

# CLAY TOKENS

The Uniform Accounting Monthly Report | September 30, 2021



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

**M&A accounting trashes the reliability of earnings. Even my students say, “huh?!?”**

When I teach advanced accounting to up-and-coming future accountants, I have to tell the students to just memorize GAAP rules and do what the standards tell them to do.

I have to specifically tell them, “Don’t try to figure this out in a way that would make common sense. You’ll get it wrong on the CPA exam.”

Allow me to share some of the questions that I’d never put on one of my exams, as they would have students’ heads spinning. It would just be unfair.

- True or false: Research and development costs should not be capitalized.
- True or false: Fair value accounting creates consistency in the financial statements.
- True or false: The pooling of interests method of acquisition accounting distorted the financial statements more than the purchase method.

Of course, all of the above answers are unequivocally false... insofar as the user of the financial statements is an investor or creditor. However, over time, accounting standards setters seemed to have strayed away from this common line of thinking.

Mergers and acquisitions are some of the most hotly anticipated and heavily scrutinized corporate transactions. With many billions of dollars at stake, it's no wonder that everyone from management to shareholders to creditors and investment bankers all want a piece of the action.

When executed correctly, they can add tremendous value to the stakeholders, and in particular, shareholders, of an acquiring company.

For instance, Disney’s acquisition of Pixar in 2006 and soon after Marvel in 2009, allowed it to build one of the world’s greatest media empires. The combined company can, among other things, consistently churn out billion-dollar blockbuster movies, and it has managed to drive a more than 7x stock price appreciation since the start of 2006.

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Meanwhile, Google's acquisition of Android in 2005 for a relatively small \$50 million gave it the ability to compete with Apple and Microsoft in the mobile operating system market and has led it to capture a lion's share (85%) of a multi-billion-dollar industry.

Despite success stories like these, top financial publications such as the Harvard Business Review still cite that experts estimate anywhere between 60%-90% of mergers actually destroy shareholder value.

While the merits of these studies, and of M&A in general, can often be debated, just looking at an acquiring firm's as-reported financials, it would appear that key performance metrics such as profitability often do deteriorate.

For instance, following Disney's \$90-billion-plus acquisition of Twenty-First Century Fox in 2019, the firm's assets nearly doubled. Meanwhile, its revenue appeared to increase by less than 20%, a fraction of the value of the acquisition, and its net income and profitability declined materially.

Based on these as-reported—and so, unadjusted—performance figures, it appears that Disney's management team lit tens of billions of dollars on fire. Can a management team really make such bad decisions and still have a job?

The answer, of course, is no. In reality, the impact of M&A transactions are being completely mishandled by GAAP Accounting Standards. As it stands, it becomes nearly impossible to compare the performance of a company before and after it has made a major acquisition.

M&A accounting distortions are widespread—ranging from the nonsensical booking of goodwill and goodwill impairments, to the haphazard combination of fair value and cost-based accounting, to the requirement for accountants to do the near-impossible task of estimating a precise multi-period estimate of free cash flow generated by an acquired asset.

As such, in order to analyze the impact of various M&A accounting distortions, we must break them into numerous sections. This month, we start by covering a topic so simple, it is a wonder how the accounting standards board got it so wrong.

In the advanced accounting course, I'm currently teaching, I happen to be covering the topic of business combinations. It is amazing how much effort is devoted to end-of-year consolidation journal entries, and in particular, to restating the values of acquired assets. Meanwhile, the combined entity is completely missing the revenue, expenses and cash flows brought on from the same transaction.

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By focusing on the legal date of the transaction, instead of the restated combination of the two entities, GAAP creates a blatant mismatch between the income statement and balance sheet following an acquisition.

It is a violation of the matching principle. We see assets and liabilities of both firms at the end of the year. However, we only see the revenue, expenses, and cash flows of the acquired company for a partial year.

The matching principle tells us to match revenues against the expenses to generate such revenue. How on earth is that possible when the income statement items are completely mis-represented against the assets that generated them?

Somehow in M&A accounting, accounting standards setters decided to be attorneys instead of accountants. Some supporters of this mismatch in the existing rules will say, “But how can we include the business activity of the entity that occurred prior to the legal ownership of the acquired entity?”

Well, if “legality” is the justification for acquisition accounting, specifically the purchase method, then why not attack any GAAP standard that differs from the Internal Revenue Service or any regulatory agency’s method of accounting? Are those not the “legal” foundations for calculating revenue and expenses?

GAAP rules often deviate from purely legal representations of revenue and expenses when it makes more sense for the users of the financials. Otherwise, we’d all simply be using OCBOA methods like Federal tax rules.

Regulatory agencies often require different accounting than GAAP for what they determine to be legal representations of revenue and expenses. GAAP accounting can widely differ.

So how can legality be a justification for creating business combination accounting that so massively distorts the economic reality of the newly combined business?

As Michael Kwatinetz, PhD, former FASB advisory committee member and managing partner of venture capital firm Azure Capital Partners, states “the current accounting standard for incorporating the financial results of the acquired company into the financial results of the acquiring company, does not consider the acquired company’s revenue from any period prior to the acquisition to be part of the consolidated company’s history.”

The implications of this standard can be massive, especially depending on when in the year an acquisition is made. In the beginning of the year, a firm will book a full year of acquired company earnings, allowing for an almost direct comparison from year-to-year. But as the year goes on, less and less of the acquired company’s annual earnings will be reflected by purchase accounting.

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This means that if a firm with a 20% ROA were to purchase an equally sized firm with a 20% ROA near the end of its fiscal year, the combined entity would show an ROA closer to 10%. The resulting analysis from this accounting treatment of earnings becomes next to useless. All else equal, this transaction should produce a firm twice the size with an ROA of ..... 20%!

In the case of the Disney - Twenty First Century Fox transaction, since the acquisition was finalized near the middle of Disney's fiscal year, billions of dollars of revenues and earnings are completely missing from its books.

By adding all the assets of an acquired company, but failing to add a full year of earnings, GAAP accounting is completely misrepresenting, and consistently underreporting, the profitability of the purchased company.

And the issue does not only apply to the period at hand.

As Michael Kwatinetz continues, "This means that one company can purchase another that has half as much revenue as it has, and for the following four quarters it will appear that the acquirer's revenue growth rate is 50% higher than it actually is."

So, by not including the full revenue and earnings of an acquired company, accounting standards are not only distorting current year performance, but also an understanding of the true impact of the acquisition for each period going forward—making it difficult to decipher how well an acquisition has performed, how well management should be compensated, or what prospective cash flows will be available to shareholders.

The solution for this particular accounting standard deficiency is fairly straightforward. In fact, it used to be a widely accepted standard for how to report acquisitions up until 2001. Under the pooling of interest method of acquisition accounting, revenue, expenses, and net income would all be consolidated between the two entities for the entire year of the acquisition.

This removed the earnings-related accounting noise created by purchase method accounting. As we'll talk about in future months, this solution also removes the noise of market value accounting for balance sheet line items, along with solving a number of other critical purchase accounting distortions.

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It just requires estimating the full year performance of the acquired company and adding the amount which likely occurred prior to the acquisition date to the earnings of the combined firm. That said, while a simple adjustment, the impact can be significant.

There is a long line of acquisitive firms, from various sectors, where as-reported earnings do not represent economic reality due to gross earnings being excluded from acquisitions.

This month, we highlight three companies with significant M&A transactions, wherein the partial year acquired company earnings severely limit the reliability of the firm's reported earnings:

- Raytheon Technologies, a defense contractor and industrials firm formed from the merger of Raytheon and United Technologies
- Danaher, an industrial conglomerate known for being a serial acquirer
- IQVIA, a clinical research services company reinvigorated by its acquisition of IMS Health

In the pages and charts below, we show the Gross Earnings Missing from M&A Activity for these firms and 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 these few line items 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/IFRS 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.*

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### [RTX](#) – Raytheon Technologies Corporation

Throughout its history, even following its acquisition of Rockwell Collins in 2018 and the merger between Raytheon and United Technologies in 2020, RTX has seen robust profitability. That said, in recent years, the firm's profitability has faded from historical peaks (Exhibit 1a).

Reflecting this UAFRS-based earnings trend, the firm has seen a moderate decline in its stock price, reflecting the slight deterioration in fundamentals as the firm digests these large business combinations.

Meanwhile, GAAP earnings have tanked dramatically over this same period, misleading investors into incorrectly believing the firm has destroyed a majority of its value through M&A activity. This as-reported performance would suggest the firm's stock price has not declined by nearly enough.

Since the firm's acquisition of Rockwell Collins in 2016, [RTX](#) share prices have declined modestly in value, compressing from just over \$105/share to about \$85/share, a less than 20% drop (Exhibit 1b). That said, according to the market, [RTX](#) appeared to be a firm with plummeting profitability, falling from corporate average levels to well below the cost of capital. This supposed destruction of shareholder value should have warranted a significantly worse stock market reaction.

However, using Uniform Accounting, we can identify a number of distortions, including multiple related to the faulty accounting of the firm's M&A transactions, as is the case here. As highlighted in the opener, the firm is only being credited for a fraction of its acquired company's total earnings in the year of the acquisition, which substantially suppresses profitability metrics (Exhibit 1c).

UAFRS-adjusted metrics paint a significantly different picture of [RTX](#), where Uniform ROA has remained robust, while fading slightly from prior peaks. Uniform ROA has declined from 13% in 2016 to slightly weaker 11%-12% levels through 2020 suggesting that the slight pullback in the firm's stock price has likely been justified.

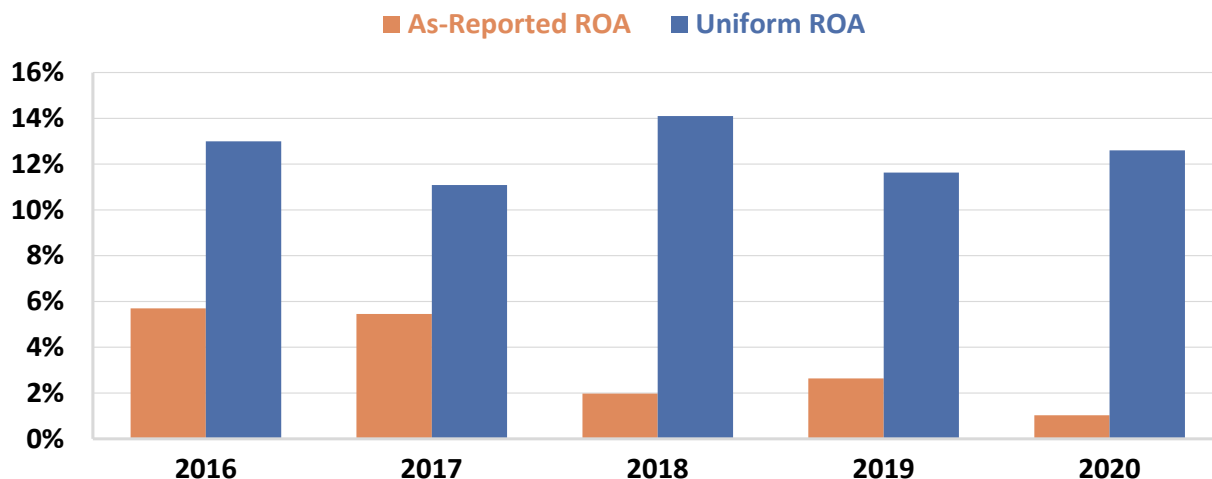
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### Exhibit 1a

#### Raytheon Technologies Corporation (RTX) Uniform ROA vs. ROA



Source: UAFRS, CapitalIQ

### Exhibit 1b

#### Raytheon Technologies (RTX) Stock Chart



Source: CapitalIQ

### Exhibit 1c

RTX - Raytheon Technologies Corporation	2016	2017	2018	2019	2020
Gross earnings missing from M&A	0.0	0.0	597.6	0.0	361.3
Uniform earnings	6,742.6	6,285.2	7,564.9	7,312.1	7,407.7
Net income	5,055.0	4,552.0	5,269.0	5,537.0	-3,519.0
% Variance	-25.0%	-27.6%	-30.3%	-24.3%	-147.5%
Uniform net assets	51,891.7	56,683.4	53,570.9	62,864.1	58,958.0
Total assets	89,706.0	96,920.0	134,211.0	139,615.0	162,153.0
% Variance	72.9%	71.0%	150.5%	122.1%	175.0%
Uniform ROA	13.0%	11.1%	14.1%	11.6%	12.6%
As-reported ROA	5.7%	5.5%	2.0%	2.6%	1.0%
Uniform ROA vs ROA - Variance	7.3%	5.6%	12.1%	9.0%	11.5%

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### [DHR](#) – Danaher Corporation

Well-known for its acquisitive growth strategy, [DHR](#) has been able to improve its already robust profitability for much of the past decade by using management expertise to create new efficiencies in its purchased business lines (Exhibit 2a).

Since 2014, the firm's stock price has been on an impressive streak, moving generally in the same direction as its Uniform-calculated earnings. The market has generally reacted positively to the firm's large acquisitions, including Pall Corp in 2015, Cepheid in 2016, and Cytiva in 2020, among others.

Meanwhile, GAAP earnings shows a firm that has seen weak profitability in recent years, declining to near cost of capital levels. This fails to explain the firm's meteoric stock price movements, displaying how these standards demonstrate a dislocation between economic reality and as-reported performance.

Since 2014, [DHR](#) shares have seen material appreciation, rising from approximately \$65/share to nearly \$330/share, a well over 400% increase (Exhibit 2b). That said, according to the market, [DHR](#) appeared to be a firm which saw weak and generally flat profitability, particularly following its business reorganization in 2015, and not one with strengthening fundamentals that would justify the company's stock outperformance.

However, using Uniform Accounting, we can identify a number of distortions, including multiple related to the faulty accounting of the firm's M&A transactions, as is the case here. As highlighted in the opener, the firm is only being credited for a fraction of its acquired company's total earnings in the year of the acquisition, which substantially suppresses profitability metrics (Exhibit 2c).

UAFRS-adjusted metrics paint a significantly different picture of [DHR](#), where Uniform ROA substantially improved over the same time frame, nearly doubling its profitability from an already robust 20% in 2014 to 41% levels in 2020. This earning trend justifies the firm's stock price improvement.



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Exhibit 2a

### Danaher Corporation (DHR) Uniform ROA vs. ROA

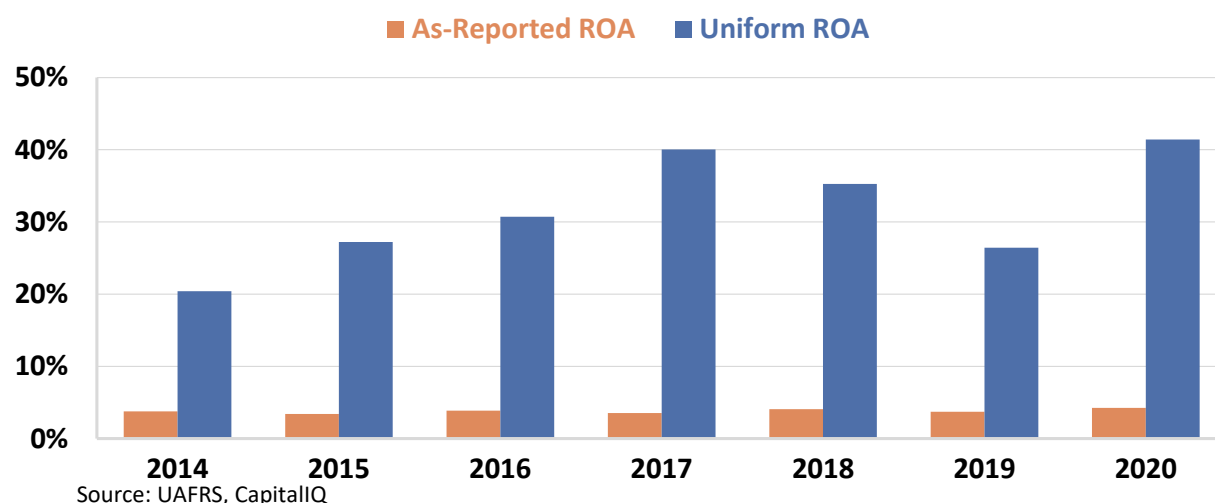


Exhibit 2b

### Danaher (DHR) Stock Chart



Exhibit 2c

DHR - Danaher Corporation	2014	2015	2016	2017	2018	2019	2020
Gross earnings missing from M&A	163.9	477.9	0.0	0.0	0.0	0.0	207.9
Uniform earnings	2838.6	4367.4	3,111.7	3,981.8	3,150.8	3,067.8	5,065.4
Net income	2695.0	2598.0	2,553.7	2,492.1	2,561.0	3,008.0	3,646.0
% Variance	-5.1%	-40.5%	-17.9%	-37.4%	-18.7%	-1.9%	-28.0%
Uniform net assets	13,904.2	16,260.4	10,431.7	10,254.3	9,498.0	12,221.2	12,617.3
Total assets	36,991.7	48,222.2	45,295.3	46,648.6	47,832.5	62,082.0	76,161.0
% Variance	166.0%	196.6%	334.2%	354.9%	403.6%	408.0%	503.6%
Uniform ROA	20.4%	27.2%	30.7%	40.0%	35.3%	26.4%	41.4%
As-reported ROA	3.8%	3.4%	4.0%	3.5%	4.1%	3.7%	4.3%
Uniform ROA vs ROA - Variance	16.6%	23.8%	26.8%	36.5%	31.2%	22.7%	37.2%

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### [IQV](#) – IQVIA Holdings Inc.

Following its acquisition of IMS Health in 2016, [IQV](#)'s Uniform earning power has proven to be robust and improving, consistently expanding in each year leading up to the global pandemic (Exhibit 3a).

The firm's stock price reflected this improvement in Uniform-calculated earnings from 2016-2020, with significant appreciation over that time period.

Meanwhile, GAAP earnings had remained at paltry levels over this same timeframe, only worsening following the completion of this transformative acquisition. These earnings figures distort the economic reality of the firm's performance.

From the end of 2016 up through the start of US lockdowns, [IQV](#)'s share price saw a meteoric rise, climbing from approximately \$75/share to over \$150/share, representing an over 100% appreciation in value (Exhibit 3b). Yet, according to the market, [IQV](#) appeared to be a firm that likely warranted a decline in stock price due to consistently poor and recently faltering fundamentals, and not one that had managed to strengthen its already impressive performance.

However, using Uniform Accounting, we can identify a number of distortions, including multiple related to the faulty accounting of the firm's M&A transactions, as is the case here. As highlighted in the opener, the firm is only being credited for a fraction of its acquired company's total earnings in the year of the acquisition, which substantially suppresses profitability metrics (Exhibit 3c).

UAFRS-adjusted metrics paint a slightly different picture of [IQV](#), where Uniform ROA jumped from highly robust 63% levels in 2016 to a peak of 79% in 2019, as the firm was successfully able to reap synergy from its integration of IMS. These Uniform metrics better explain the rationale behind the firm's substantial stock price appreciation.

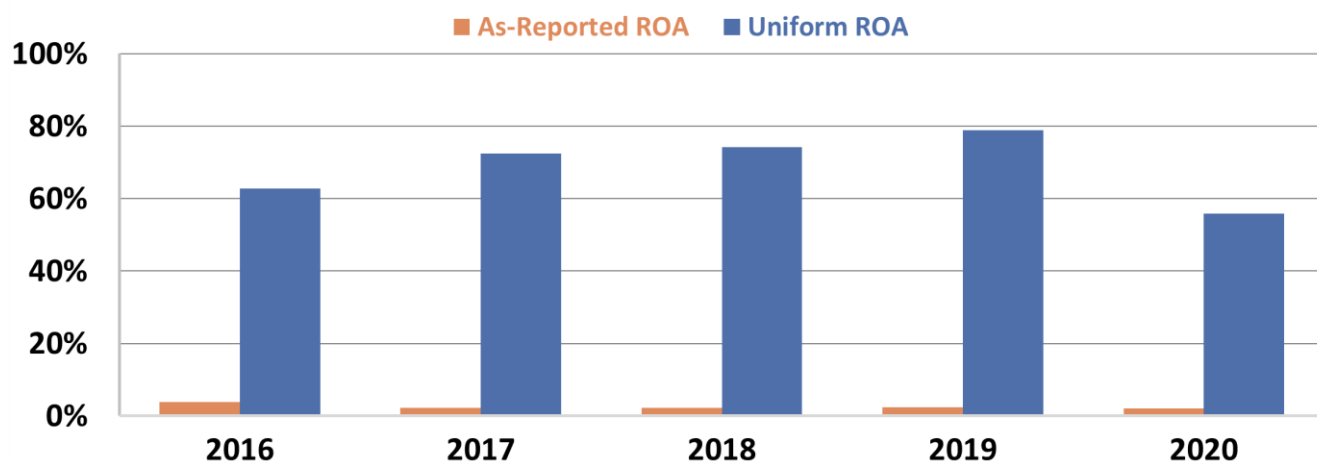
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Exhibit 3a

### IQVIA (IQV) Uniform ROA vs. ROA



Sources: UAFRS, CapitalIQ

Exhibit 3b

### IQVIA (IQV) Stock Chart



Source: CapitalIQ

Exhibit 3c

IQV - IQVIA Holdings Inc.	2016	2017	2018	2019	2020
Gross earnings missing from M&A	648.0	0.0	0.0	0.0	0.0
Uniform earnings	1,099.9	1,484.2	1,524.5	1,506.7	1,556.5
Net income	72.0	1,277.0	259.0	191.0	279.0
% Variance	-93.5%	-14.0%	-83.0%	-87.3%	-82.1%
Uniform net assets	1,751.2	2,051.2	2,055.1	1,909.5	2,782.3
Total assets	21,208.0	22,857.0	22,549.0	23,251.0	24,564.0
% Variance	1,111.1%	1,014.3%	0,997.2%	1,117.6%	0,782.9%
Uniform ROA	62.8%	72.4%	74.2%	78.9%	55.9%
As-reported ROA	3.8%	2.2%	2.3%	2.4%	2.1%
Uniform ROA vs ROA - Variance	59.0%	70.1%	71.9%	76.5%	53.8%

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### 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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