

CLAY TOKENS

The Uniform Accounting Monthly Report | December 21, 2021



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

GAAP is unhelpful and uncooperative in its treatment of acquired assets

In our most recent issue, we highlighted how M&A accounting violates the matching principle and misrepresents economic reality by consistently underreporting the profitability of an acquired company. This causes multi-period distortions in the acquiring firm's income statement.

This month, we stay on the topic of faulty M&A accounting, but shift to an aspect that is thought of most often in conjunction with the balance sheet.

This month, we are discussing goodwill... and not the nonprofit donation organization.

In a business sense, goodwill simply represents acquired assets that are not tangible physical assets, and are not intangible assets that can be easily valued, like say a trademark.

More specifically, goodwill is the portion of an acquisition purchase price that is higher than the total "net fair value" of all the assets purchased and liabilities assumed in an acquisition. In other words, it represents the excess purchase price of an M&A transaction.

In an acquisition, the acquiring company will typically use debt (an increase in liabilities) and cash (a reduction in assets), and even sometimes additional equity to finance a transaction. But often, the net assets received in the transaction are not sufficient to satisfy the simple accounting equation: $Assets = Liabilities + Owner's Equity$.

In these scenarios, the acquirer is paying an additional premium in order to entice the existing management team or shareholders of the target firm to sell. It is an often expected, but not required, part of a bid and can vary in size depending on a number of factors, including the target company's earning power in particular, competition within the industry, bidding competition, and frankly, the negotiating skills of management teams.

This "acquisition premium", reported as goodwill on the balance sheet, has nothing to do with the ongoing performance of the business, it is just meant to balance the books.

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Even worse, it allows the past valuation of an acquired company to influence the current financial statements of the combined company. This completely eliminates comparability across years and across firms.

For instance, if two companies own near identical assets and run nearly identical businesses, but one grew through acquisitions, while the other grew organically, their balance sheets will look wildly different. Namely, the “assets” of the acquirer will be far larger.

As a result, even if the firms had identical business performance, profitability metrics such as ROA will look far worse for the acquirer because its asset efficiency will lag, and other ratios will be wildly skewed.

This lack of performance comparability is at its most extreme when a high return business, with few-to-no operating assets, is acquired. Think of mature software companies as an example.

These companies can be wildly profitable and utilize very few physical assets to generate significant recurring revenue streams. It is logical to assume that if a less profitable business, such as a manufacturing company, with a great reliance on physical assets and maintenance, were to acquire a software company, its total profitability would increase. But since the whole excess of the purchase price to net assets of the software company would be recorded as an “asset” on the manufacturing company’s balance sheet, its as-reported ROA would likely go down.

Thus, including goodwill in the analysis of financial statements is an act of sheer folly. Financial analyses such as corporate fade, corporate benchmarking, and investment decisions become practically useless when including goodwill. It becomes next to impossible to truly understand how good of a business a combined entity really is.

As such, goodwill should not be thought of as an operating asset. It has nothing to do with the day-to-day operations of a company.

At its core, goodwill is just a balancing item. Its purpose is to “balance” the “balance sheet”.

Some argue that goodwill may reflect “value” such as growth potential, synergies and market access, among others, but this “value” is incredibly uncertain. Under this assumption, goodwill reflects the value of the acquired business at the time of the acquisition, yet this value will fluctuate significantly over time as business conditions change.

But reality is quite different. In a business liquidation or bankruptcy negotiation, the goodwill a company previously held is assumed to have absolutely no resale value, highlighting this isn’t an asset with carrying value at all.

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This accounting treatment adds unnecessary subjectivity to the valuation of companies, which can greatly reduce the quality of earnings and the utility of financial statements for end users.

In fact, in a research paper published jointly by researchers from Emory University, Duke University, and Columbia Business School, it was found through interviews of several anonymous CFOs that management teams are taking full advantage of the discretion that goodwill accounting standards provide:

“Acquisition accounting would be the biggest area where I’ve seen some CFOs taking advantage. I have seen acquisitions used to establish numerous balance sheet items and those provide huge opportunities in the future to manage the P&L.”

The subjectivity in keeping goodwill on the balance sheet allows CFOs to take large goodwill impairments when needed.

Thus, goodwill impairments can also distort profitability comparisons between companies that have goodwill on their balance sheets and those that do not.

Shrewd CFOs and Boards can use the flexibility in goodwill accounting to make a number of adjustments to their reported performance. Given the complexity of goodwill impairment estimates, slight changes in estimated future cash flows and interest rates can lead to a wide range of “fair value” estimates.

As such, it has been common for impairment to be delayed until a period of already bad results in order to take a “big bath” and show improvements in subsequent quarters or until a new executive officer takes office to give them a clean slate.

Worse yet, goodwill is not the only acquisition-related item financial statement users need to worry about on the balance sheet.

Often, to get rid of goodwill, or not record it in the first place, management teams can allocate the “acquisition premiums” elsewhere...in “operating” intangible assets. Since goodwill is meant to represent assets that are not separately identifiable, anything that can be “separated” qualifies for this special treatment.

Non-tangible assets from licenses and trademarks and copyrights to client lists to patents can all be lumped into this category. While at first it may seem that management may be extracting more “value”, in reality, these acquired intangibles serve merely as a justification for reducing the size of the goodwill line item.

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The issue with intangibles, as with goodwill, is that it severely reduces comparability and has little to do with the operations of a firm.

If a company were to build or develop internally the same assets it acquires, none would show up on the balance sheet. If an “intangible asset” is built instead of bought, why should it be assigned a different value?

For instance, some of the largest brands in the world, including Coca-Cola, McDonald’s, and Apple have no “brand” or “logo” intangible asset on their books. Meanwhile, the premium of small acquisitions of little-known companies can appear as intangible assets with significant value. Clearly, the latter is not worth more than the former. Moreover, goodwill and intangible assets don’t reflect the economic reality of a business.

The solution for this particular accounting standard deficiency is fairly straightforward... simply exclude goodwill and intangible assets from a firm’s operating assets, and exclude the impairment of goodwill and intangibles from a firm’s operating earnings.

Now, as an aside, there may be times where analyzing goodwill can matter. Namely, for serial acquirers, or firms that grow primarily through acquisition, it can help investors assess a management team’s ability to pursue accretive acquisitions. It can help reveal how much and how often management overpays. That said, this avenue examines M&A performance and not necessarily operating performance, so it falls outside the scope of this reading.

There is a long line of firms which have completed material acquisitions, from various sectors, where as-reported assets do not represent economic reality due to goodwill and acquired intangibles being included in the operating asset base.

This month we highlight three companies, with significant M&A transactions, wherein the inclusion of goodwill and acquired intangibles severely limit the reliability of the firm’s reported asset-based ratios:

- Leidos, a defense contractor and acquirer of portions of Lockheed Martin’s and L3’s security and information systems businesses
- MSCI, an investment data-focused firm which has recently acquired Real Capital Analytics
- ANSYS, an engineering simulation software firm and acquirer of numerous smaller software players

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

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While all of the 130+ adjustments have been applied, we hone in on how this line item 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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[LDOS](#) – Leidos Holdings, Inc.

Following its acquisition of Lockheed Martin's Information Systems and Global Solutions division in 2016, LDOS saw improvements in profitability. Since then, profitability has remained robust, even after the firm's acquisition of L3Harris's Security and Detection business in 2020. (Exhibit 1a).

Reflecting this UAFRS-based earnings trend, the firm has seen a material appreciation in its stock price, showcasing how these transactions have been accretive to the firm's performance.

Meanwhile, GAAP earnings have remained weak and stagnant over this same period, misleading investors into incorrectly believing the firm has been unable to uncover accretive value through M&A activity. This as-reported performance would suggest the firm's stock price rise has been wholly unwarranted.

Since the firm's acquisition of Lockheed's Systems and Global solutions business in 2016, [LDOS](#) share prices have increased materially in value, rising from approximately \$50/share to over \$85/share, an over 65% rise (Exhibit 1b). That said, according to as-reported metrics, [LDOS](#) appeared to be a firm with weak and stagnant profitability, just hovering above the cost of capital over a five-year period. This supposed underwhelming performance should not warrant the firm's stock price movements.

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 holds significant goodwill and non-operating intangibles on its balance sheet, which substantially suppresses profitability metrics (Exhibit 1c).

UAFRS-adjusted metrics paint a significantly different picture of [LDOS](#), where Uniform ROA improved following the Lockheed transaction and has remained robust ever since. Uniform ROA expanded from 29% in 2016 to powerful 38%-41% levels through 2020, suggesting that the appreciation in the firm's stock price has likely been justified.

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Exhibit 1a

Leidos Holdings (LDOS) Uniform ROA vs. ROA

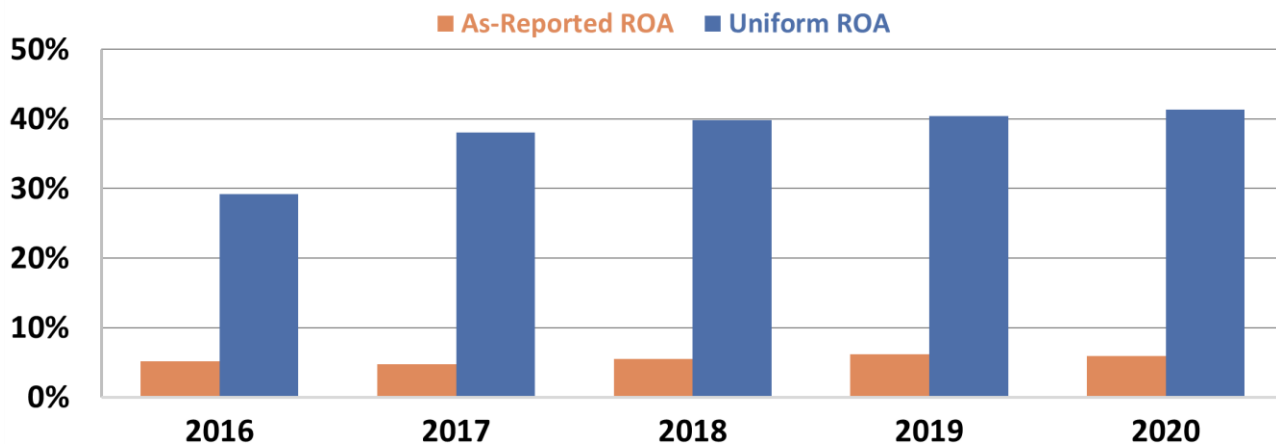


Exhibit 1b

Leidos Holdings (LDOS) Stock Chart



Exhibit 1c

LDOS - Leidos Holdings, Inc.	2016	2017	2018	2019	2020
Goodwill & other intangibles	6,955.0	6,955.0	6,955.0	6,955.0	9,042.0
Uniform earnings	507.6	821.1	917.4	920.7	1,107.4
Net income	244.0	366.0	581.0	667.0	628.0
% variance	-51.9%	-55.4%	-36.7%	-27.6%	-43.3%
Uniform net assets	1,737.7	2,159.7	2,301.6	2,280.7	2,679.3
Total assets	9,132.0	8,990.0	8,770.0	9,367.0	12,511.0
% variance	425.5%	316.3%	281.0%	310.7%	366.9%
Uniform ROA	29.2%	38.0%	39.9%	40.4%	41.3%
ROA	5.1%	4.7%	5.5%	6.2%	5.9%
Uniform ROA vs ROA - variance	24.1%	33.3%	34.4%	34.2%	35.4%

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[MSCI](#) – MSCI Inc.

MSCI took years to digest its last large-scale acquisition of RiskMetrics Group in 2010, but in recent years, it has seen an acceleration in Uniform profitability, driven by a smart realignment of its business focus (Exhibit 2a).

Since the start of 2018, the firm's stock price has been on an impressive streak, moving in the same direction as its Uniform-calculated earnings. This time around, MSCI's newest \$1bn acquisition of Real Capital Analytics has been met with more optimism due to its past successes.

Meanwhile, GAAP earnings shows a firm that has seen fairly average and stable profitability in recent years. This pedestrian performance 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 2018, [MSCI](#) shares have seen material appreciation, rising from approximately \$130/share to nearly \$575/share, an almost 350% increase (Exhibit 2b). That said, according to as-reported metrics, [MSCI](#) appeared to be a firm which saw stagnant profitability, with as-reported ROA ranging from 11% to 13% levels over the past four years, 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 holds significant goodwill and non-operating intangibles on its balance sheet, which substantially suppresses profitability metrics (Exhibit 2c).

UAFRS-adjusted metrics paint a significantly different picture of [MSCI](#), where Uniform ROA substantially improved over the same time frame, expanding its profitability from an already robust 29% in 2017 to 51% levels in 2020. This earning trend justifies the firm's stock price improvement.

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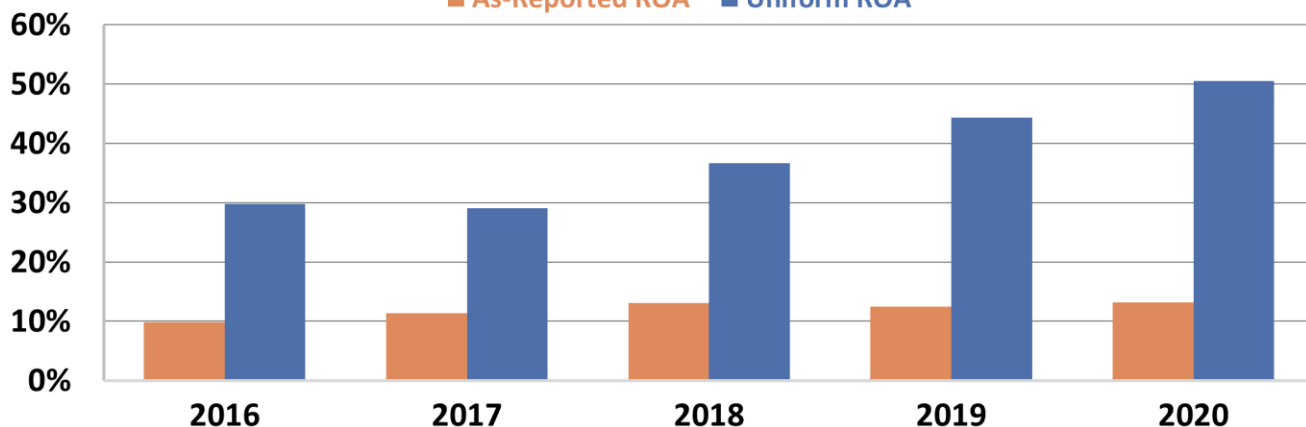
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Exhibit 2a

MSCI Inc. (MSCI) Uniform ROA vs. ROA

■ As-Reported ROA ■ Uniform ROA



Sources: UAFRS, CapitalIQ

Exhibit 2b

MSCI Inc. (MSCI) Stock Chart

— Stock Price



Source: CapitalIQ

Exhibit 2c

MSCI - MSCI Inc.	2016	2017	2018	2019	2020
Goodwill & other intangibles	2,600.7	2,600.7	2,600.7	2,600.7	2,600.7
Uniform earnings	399.2	447.1	621.9	790.7	879.6
Net income	260.9	304.0	507.9	563.6	601.8
% variance	-34.6%	-32.0%	-18.3%	-28.7%	-31.6%
Uniform net assets	1,342.6	1,537.0	1,694.6	1,784.3	1,742.2
Total assets	3,082.6	3,275.7	3,388.0	4,204.4	4,198.6
% variance	129.6%	113.1%	99.9%	135.6%	141.0%
Uniform ROA	29.7%	29.1%	36.7%	44.3%	50.5%
ROA	9.8%	11.4%	13.0%	12.4%	13.1%
Uniform ROA vs ROA - variance	19.9%	17.7%	23.7%	31.9%	37.3%

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[ANSS](#) – ANSYS Inc.

Despite being a serial acquirer in recent years, scooping up the likes of Optis in 2018, Granta Design and Livermore Software in 2019, and Analytical Graphics in 2020, ANSS has managed to maintain consistently robust profitability on a growing asset base (Exhibit 3a).

The firm's stock price has reflected this strength in Uniform-calculated earnings since the end of 2018, with significant appreciation over that time period.

Meanwhile, GAAP earnings have deteriorated over this same timeframe, consistently worsening following the completion of these transformative acquisition from corporate average levels towards the cost of capital. These earnings figures distort the economic reality of the firm's performance.

Since the end of 2018, [ANSS's](#) share price has seen a meteoric rise, climbing from approximately \$150/share to over \$385/share, representing an over 150% appreciation in value (Exhibit 3b). Yet, according to as-reported metrics, [ANSS](#) is a firm that likely warranted a decline in stock price due to consistently deteriorating 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 holds significant goodwill and non-operating intangibles on its balance sheet, which substantially suppresses profitability metrics (Exhibit 3c).

UAFRS-adjusted metrics paint a significantly different picture of [ANSS](#), where Uniform ROA remained at robust 35%-38% levels from 2018-2020, as the firm was successfully able to reap synergy from its integration of various acquisitions. These Uniform metrics better explain the rationale behind the firm's substantial stock price appreciation.

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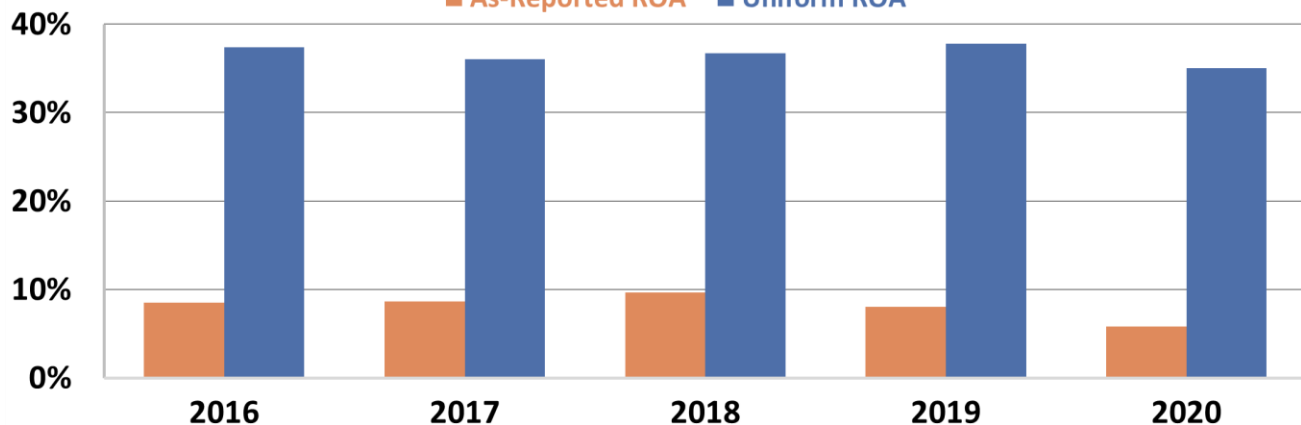
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Exhibit 3a

ANSYS Inc (ANSS) Uniform ROA vs. ROA

■ As-Reported ROA ■ Uniform ROA



Sources: UAFRS, CapitalIQ

Exhibit 3b

ANSYS Inc. (ANSS) Stock Chart

— Stock Price



Source: CapitalIQ

Exhibit 3c

ANSS - ANSYS, Inc.	2016	2017	2018	2019	2020
Goodwill & other intangibles	1,768.0	1,794.3	2,041.9	3,148.1	3,991.3
Uniform earnings	360.0	374.2	489.1	576.7	636.5
Net income	265.6	259.3	419.4	451.3	433.9
% variance	-26.2%	-30.7%	-14.2%	-21.7%	-31.8%
Uniform net assets	962.0	1,038.4	1,331.0	1,525.3	1,818.3
Total assets	2,800.5	2,941.6	3,266.0	4,838.9	5,940.6
% variance	191.1%	183.3%	145.4%	217.2%	226.7%
Uniform ROA	37.4%	36.0%	36.7%	37.8%	35.0%
ROA	8.5%	8.7%	9.8%	8.0%	5.8%
Uniform ROA vs ROA - variance	28.9%	27.4%	26.9%	29.8%	29.2%

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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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