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

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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

The US tax code is a nightmare for taxpayers.

The process of filing every year is met with dread and resignation from businesses and individuals alike. The U.S. tax code is extremely large and complex. What’s worse, even a small mistake could lead to an audit or fine from the IRS.

For context, tax statutes passed by Congress into law total about 2,652 pages and explain tax regulations in over 1 million words. By comparison, that is longer than the King James Bible, with 788,280 words, and comparable to the entire Harry Potter collection of novels.

On top of the statutes, there are many more examples of case law, IRS regulations, revenue rulings, and other clarifications needed to garner a full comprehension of US taxes.

Combined, all of these sources sum to over 70,000 pages and 32 million words. And these figures don’t even consider the tax codes of other nations. With such a lengthy anthology, it's no wonder tax specialists exist, many of whom, by and large, focus on one small part of the whole tax equation.

Compared to corporations, individual taxes are a breeze. Individuals typically don’t have to deal with the complexity of subsidiaries and holding structures, partial ownership and JV interests, international jurisdictions, and more. These headaches are left to the many accountants employed by the firms, who are often paid large sums in order to try to minimize these tax bills.

Unfortunately, tax codes are not just a nightmare for individual taxpayers and accountants. They also can be an important issue for investors.

In extreme cases, taxes can lead to soaring litigation costs and potentially massive bills down the line.

For instance, Apple has been locked in a near-decade long dispute with European Union regulators over the handling of tax agreements with Ireland. Slated to come to its conclusion near the end of 2023, this fight could ultimately lead to a 13-billion-euro payment, a rather material consideration for shareholders.

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Beyond tax litigation and disputes, for many firms, taxes can end up being a critical component of understanding whether to invest into a firm or pass it by. This is because, as many of the top investors know, it is important to make decisions on the basis of after-tax earnings.

Since taxes are a real expense companies face, and require a cash outlay in almost every year, they are an important consideration when understanding the underlying operating fundamentals of a firm. They are essential to properly evaluate historical performance and model potential future results.

However, as-reported tax expenses can sometimes stray significantly from both conventional wisdom and operating reality.

Take the pharmaceutical company AbbVie for example.

In 2020, the firm's EBT (earnings before taxes) was $3.4 billion. One would stand to reason the firm's earnings would decrease after deducting taxes. After all, the IRS always wants to collect its "fair share".

Assuming AbbVie paid a corporate average of 20%, an additional $700 million would go to the government through tax payments. Therefore, the firm's earnings after tax should sit around $2.7 billion.

However, based on reported values, this was far from the case. AbbVie reported earnings after taxes in 2020 of $4.6 billion, about $1.2 billion higher than its earnings before taxes and about $2 billion higher than a reasonable estimation.

With such a deviation from expectation, it becomes difficult for investors to understand the true earnings performance of AbbVie, and even harder to extrapolate its future capacity to reward shareholders through business reinvestment and cash distributions.

In any given year, a company can take advantage of various "tax shields" present in the tax code that protect them from reporting an economically accurate "effective" tax rate and payment.

Fortunately, it is possible to adjust for the one-time distortions inherent to tax law, allowing a company to be accurately compared year to year over a lengthy time period.

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Using Uniform Accounting, the benefits of these tax shields are removed from operating earnings as these one year-tax windfalls are not representative of the underlying reality of business. While there are many reasons why taxes could deviate from reasonable expectations, there are two tax shields that are encountered most regularly: net operating loss tax shields and interest expense tax shields.

The first tax shield-requiring adjustment relates to net operating losses (NOLs).

NOLs occur when a company's expenses exceed its income - the government considers the business running at a "loss" that year. Therefore, the IRS doesn't tax the company in order to help it get back on its feet. The rationale being that a company that survives will pay taxes later down the road.

However, the IRS tax code also allows companies to carry forward these NOLs into future years. A company with an especially large loss one year could pull forward this item for multiple years, claiming no tax expense the whole time. Naturally, the ability to do so is limited, and until the NOLs run out, investors would be tricked into believing that the firm is far more profitable than it is.

Under Uniform Accounting, NOL tax shield adjustments are made when a firm's effective tax rate is materially lower than the norm for the company. In essence, this adjustment helps to square up taxes to a more reasonable level - a level that is much more representative of a firm's underlying performance and expected future results.

When a firm's effective tax falls below its average tax rate and is employing NOLs, an adjustment is made to add back the impact of this NOL on calculating the real operating tax burden of the firm. Hence, the artificial "boost" from NOLs is removed from the year in question.

The second common tax shield-requiring adjustment is related to interest expenses.

Interest payments on debt are considered a tax-deductible expense per tax code - therefore, taking on debt creates a tax shield. This can lead to companies increasing their leverage and interest payments to take advantage of the associated tax benefit. As such, highly leveraged firms can look far more tax efficient than is accurate.

That said, at its heart, leverage and interest is not an operating consideration, it's a financing decision. As such, their impact should not be considered in the analysis of a firm's operating after-tax earnings. It should instead be considered in the analysis of capital structure and capital allocation.

So for the same reason Uniform Accounting adds back interest expense to operating earnings, the "extra" tax benefit from interest is removed.

Ultimately, the tax adjustments inherent to Uniform Accounting derive a cleaner operational picture.

Looking back at AbbVie, both tax shield adjustments affect the firm, and have continued to severely distort the company's tax burden and operating earnings. When adjusting for the billions of NOLs employed in 2020, as well as the $2.4 billion interest expense the firm faced that year, the firm's $1.2 billion tax benefit becomes a $600 million tax charge, much closer to reasonable expectations and far more indicative of long-run operating realities.

This higher tax expense makes sense from a logical point of view. Higher taxes should correlate with better performance, and not vice versa as permissible in as-reported figures.

Financial statement users, and investors in particular, have a key incentive to understand the core expenses affecting a company. Understanding underlying operating performance can lead to critical decisions with potential for alpha generation.

Through the adjustments made to taxes under Uniform Accounting, investors can understand a company's true tax burden without major distortions, allowing them to make more informed investment decisions.

As a result, taxes become far less of a nightmare when analyzing companies, and only a nightmare when personal ones are due.

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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