

CLAY TOKENS

The Uniform Accounting Monthly Report | May 5, 2023



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

Proper valuation can make or break a business

In 1993, Quaker Oats bought Snapple for \$1.7 billion... about \$1 billion higher than what most thought the company was "worth" on Wall Street. Following its previous success with Gatorade, Quaker must have thought it could replicate the formula, leveraging its expertise with supermarkets and retailers to generate great rewards for investors.

However, its efforts failed to materialize. Quaker Oats sold Snapple just a few years later for only \$300 million, a massive loss in equity value.

On the other hand, Google bought Android (then a little-known mobile software company) for \$50 million in 2005. Google's goal was to expand the reach of Android software to customers around the globe, and inundate the brand offerings with novel ideas.

Now, Android is a powerhouse in smartphone software, powering 72% of mobile phones worldwide, and creating massive value for Google to boot.

While everyone loves success stories and laments failures, an often overlooked question is how management is assigning the "value" to companies they aim to acquire.

Of course, hindsight is always 20/20. Although the deals are talked about now, what mattered to management were the valuations at the moment of purchase.

If management is basing valuations on misleading or bad data to start, or considering the wrong value parameters altogether, then no matter the quality of their insights, they could be making a huge M&A mistake.

So what should management teams and investors be considering for a firm's value?

Well...it isn't market capitalization. This doesn't properly represent the full firm's value.

**Presented to the UAFRS
Advisory Council**

Prepared by Valens Research
1(917) 284 6008

Joel Litman, CPA
Chief Investment Strategist

Rob Spivey, CFA
Director of Research

Angelica Lim
Research Director

Aaron Karasik, CFA
Senior Analyst

CLAY TOKENS

The Uniform Accounting Monthly Report | May 5, 2023

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

As an example, imagine if two companies both had a market capitalization of \$1 million. Just looking at that metric would leave investors valuing them the same.

However, if one had a massive amount of debt, let's say \$5 million, it would be short sighted for a purchaser to value it at just \$1 million. After all, if you buy a firm with debt, you'll be on the hook to pay it back.

To understand a reasonable "all-in" purchasing price, the debt needs to be taken into account. In this case the company's "value" would skyrocket to \$6 million.

Meanwhile, imagine if the second firm has \$750,000 in cash just sitting in the bank. If you valued this company at its market cap, you would shell out \$1 million just to immediately add \$750,000 back into your bank account. You'd think you were paying a lot more for the business than you *really* were paying.

When adjusting for cash, the value of this company would fall drastically to \$250,000, a far cry from its peer's purchase value of \$6 million.

This simple equation (Market Capitalization + Debt – Cash) forms the basis of Enterprise Value ("EV"), a measure of the all-in worth of an entire company.

Using the aforementioned common sense adjustments, EV more accurately represents how much money a firm would need to purchase another outright.

However, the "enterprise value" that most bankers rely on falls short in some critical areas. This is not necessarily their fault. Rather it's a function of the shortcomings of as-reported accounting.

Not all cash and investments are created equal

A major shortcoming of the traditional EV calculation is that it subtracts the entire cash balance of a company.

If an acquiring firm immediately sucks out all cash from its new company, then there would be no liquidity to cover payroll or manage other operating expenses. The acquired firm may quickly cease to exist. As such, at least some cash must be retained to cover day-to-day operations.

CLAY TOKENS

The Uniform Accounting Monthly Report | May 5, 2023

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

We cover this concept, the difference between operating and “excess” cash, in more detail in our January 2022 Clay Tokens publication. Once operating cash requirements are determined, anything extra is deemed to be “excess” cash and removed from Uniform performance and Uniform EV calculations.

We only deduct excess cash from enterprise value because the rest, the operating cash, can’t be returned to the acquiring company to be used for other things.

In addition to excess or “non-operating” cash, the other line item deducted to derive Uniform EV is non-operating long-term investments. This concept closely reflects the rationale for removing cash from enterprise value in the first place.

For instance, if you’re attempting to acquire Mastercard, you wouldn’t pay for Mastercard’s equity ownership in PayPal... that has nothing to do with day-to-day operations. This stake could be easily liquidated by the acquirer as needed, just like excess cash could be used for other purposes.

By also removing non-operating long-term investments, Uniform EV gives users a better understanding of true firmwide valuations for the operating business. The business that is actually valued based on the company’s cash flows.

As such, Uniform EV should be higher for firms such as Electronic Arts or Nike, which require large amounts of operating cash on their balance sheet and look artificially cheap using traditional EV calculations. On the other hand, Uniform EV would lead to lower valuations for companies such as Discover, which holds many non-operating investments on its balance sheet.

As-reporting accounting has botched the treatment of leases

Investors should recognize that debt is not just what’s present on the books.

Historically, operating leases have been an “off-balance sheet” form of debt despite powering critical parts of a business. While these leases have been added to the reported balance sheet recently through GAAP’s ASC 842 standard and IFRS 16, as-reported accounting rules did so in a sloppy manner.

CLAY TOKENS

The Uniform Accounting Monthly Report | May 5, 2023

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

The nuances in finding the “right” estimation of capitalized operating leases can be rather complicated, and we cover it in more detail in the April 2021 Clay Tokens publication. To summarize, the new accounting standards have actually led to a larger divergence between accounting statements and economic reality and has led to more discretion from management teams on how to report.

Notably, for enterprise value considerations, these operating lease obligations need to be considered too as an “adjusted debt” item. If a company does not pay for its mission-critical leases, its operations would at the very least be disrupted, if not cease to function entirely.

In Uniform accounting, operating leases are added to the total book value of debt, since these leases are considered operationally vital and are largely financed through a payment that is implicitly structured like paying down an amortizing loan (leasing is inherently a decision whether to pay via lump sum or installments).

As an example, FedEx has extremely high operating lease costs. The firm rents trucks to move packages. It would be nearly impossible for any financial statement user to claim that if FedEx didn't pay for its trucks, it could keep running smoothly. FedEx uses operating leases to “finance” assets while another company (such as UPS) may instead elect to take out a physical loan and buy similar trucks.

Unfortunately, as-reported EV doesn't factor in these operating leases as debt, which can provide an artificially cheap picture of the all-in value of a company. By factoring these leases into an adjusted debt value, Uniform EV can more accurately reflect the core obligations of a business, not allowing the technicality between a debt-financed and lease-financed item to distort valuations.

Debt is not the only obligation

Another fault with the traditional EV calculation is that it can be too simplistic when categorizing “debt” and other obligations. Book debt is not the only obligation a would-be acquirer is liable for.

In an acquisition, investors need to consider all other significant obligations and claims on the business that they would owe to employees, shareholders, and other stakeholders.

CLAY TOKENS

The Uniform Accounting Monthly Report | May 5, 2023

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

While more robust traditional EV calculations may include preferred stock and minority interest ownership considerations, they often fail to include pension obligations, stock option claims, and other long-term liabilities from their calculation of “debt”.

These are obligations that investors are on the hook for if they choose to buy the company

When added to debt – as it is in Uniform Accounting – the adjusted debt value would generally increase EV and display a clearer picture of the total acquisition cost of a company.

The difference between as-reported and Uniform accounting can lead to huge differences in enterprise valuation, as demonstrated below with major US airline, Southwest (LUV).

This table shows the calculation breakdown between traditional EV and Uniform EV. It highlights some of the significant shortcomings of the traditional method, and how it can lead to a wildly distorted interpretation of the all-in value of a business.

Southwest (LUV) As-Reported Enterprise Value		
Market Capitalization	\$	19,179.77
Book Value of Debt	\$	9,431.00
+ Preferred Stock	\$	-
Total Debt	\$	9,431.00
Minority Interest	\$	-
Cash	\$	12,292.00
As-Reported Enterprise Value	\$	16,318.77

Southwest (LUV) Uniform Enterprise Value		
Market Capitalization	\$	19,179.77
Book Value of Debt	\$	10,731.00
- Financial Sub Debt	\$	-
+ Operating Lease Debt	\$	19,174.00
+ Other Long Term Liabilities	\$	890.00
+ Preferred Stock	\$	-
+ Pension Obligations	\$	330.00
+ Stock Option Claims	\$	-
Total Debt	\$	31,125.00
Minority Interest	\$	-
Non-Operating EV (Excess Cash)	\$	4,863.10
Uniform Enterprise Value	\$	45,441.67

CLAY TOKENS

The Uniform Accounting Monthly Report | May 5, 2023

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

In Uniform EV, adjustments are made for operating lease debt (on LUV's planes), other long-term liabilities, and pension obligations which drastically increases the total debt amount owed by Southwest. After additionally adjusting for excess cash, these adjustments contribute to a massive \$29 billion difference in absolute terms, with Uniform EV being nearly 3x higher as-reported EV when adjusting for the traditional shortcomings.

In totality, Uniform EV gives a more accurate assessment of all claims to the business over as-reported, as traditional EV misses key considerations an investor needs to be accounting for when considering business valuations.

These adjustments make it possible to address the original shortcomings that management teams face when it comes to valuation. Uniform EV properly gauges the true value of acquiring or investing in a firm. Perhaps with Uniform EV by their side, Quaker Oats' management team could have avoided permanently etching their name in the history books with their infamously destructive M&A transaction.

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.

CLAY TOKENS

The Uniform Accounting Monthly Report | May 5, 2023

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

Disclaimer

© 2023 (Valens Research LLC, Valens Credit LLC, Valens Securities, Equity Analysis & Strategy and Altimetry Research and/or its licensors, predecessors, successors, parents, subsidiaries, affiliates, officers, directors, shareholders, investors, employees, agents, representatives, products ((including but not limited to FA Alpha, FA Alpha Academy and FA Alpha brand)) and attorneys and their respective heirs, successors, and assigns hereinafter referred to as the "**Valens**").

All rights exclusively and explicitly reserved.

Credit, business, stock, equity, asset and asset allocation, income and outcome, growth, liquid, investment, spending, income, cash and cash flow or any kind of analyses issued hereby, by Valens ("**Valens' Analyses**"), are Valens' current opinions of the relative future credit or personal asset and asset allocation risks, business, equity and other related assets of the relevant persons, entities, credit commitments, or debt or debt-like securities, credit, business and risk analyses, and research publications published or soon to be published or shared by or with in association with Valens ("**Valens Publications**") may include Valens' current opinions of the relative future credit or cash or asset risk of entities or persons, credit commitments, income, outcome or debt or debt-like securities, business, equity and other related assets.

Valens' Analyses and Valens Publications do not constitute or provide professional investment or financial offer or advice to any person or company. Valens' Analyses and Valens Publications are not and do not provide recommendations to purchase, sell, or hold particular securities, spend or hold personal assets and properties.

Valens accepts no liability and responsibility from any kind of damage or responsibility that may arise from any false notion, misguidance or mistake regarding the aforementioned. Valens' Analyses may not address any other risk arising either from personal or commercial investment and action.

Neither Valens' Analyses nor Valens Publications comment on the suitability of an investment or allocation for any particular person and neither Valens' Analyses nor Valens Publications under any circumstance accept any kind of liability or responsibility arising from self-misguidance of any particular person or any other 3rd parties.

Valens issues Valens' Analyses and publishes Valens Publications with the expectation and understanding that each 3rd party and each user of the information contained herein or to be issued by Valens will make their own study and evaluation, in a deliberate, cautious and prudent way, of each security that is under consideration for purchasing, holding, selling or for any transaction.

It would be dangerous for 3rd parties or any other information receivers, to make any financial or investment decision based solely on any of the Valens' ratings, Valens Publications or Valens' Analyses. It is highly recommended to contact your contracted financial, legal or other professional adviser.

All information and calculation contained herein is obtained by Valens from sources believed by it to be accurate, up to date and reliable. Because of the possibility of human or mechanical error as well as other factors, however, all information contained herein is provided "as is"; without representation of accuracy or any kind of warranty, obligation or any kind of commitment and undertaking.

Valens adopts all reasonable measures so that the information used or to be used assigning a credit, business, equity or any other rating if any, is of sufficient quality. Valens considers from its sources including, when appropriate, independent third-party sources, to be reliable.

However, Valens is not an auditor and cannot in every instance independently verify or validate information received in the rating or any other process. Under no circumstances shall Valens have any liability or responsibility to any person or entity/entities for any kind of loss or damage in whole or in part caused by, resulting from, or relating to, any error (negligent or otherwise) or other circumstance or contingency within or outside the control of Valens in connection with the procurement, collection, compilation, analysis, interpretation, communication, publication or delivery of any such information, or any direct, indirect, special, consequential, compensatory or incidental damages whatsoever (including without limitation loss of profits), even if Valens is advised in advance of the possibility of such damages, resulting from the use of or inability to use of any such information.

Any analysis, financial reporting analysis, projections, calculations, assumptions and other observations constituting part of the information contained herein are, and must be construed solely as, statements of opinion and not statements of fact or recommendations to purchase, sell or hold any securities and/or assets. Each user of the information contained herein must make their own study and evaluation, in a deliberate, cautious and prudent way, of each security considered for purchasing, holding, selling or doing any kind of transactional action whether for trade or personal purposes.

No warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability or fitness for any particular purpose of any such rating or other opinion or information or calculation is given or made by Valens in any form or manner whatsoever.

All intellectual property rights in relation to Valens' Analyses and Valens Publications and any information or material contained herein are the exclusive property of Valens. Aforementioned cannot be copied, recorded by any audio or video recording device, screen capturing or screen recording device or any device capable of performing such function and cannot be reproduced or used without the mutual and prior written consent of respective right owner(s). 3rd parties cannot use Valens' Analyses or Valens Publications for advertising purposes, to solicit business or for any other purpose. Using, copying or reproducing any materials, content and information of Valens' Analyses is prohibited, unless permitted by speakers in writing. It is strictly prohibited to reproduce, record, represent, display, modify, adapt or translate Valens' Analyses or Valens Publications and/or any work and material contained herein in whole or in part, whether for free or for financial consideration, without speakers' mutual and prior written consent.

Valens' Analyses, including the attached exhibits or documents, if any, is confidential and is intended for the sole and exclusive use of the person to whom this material has been delivered by Valens. Any further distribution, divulgence or reproduction of these materials is strictly prohibited.

All information contained herein is protected by relevant law of United States of America, including but not limited to copyright law and intellectual property law and none of such information may be copied or otherwise reproduced, repackaged, further transmitted, transferred, disseminated, redistributed or resold, or stored for subsequent use for any such purpose, including but not limited to commercial or non-commercial use, in whole or in part, in any form or manner or by any means whatsoever, by any person or legal entity/entities without Valens' prior and explicit written consent and civil and criminal liability will arise in violation of the mentioned above.