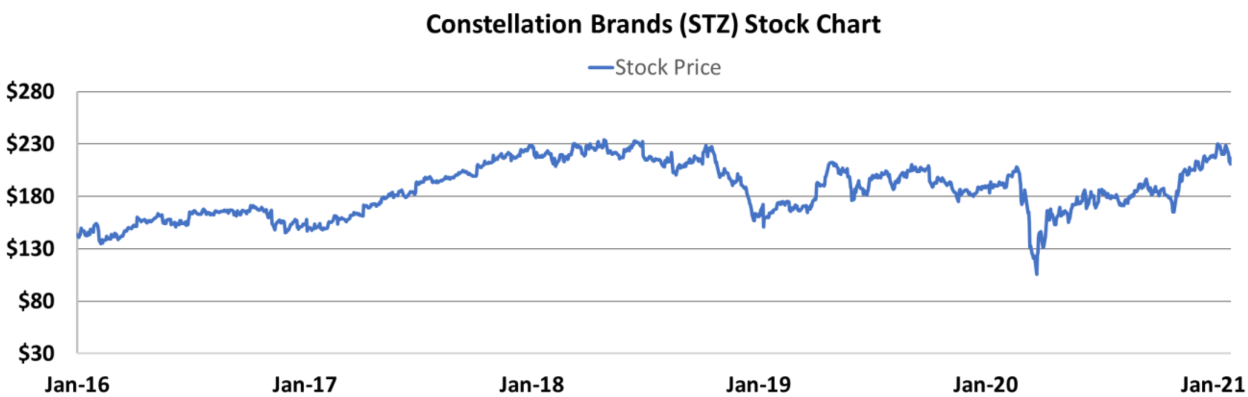
Deficiencies in GAAP/IFRS vis-a-vis Uniform Accounting

Exhibit 2a



Sources: UAFRS, CaptialIQ

Exhibit 2b



Source: CapitalIQ

Exhibit 2c

STZ - Constellation Brands, Inc.	2017	2018	2019	2020	2021
Long-term investments	103.1	793.7	6,700.3	4,211.0	4,606.5
Equity income/(loss) from Affiliates	27.3	487.2	2,101.6	(2,668.6)	150.3
Uniform earnings	1,656.5	1,987.3	2,126.5	2,352.2	2,202.4
Net income	1,528.6	2,303.4	3,435.9	(11.8)	1,998.0
% Variance	7.7%	15.9%	61.6%	-100.5%	-9.3%
Uniform net assets	6,097.1	7,006.0	7,649.1	6,990.3	7,760.9
Total assets	18,602.9	20,538.7	29,231.5	27,323.2	27,104.2
% Variance	205.1%	193.2%	282.2%	290.9%	249.3%
Uniform ROA	27.2%	28.4%	27.8%	33.6%	28.4%
ROA	7.9%	8.0%	6.6%	6.0%	6.8%
Uniform ROA vs ROA - Variance	19.2%	20.4%	21.2%	27.6%	21.6%

**in USD millions*

KO – The Coca-Cola Company

KO's Uniform earning power has proven to be consistently robust, and has remained stable at 40%+ levels over the past several years (Exhibit 3a)

The firm's stock price generally reflects this stability in Uniform-calculated earnings, with modest appreciation over the past couple years

Meanwhile, GAAP earnings have been deteriorating since the introduction of mark-to-market accounting rules. These earnings figures distort the economic reality of the firm's performance.

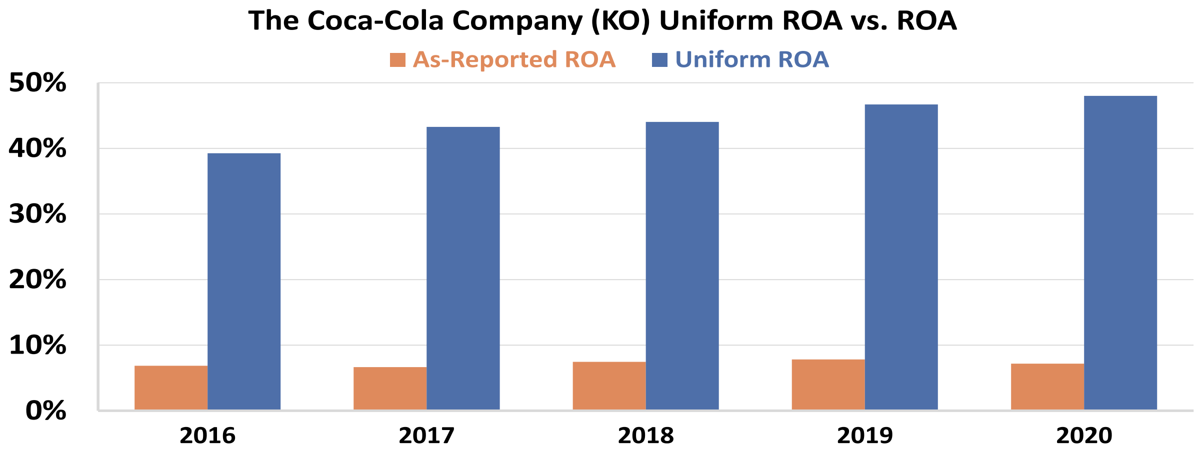
Since the mark-to-market accounting rules were implemented, KO share price has remained fairly stable, rising from approximately $45/share at the start of 2019 to $55/share, a modest 15% increase (Exhibit 3b). That said, according to the market, KO appears to be a firm that has seen fading profitability since this rule change, distorting investors' understanding of its recent stock price movements.

However, using Uniform Accounting, we can identify distortions such as a firm's earnings being misstated due to the mistreatment of the firm's long-term equity investment in Monster Beverage, as well as numerous public bottling operations, and its associated mark-to-market equity income adjustments.

According to as-reported metrics, KO saw its ROA decline from over 8% in 2019 to 7% in 2020. Meanwhile, UAFRS-adjusted metrics paint a slightly different picture of KO, where Uniform ROA remained stable at robust 47%-48% levels over the same timeframe, better explaining the rationale behind the firm's stock price appreciation (Exhibit 3c).

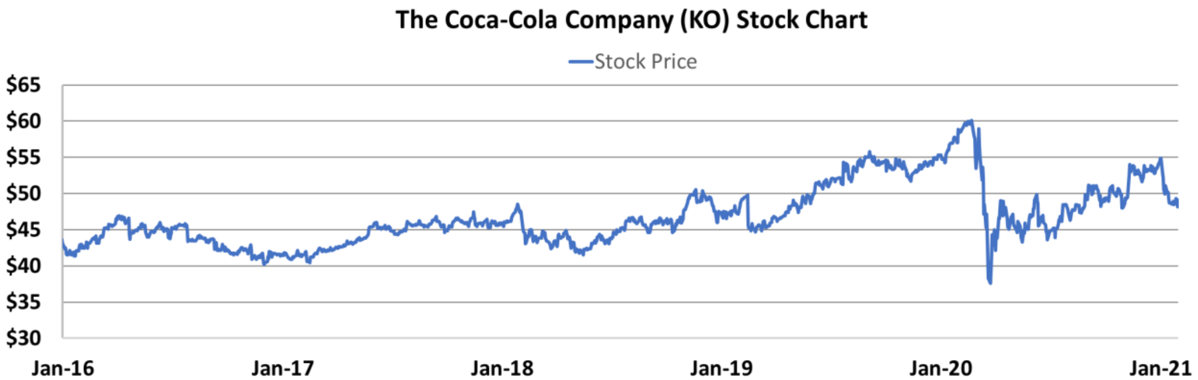
Deficiencies in GAAP/IFRS vis-a-vis Uniform Accounting

Exhibit 3a



Source: UAFRS, CapitalIQ

Exhibit 3b



Source: CapitalIQ

Exhibit 3c

KO - The Coca-Cola Company	2016	2017	2018	2019	2020
Long-term investments	18,569.0	23,281.0	21,538.0	21,730.0	22,311.0
Equity income/(loss) from Affiliates	835.0	1,072.0	1,008.0	1,049.0	978.0
Uniform earnings	7,505.4	6,437.0	6,758.1	7,144.8	6,856.9
Net income	6,527.0	1,248.0	6,434.0	8,920.0	7,747.0
% Variance	-13.0%	-80.6%	-4.8%	24.8%	13.0%
Uniform net assets	19,123.8	14,873.7	15,350.5	15,298.7	14,283.8
Total assets	87,270.0	87,896.0	83,216.0	86,381.0	87,296.0
% Variance	356.3%	491.0%	442.1%	464.6%	511.2%
Uniform ROA	39.2%	43.3%	44.0%	46.7%	48.0%
ROA	6.9%	6.7%	7.5%	7.8%	7.2%
Uniform ROA vs ROA - Variance	32.4%	36.6%	36.6%	38.9%	40.8%

**in USD millions*

Deficiencies in GAAP/IFRS vis-a-vis Uniform Accounting

Definitions

Uniform Net Assets – Net Asset' is calculated as Net Working Capital + Long Term Non-Depreciating Operating Assets (including Land and Non-Depreciating Operating Intangible Assets, excluding Goodwill and other acquisition-related Intangible Assets) + Inflation-Adjusted Net PP&E + Net capitalized R&D + Net Capitalized Leases + Net Depreciating Operating Intangible Assets

Uniform ROA – UAFRS-adjusted ROA is a cleaned up Return on Asset ratio, used to understand the operating fundamentals of the company. UAFRS-adjusted ROA is Earnings' divided by Asset'.

Uniform Earnings is calculated as Net Income + Special Items + Interest Expense + Depreciation and Amortization Expense + R&D Expense + Rental Expense + Minority Interest Expense + Pension Charges + LIFO to FIFO adjustments + Stock Option Expense + Purchase Accounting Cash Flow Adjustments - Non-Operating (Investment) Income - Asset Life Based Charge on Depreciating Assets. Asset' is Net Asset', or Net Working Capital + Long-Term Non-Depreciating Operating Assets (including Land and Non-Depreciating Operating Intangible Assets, excluding Goodwill and other acquisition related Intangible Assets) + Inflation Net PP&E + Net Capitalized R&D + Net Capitalized Leases + Net Depreciating Operating Intangible Assets.

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