

# CLAY TOKENS

The Uniform Accounting Monthly Report | April 30, 2022



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

### A company's side gig can become an investor's primary headache

Three months ago, in Clay Tokens, we covered the concept of excess cash...

Specifically, we discussed how not all cash is created equal. As Benjamin Graham identified in *The Interpretation of Financial Statements* in 1937: "there is a tendency to hold more cash than the business needs."

As such, we are left with two categories of cash. One that is operating and is used for the day-to-day activities of a firm. And one that is in excess, unnecessary for the business to function and often used for various financing and investing activities that are peripheral to a firm's core operations.

Due to this bifurcation, to get an accurate assessment of the operating strength of a company, a different accounting treatment is necessary for the cash that is essential for operations and for the cash that is in "excess."

This distinction becomes important because firms with material amounts of excess cash on hand can see their as-reported profitability (ROA) look significantly worse than is economically accurate. This distortion occurs because a lot of the balance sheet is taken up by cash that is earning little to no return.

If excess cash is not removed, huge cash generators can look like bad businesses.

In the same vein, for most companies, long-term investments (as opposed to short-term cash and investments) should also be excluded from an examination of operating profitability.

At their core, long term investments—which generally consist of marketable bond and equity securities—are an asset allocation decision. These investments are not necessary for operations, although of course, there are always some exceptions to this rule.

Instead of returning capital to shareholders, often companies are simply diverting some "excess cash" to these "excess investments." As such, the returns on these investments can be materially different from the operating returns of the company, causing a disconnect between economic reality and accounting intricacies.

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Therefore, just as excess cash is removed to see the true operating profitability of a firm, the same should be done with long-term investments.

For example, let's take a look at Apple (AAPL), one of the companies used when examining excess cash. Looking at its as-reported profitability, it is likely baffling as to why it would ever be valued so richly. With ROA hovering near corporate average 10% levels, having a market cap that is in the trillions of dollars—the largest in the world—just doesn't line up.

Apple has a sizable cash and short-term investment balance of \$64bn, but a vast majority is not necessary for the business to function. The excess cash is often used for financing or investment purposes instead.

While the firm's institution of a modest dividend may have diverted some cash from excess holdings to shareholders, a vast majority of its cash flows end up on its books, and not simply in its massive cash account.

Instead, it has allocated this mass stockpile of cash it generates towards long-term investments.

Those that think Apple holds too much cash on hand are likely even less pleased to hear its long-term investment balance is over double total cash levels... at nearly \$140bn. And these investments are almost exclusively marketable securities such as treasury and agency bonds, corporate debt purchases, and mortgages.

In other terms, they are financial assets that have nothing to do with Apple at an operational level.

When these short- and long-term investments are excluded from operating assets, as done under Uniform Accounting, it becomes clear the firm's actual operations are highly profitable, with a 55% ROA. Add on top the level of growth the firm has seen over the past few decades and it soon becomes no wonder why the market applies such a high valuation to the name.

Like with excess cash, the long-term investment itself does not go away.

Once they are removed from the balance sheet, long-term investments are then deducted from the enterprise value of the company. The purpose of this adjustment is to properly represent the part of the value investors are getting when they buy a company's stock.

Like with the treatment of cash, the equity value implicitly captures the non-operating investments, which have easily discoverable marked-to-market values. That said, unlike with excess cash, long-term investments can have a much higher impact on the income statement. This impact is mainly seen through the inclusion of investment income in earnings.

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Investment income is the income arising from a company's long-term investments, such as those in stocks, associates/affiliates, partnerships, and/or joint ventures.

Since the associated assets or investments are generally considered to be peripheral to the company's core operations and are excluded from the balance sheet, this income needs to also be excluded from any analysis of operating earnings.

However, as with most things in accounting, there are exceptions to the rule. Namely, when long-term investments are actually highly impactful to operations, they should be kept in the balance sheet. By extension, the associated income should remain on the income statement.

One of the most common exceptions, for example, are operating joint ventures (JVs). These are long-term partnerships created between two distinct parties, with shared ownership, returns and risks. Often the learnings gained from these JVs can be applied to the firm's core operations or the JV can contribute directly to the operations of a parent company by being a vendor or supplier.

Another common example are conglomerates. They are known to be large, diversified, and mature companies that have stakes in a variety of different industries and sectors. As such, the "core" business often may not be clear and conglomerates in many ways are focused on making investment decisions to operate.

Similarly, asset management companies often also make the majority of their profits on their short- and long-term investments. They transact in securities in massive quantities as part of their daily operations. The management of these financial assets literally constitutes their name.

In each of these scenarios, both long-term investments and investment income are treated as operating assets and earnings. However, as mentioned, they represent a small portion of publicly traded companies and are the exception, not the rule.

For the rest of the vast universe of companies, when not adjusted, long-term investments and related income on financials just distort the true profitability of the core business.

There is a long line of firms, from various sectors, where as-reported assets do not represent economic reality due to the inclusion of non-operating long-term investments in the operating asset base. Meanwhile for the same firms, as-reported earnings are also misstated due to the inclusion of investment income in the operating earnings number.

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This month, we highlight three companies wherein the inclusion of long-term investments and investment income as “operating” limit the reliability of the firm’s reported asset- and earnings-based ratios:

- Archer-Daniels-Midland, a multinational food processing and commodities trading corporation;
- Churchill Downs, a racetrack and casino operator; and
- Constellation, a leading American brewer and distributor.

In the pages and charts below, we show the long-term investments and investment income for these firms and the difference between as-reported GAAP assets and UAFRS-based assets, and as-reported GAAP earnings and UAFRS-based earnings.

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

### [CHDN](#) – Churchill Downs, Inc.

Since 2018, excluding a pandemic-related dip, Churchill Downs has seen improving profitability, driven by a successful transition beyond legacy horse track operations (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.

Meanwhile, GAAP earnings have remained largely flat over this same time period, misleading investors into incorrectly believing the firm hasn't seen any improvement in operations since pre-pandemic levels. This as-reported performance would suggest the firm's stock price rise has been wholly unwarranted.

Between 2018 and 2021, [CHDN](#) share prices increased materially in value, excluding a dip in 2020 due to pandemic-related headwinds, rising from \$80/share to \$240/share, a 200% increase in price (Exhibit 1b). That said, according to as-reported metrics, [CHDN](#) appeared to be a firm that remained stagnant, with minimal improvement in profitability over the same time period. This supposed lackluster performance implies the firm's materially positive stock price movements are unwarranted.

However, using Uniform Accounting, we can identify distortions such as a firm carrying non-operating long-term investments on the balance sheet and corresponding non-operating investment income on its income statement, which can substantially suppress profitability metrics (Exhibit 1c).

UAFRS-adjusted metrics paint a significantly different picture of [CHDN](#), where Uniform ROA improved from corporate average 10% levels in 2018 to 14% in 2021, suggesting that the appreciation in the firm's stock price has likely been justified.

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

Exhibit 1a

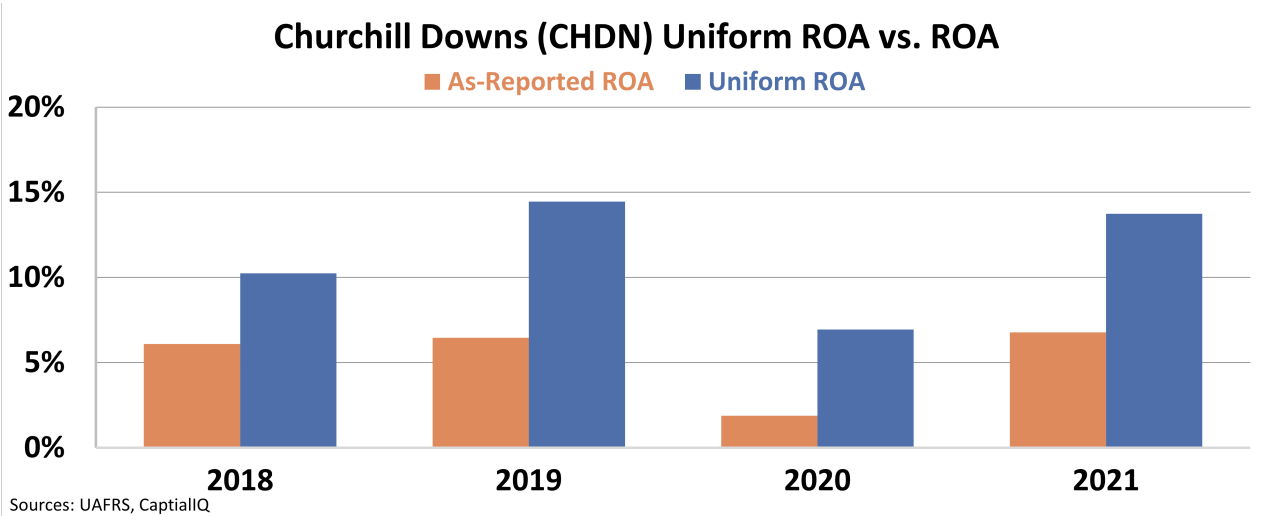


Exhibit 1b

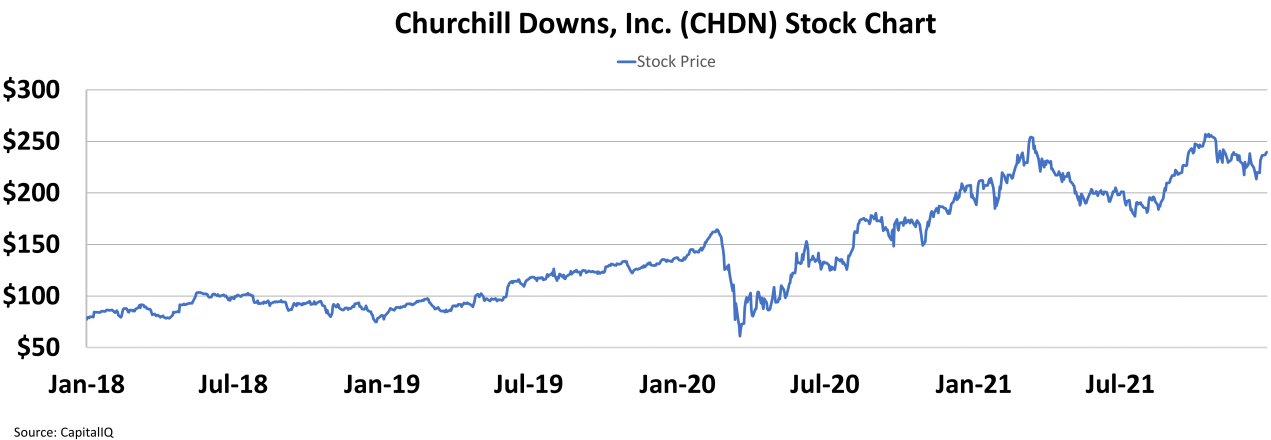


Exhibit 1c

CHDN - Churchill Downs Incorporated	2018	2019	2020	2021
Non-Operating Long-term Investments	108.1	634.5	630.6	663.6
Investment Income	29.6	50.6	27.7	143.2
Uniform Earnings	105.5	160.2	98.9	207.9
Net Income	137.5	-81.9	249.1	255.1
% Variance	30.3%	-151.1%	151.9%	22.7%
Uniform Assets	1030.8	1108.7	1423.3	1513.3
Total Assets	1725.2	2551.0	2686.4	2981.6
% Variance	67%	130%	89%	97%
Uniform ROA	10.2%	14.4%	6.9%	13.7%
ROA	6.1%	6.5%	1.9%	6.8%
Uniform ROA vs ROA - Variance	4.1%	7.9%	22.5%	6.9%

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### [CGNX](#) – Cognex Corporation

**Cognex saw lower profitability in 2018-2019, amidst reduced spending in its automotive and electronics markets, but soon rebounded and recovered beyond pre-pandemic levels by 2021 (Exhibit 2a).**

**Reflecting this UAFRS-based earnings trend, the firm saw its stock performance rebound materially following a brief dip in 2018-2019, moving in the same direction as its Uniform-calculated earnings.**

**Yet, GAAP earnings show a firm that has still yet failed to fully recover, with profitability bouncing back to slightly muted levels. This disappointing performance is misaligned with the firm's solid stock price recovery, displaying how current accounting standards enable a dislocation between economic reality and as-reported performance.**

[CGNX](#) shares fell from \$61/share at the beginning of 2018 to below \$40/share in late 2018 and into early 2019, due to industry related headwinds. However, the firm made a quick recovery and has continued to rise since, hovering around \$80/share by the end of 2021, an over 100% increase from lows (Exhibit 2b). That said, according to as-reported metrics, [CGNX](#) appears to be a firm that didn't quite yet recover from its dip, as ROA fell from 11% in 2018 to 6% in 2019, and only rebounded to 10% by 2021. This does not appear to be a firm deserving of significant stock price appreciation since 2018, rather a company whose returns should be more stationary.

However, using Uniform Accounting, we can identify distortions such as a firm carrying non-operating long-term investments on the balance sheet and corresponding non-operating investment income on its income statement, which can substantially suppress profitability metrics (Exhibit 2c).

UAFRS-adjusted metrics paint a significantly different picture of [CGNX](#), where Uniform ROA has rebounded much faster in the same three-year period, falling from 31% in 2018 to 25% in 2019, but quickly expanding to 39% by 2021. This earning trend and improvement justifies the firm's stock price performance.

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Exhibit 2a

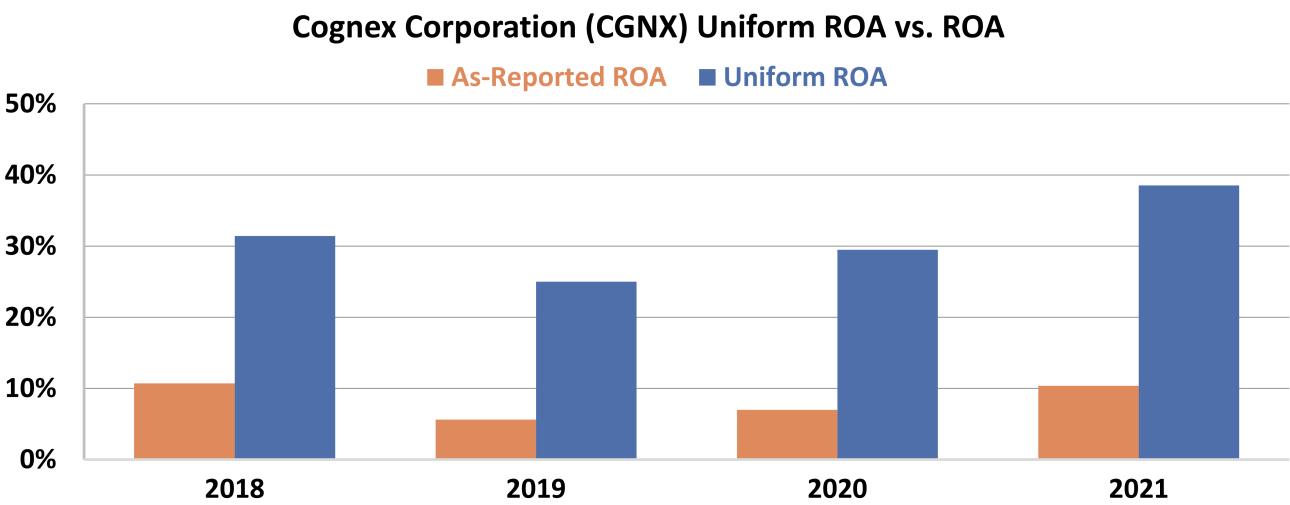


Exhibit 2b

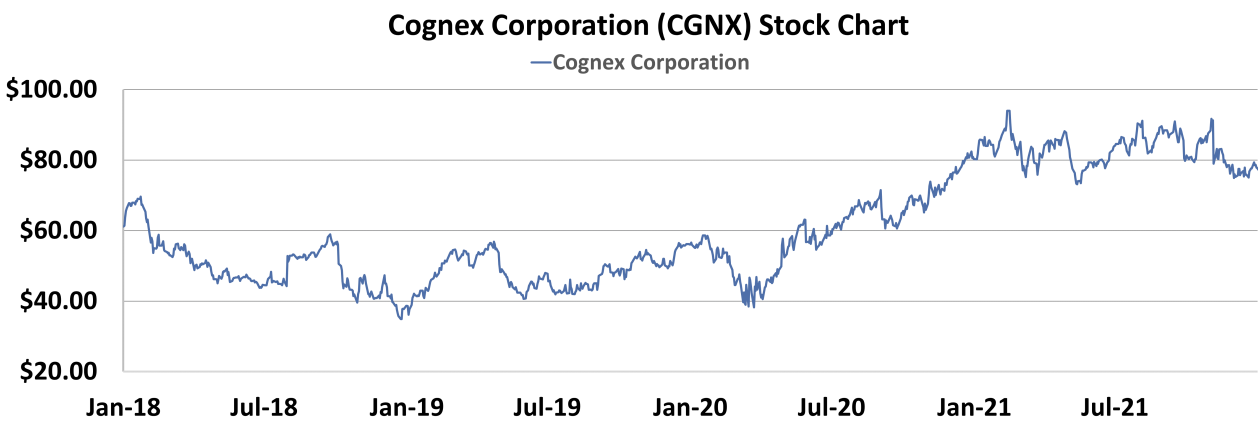


Exhibit 2c

CGNX - Cognex Corporation	2018	2019	2020	2021
Non-Operating Long-term Investments	290.7	883.0	829.8	1002.3
Investment Income	14.7	19.7	12.0	6.7
Uniform Earnings	231.3	168.4	226.2	333.3
Net Income	219.3	203.9	176.2	279.9
% Variance	-5.2%	21.1%	-22.1%	-16.0%
Uniform Assets	735.8	673.0	766.3	865.5
Total Assets	1289.7	1885.9	1800.7	2003.7
% Variance	75%	180%	135%	132%
Uniform ROA	31.4%	25.0%	29.5%	38.5%
ROA	10.7%	5.6%	7.0%	10.4%
Uniform ROA vs ROA - Variance	20.7%	19.4%	22.5%	28.1%

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### [STZ](#) – Constellation Brands

For years a wine and spirits company, Constellation Brands' acquisition of Grupo Modelo in 2014 helped the firm enter the higher volume beer market. As such, since this acquisition, [STZ](#) has seen its profitability accelerate (Exhibit 3a).

To accompany this trend in Uniform-calculated earnings, the firm's stock price has dramatically risen, with overall appreciation from 2017 to 2020.

Meanwhile, GAAP earnings have remained fairly stagnant over this same time period, portraying a company that has failed to see any transformational and lasting shift through its acquisition of Grupo Model. Faulty accounting treatment distorts the economic reality of the firm's performance.

Since 2017, [STZ](#) shares have seen material appreciation, rising from \$150/share in 2017 to \$225/share in 2021 (Exhibit 3b), a 50% increase, even in a time when the company faced pandemic-related headwinds. That said, according to as-reported metrics, [STZ](#) appeared to be a firm with declining profitability, remaining only slightly above cost-of-capital levels. This does not appear to be a firm with strengthening fundamentals that would justify the company's stock performance.

However, using Uniform Accounting, we can identify distortions such as a firm carrying non-operating long-term investments on the balance sheet and corresponding non-operating investment income on its income statement, which can substantially suppress profitability metrics (Exhibit 3c).

UAFRS-adjusted metrics paint a significantly different picture of [STZ](#), where Uniform ROA rose from 27% in 2017 to a peak of 34% in 2020. These robust profitability metrics better explain the rationale behind the firm's stock price appreciation over this time period.

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

Exhibit 3a

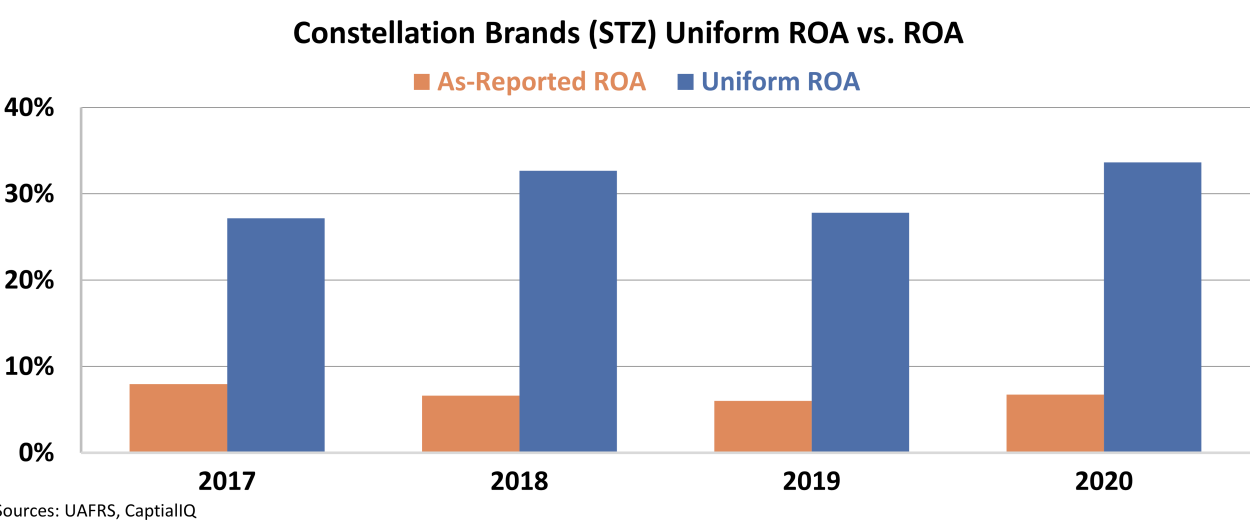


Exhibit 3b

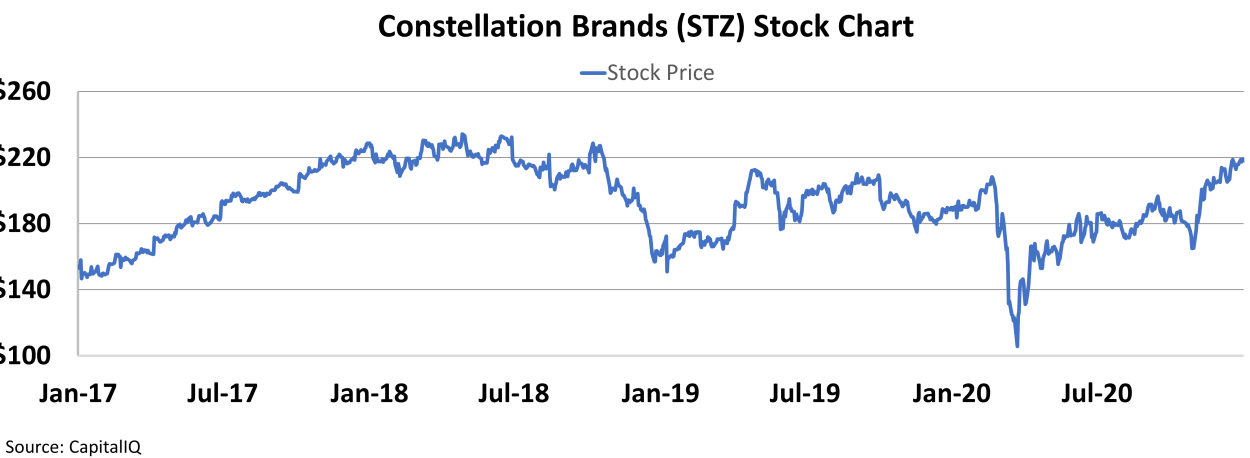


Exhibit 3c

STZ - Constellation Brands	2017	2018	2019	2020
Non-Operating Long-term Investments	103.1	793.7	8883.6	6867.3
Investment Income	27.3	487.2	2101.6	-2668.6
Uniform Earnings	1656.5	2289.4	2126.5	2352.2
Net Income	1528.6	2303.4	3435.9	-11.8
% Variance	-7.7%	0.6%	61.6%	-100.5%
Uniform Assets	6097.1	7006	7649.1	6990.3
Total Assets	18602.4	20538.7	29231.5	27323.2
% Variance	205%	193%	282%	291%
Uniform ROA	27.2%	32.7%	27.8%	33.6%
ROA	7.9%	8.0%	6.6%	6.0%
Uniform ROA vs ROA - Variance	19.3%	24.7%	21.2%	27.6%

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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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