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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

Kyle Pinkerton, CFA
Senior Analyst

GAAP has no interest in accounting for different operating realities

Last issue, we discussed our financial subsidiary adjustment. This adjustment helps rectify the incongruence in balance sheet accounting between operating companies and their bank-like financial subsidiaries.

For a bank, its assets are akin to a normal operating company's liabilities and vice versa. This is because traditional loans (which represent liabilities to a retail company, as an example) are actually the bread and butter of how banks conduct business and make profits.

Comparing a bank directly to an operating company would thus be nonsensical. The former's profitability is most accurately represented by return on equity ("ROE"), while the latter can be more accurately judged based on return on assets ("ROA").

So when a normal reporting entity, like a retail company, has a bank-like division within its overall structure, the financial subsidiary adjustment comes into play. In order to get a true understanding of the performance and valuation of the combined company, we must properly adjust for that differing segment and the inherent mismatch between assets and liabilities.

That said, financial subsidiaries aren't the only way that the confusing accounting for banks has muddied accounting for regular operating companies.

This month's issue continues to examine the pitfalls of bank accounting, but this time within the context of a much more commonly seen line item... interest expense.

Interest expense represents the cost incurred for borrowed funds such as bonds, loans, convertible debt, or lines of credit.

When the Financial Accounting Standards Board ("FASB") developed Generally Accepted Accounting Principle ("GAAP") standards for reporting this expense, they focused on satisfying banks.

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For banks, interest expense is a primary operating cost, or put plainly, the cost for a bank to lend. Essentially, interest expense represents how much cash must be paid for deposits entrusted to it, and other borrowings. Without deposits, a bank would not exist and would not be able to lend. It therefore makes sense why interest is accounted for as an operating cash flow for banks.

For most reporting entities, however, this is not the case. Most reporting entities do not rely on deposits to operate their business and do not pay interest on those deposits as part of their daily operations.

This means that for the majority of companies, statement of cash flow reporting standards for operating flows include a cost not included in ongoing operations.

When a regular company incurs interest expense, it typically is because it has previously invested in assets like working capital, plant, property, and equipment ("PP&E"), or capitalized research and development ("R&D").

The firm is incurring this interest because it made a financing decision to raise new money through debt.

Companies have three main ways to raise money to finance their growth and ongoing operations. First, they can raise money organically through their operations, building up sufficient levels of cash on hand to do with as they please. Second, they can raise money through equity markets, whether it be through an IPO or follow-on offering or private placement of some sort. Third, they can raise money through credit markets by issuing debt or taking on loans.

The first method clearly does not entail any subsequent financing costs. That said, when relying on equity or debt markets to purchase something, investors or lenders generally expect the company to pay them for using their capital… unfortunately "free" money is hard to come by.

For equity financing, the cost comes in through two avenues - the first is often giving up a claim to part of the business and the second is far more concrete, having to appease shareholders through the issuance of dividends. Dividends act as a way to return capital to those shareholders who helped fund business needs.

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Intuitively, FASB labels cash flows from the payment of dividends as a financing activity. After all, it's a payment a company makes thanks to its financing decisions.

So then why is interest expense not labeled as such?

Similar to dividends, interest expense represents the act paying a party for funding business needs. In this case, that party is a creditor. That is clearly a financing activity. How then are dividends rightly labeled as a financing cash flow, while interest is not?

Inconsistencies in GAAP reporting relating to interest are unfortunately not uncommon and have only gotten worse over time.

Even Michael Fetters and John Leslie Livingston, notable accountants and economists, note these inaccuracies in their publication "Inconsistency in U.S. Accounting Standards: The Treatment of Interest".

They conclude that "a study examining the treatment of interest found inconsistencies in two-thirds of the relevant U.S. GAAP pronouncements."

While GAAP has and will continue to mischaracterize the realities of operating and financing costs by blanketing interest expense as an operating expense for all companies, fortunately, there is an easy fix to interest expense accounting that helps users better evaluate the true operating performance of a firm.

In order to make this adjustment, one must first add interest expense back to net earnings. This is because, as previously discussed, interest expense is truly a financing activity and not an operating one.

However, doing this alone may overstate operating earnings. This is because interest costs can be deducted for tax reporting purposes. In other words, interest on debt is a tax-deductible expense. Thus taking on debt and incurring creates a "tax shield".

As such, if interest were simply added back, highly levered companies would get an added interest tax shield that reduces income tax expenses and would inflate net operating earnings. So, we must remove this interest tax shield in addition to its related interest expense.

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By applying these adjustments, a company's profitability relative to peers regardless of the amounts of leverage can be assessed fairly.

There is a long line of firms, from various sectors, where as-reported earnings do not represent economic reality due to the misrepresentation of interest expense and its related tax impact.

This month, we highlight three companies wherein the inclusion of interest expense in operating earnings limit the reliability of the firm's reported earnings-based ratios.

- YUM! Brands, a parent of popular fast-food chains;
- The Kraft Heinz, a legacy multinational food giant; and
- PepsiCo, an industry-leading beverage and snack company.

In the pages and charts below, we show the impact of interest expense and interest expense tax shields for these firms and the difference between as-reported GAAP Earnings and UAFRS-based Earnings.

While all of the 130+ adjustments have been applied, we hone in on how these 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.

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YUM – YUM! Brands Incorporated

Since 2017, YUM has seen increasingly robust profitability, excluding an outlier year in 2020, when the firm was hit with material pandemic-related headwinds (Exhibit 1a).

Reflecting this UAFRS-based earnings trend, the firm has seen a material appreciation in stock price, generally moving in the same direction as its Uniform-calculated earnings, inclusive of a brief drawdown in 2020 amid the peak of the pandemic.

Meanwhile, GAAP earnings have remained largely flat over this same time period. This steady performance fails to explain the firm's improving stock price, displaying how current accounting standards enable a dislocation between economic reality and as-reported performance.

YUM share prices have continuously appreciated in recent years, rising from $60 at the start of 2017 to over $135 by the end of 2021, a 125% gain (Exhibit 1b). That said, according to as-reported metrics, YUM appeared to be a firm that had remained stagnant, with strong, yet stable levels of profitability over the same time period. This steady performance implies the firm's materially positive stock price movements are wholly unwarranted.

However, using Uniform Accounting, we can identify distortions such as the faulty inclusion of interest expense, and implicitly, an interest expense tax shield, in the calculation of a firm's operating earnings, which can lead to artificially deflated earnings (Exhibit 1c).

UAFRS-adjusted metrics paint a significantly different picture of YUM, as Uniform ROA nearly doubled from an already robust 26% in 2017 to 52% levels by 2021, suggesting that the increase in the firm's stock price has likely been justified by stellar performance improvements.

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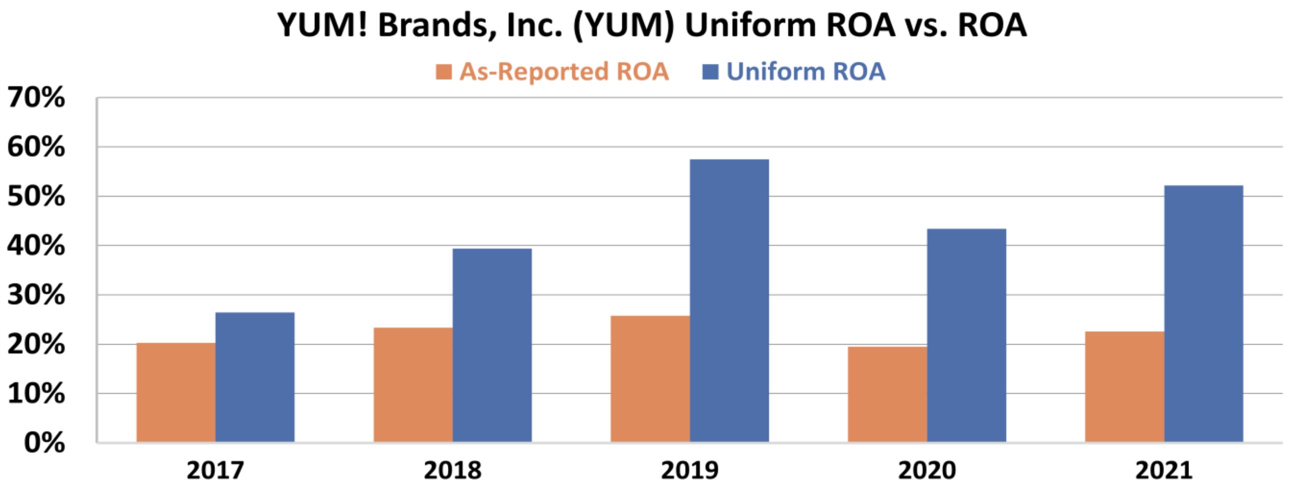
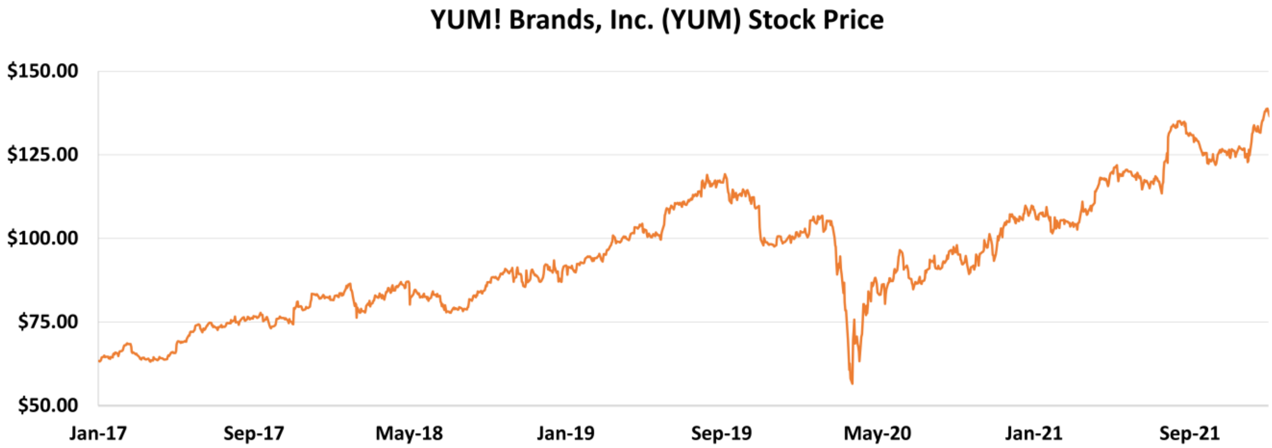
Exhibit 1a



Sources: UAFRS, Captial IQ

Exhibit 1b



Source: Capital IQ

Exhibit 1c

YUM - Yum! Brands, Inc.	2017	2018	2019	2020	2021
Interest Expense	473.0	496.0	519.0	558.0	551.0
Interest Expense Tax Shield	-104.1	-89.8	-29.9	-63.5	-32.6
Uniform Earnings	1050.4	1343.9	1658.6	1511.2	1927.0
Net Income	1340.0	1542.0	1294.0	904.0	1575.0
% Variance	27.6%	14.7%	-22.0%	-40.2%	-18.3%
Uniform ROA	26.4%	39.4%	57.5%	43.4%	52.2%
As-Reported ROA	20.3%	23.3%	25.8%	19.5%	22.6%
Uniform ROA vs ROA - Variance	6.1%	16.1%	31.7%	23.9%	29.6%

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KHC – The Kraft Heinz Company

KHC saw profitability fade materially between 2017 and 2021, following the merger between Kraft and Heinz, as the firm struggled to incorporate alleged synergies into the combined business (Exhibit 2a).

Reflecting these Uniform ROA trends, the firm's stock price has declined significantly since hitting peaks in 2017, echoing the indications of a deterioration in the firm's fundamental outlook.

Meanwhile, GAAP earnings have remained flat over this same time period, portraying the firm as one that has not seen material disruptions to its operating fundamentals over this time period, and one that is not worthy of a stock price collapse. Faulty accounting treatment distorts the economic reality of the firm's performance.

Since 2017, KHC shares have seen material depreciation, collapsing from $90/share to under $40/share by the end of 2021 (Exhibit 2b). That said, according to as-reported metrics, KHC appears to be a firm with muted, but consistent profitability, as ROA remained steady near cost of capital levels. This does not appear to be a firm with performance that would justify a steep fall off in its stock price.

However, using Uniform Accounting, we can identify distortions such as the faulty inclusion of interest expense, and implicitly, an interest expense tax shield, in the calculation of a firm's operating earnings, which can lead to artificially deflated or otherwise distorted earnings (Exhibit 2c).

UAFRS-adjusted metrics paint a different picture of KHC, where Uniform ROA was materially stronger than as-reported ROA, but floundering, falling from 53% in 2017 to just 40% in 2021. These deteriorating profitability metrics explain the rationale behind the firm's stock price collapse over this time period.

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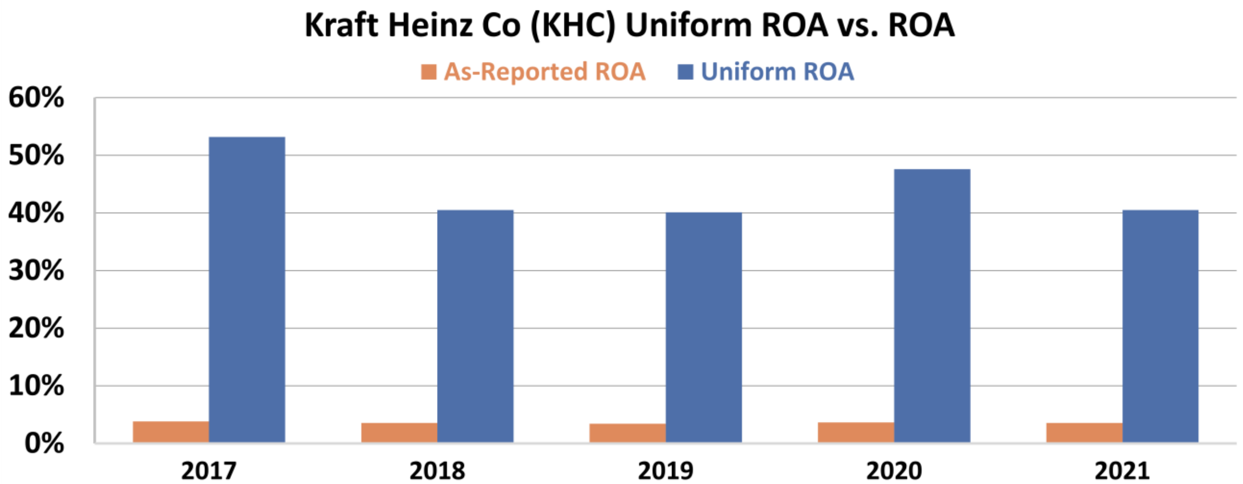
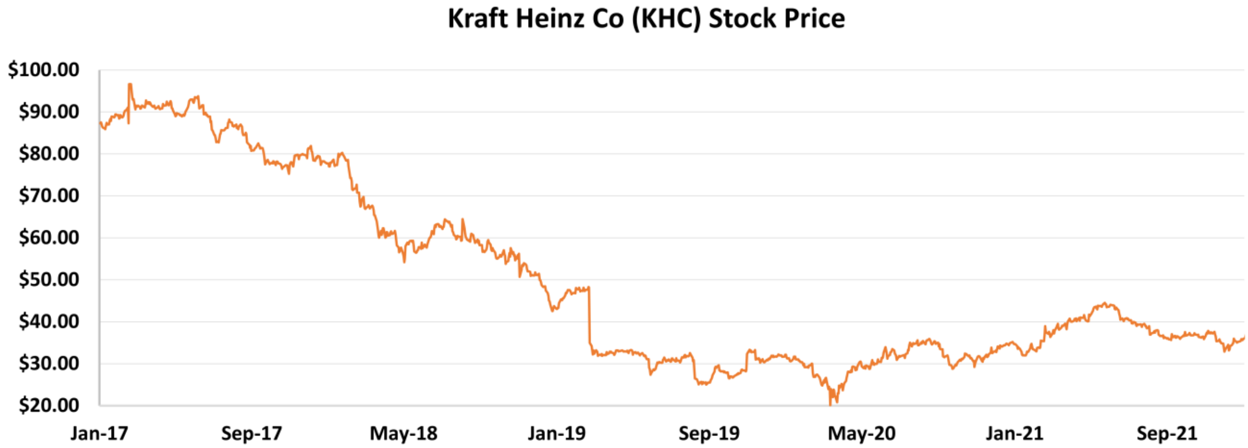
Exhibit 2a



Sources: UAFRS, Captial IQ

Exhibit 2b



Source: Capital IQ

Exhibit 2c

KHC - The Kraft Heinz Company	2017	2018	2019	2020	2021
Interest Expense	1234.0	1284.0	1361.0	1394.0	2047.0
Interest Expense Tax Shield	-350.5	-269.6	-372.3	-292.7	-819.8
Uniform Earnings	6211.7	3557.9	3749.4	4135.2	3371.7
Net Income	10941.0	-10192.0	1935.0	356.0	1012.0
% Variance	76.1%	-386.5%	-48.4%	-91.4%	-70.0%
Uniform ROA	53.2%	40.5%	40.1%	47.6%	40.5%
As-Reported ROA	3.8%	3.6%	3.4%	3.7%	3.5%
Uniform ROA vs ROA - Variance	49.4%	36.9%	36.7%	43.9%	37.0%

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PEP – PepsiCo, Inc.

Aside from an immaterial drop off in performance caused by reduced spending during the pandemic, PEP saw material improvements in profitability from 2017 to 2021 (Exhibit 3A).

Closely reflecting these trends in Uniform ROA, the firm saw its stock performance rise rapidly, moving in the same direction as its Uniform-calculated earnings.

Yet, GAAP earnings show a firm with stagnant profitability, hovering below corporate averages. This lackluster performance is misaligned with the firm's impressive stock performance, displaying how current accounting standards enable a dislocation between economic reality and as-reported performance.

PEP shares rose from $100/share at the beginning of 2017 to over $170/share by the end of 2021, a 70%+ increase (Exhibit 3b). That said, according to as-reported metrics, PEP appears to be a firm which saw virtually no improvement in profitability, with as-reported ROA declining from a paltry 9% in 2017 to 8% in 2021. This does not appear to be the financial performance of a firm deserving significant appreciation in its share price.

However, using Uniform Accounting, we can identify distortions such as the faulty inclusion of interest expense, and implicitly, an interest expense tax shield, in the calculation of a firm's operating earnings, which can lead to artificially deflated or otherwise distorted earnings (Exhibit 3c).

UAFRS-adjusted metrics paint a significantly different picture of PEP where Uniform ROA jumped from 14% to over 20% during the same five-year period. This earning trend more clearly justifies the firm's stock price performance.

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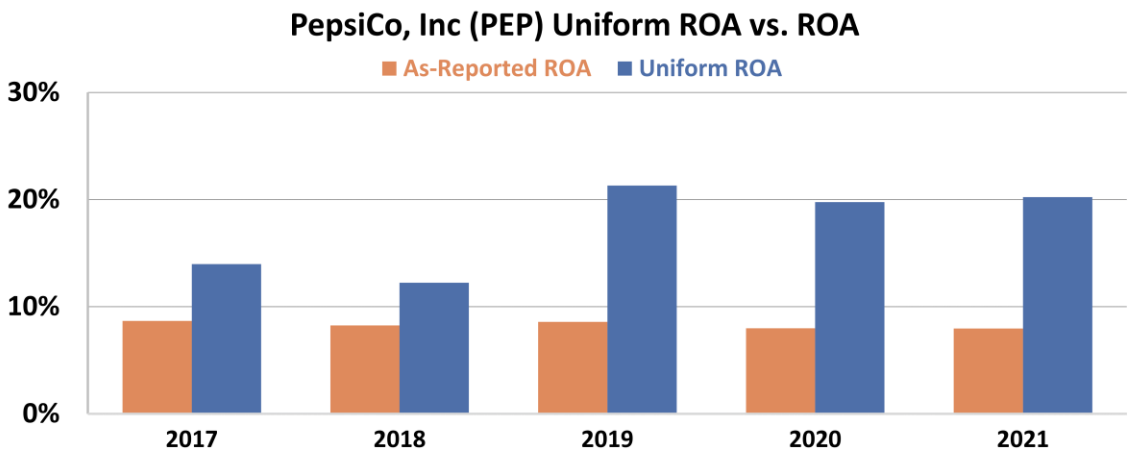
Exhibit 3a



Sources: UAFRS, Captial IQ

Exhibit 3b

Source: Capital IQ

Exhibit 3c

PEP - PepsiCo, Inc.	2017	2018	2019	2020	2021
Interest Expense	1151.0	1219.0	928.0	1257.0	1799.0
Interest Expense Tax Shield	-562.7	0.0	-195.2	-262.5	-392.4
Uniform Earnings	4984.4	4348.8	7692.8	7772.0	8275.2
Net Income	4857.0	12515.0	7314.0	7120.0	7618.0
% Variance	-2.6%	187.8%	-4.9%	-8.4%	-7.9%
Uniform ROA	14.0%	12.2%	21.3%	19.8%	20.2%
As-Reported ROA	8.7%	8.2%	8.6%	8.0%	8.0%
Uniform ROA vs ROA - Variance	5.3%	4.0%	12.7%	11.8%	12.2%

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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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