

CLAY TOKENS

The Uniform Accounting Monthly Report | March 31, 2022



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

Accounting setters poorly defined what it means to be “special”

What does it mean to be “special”?

Many folks typically think of things that imply being “better than” or “greater than” when it comes to something being “special.” Think special events, special promotions, or special athletes...

While being superior is often at the heart of most common dictionary definitions of the word, there’s another meaning of “special” that accountants have gravitated to... “special” as in “unusual.”

A special item, otherwise known as an unusual or extraordinary item, is an accounting term for large, one-time charges or benefits on a firm’s income statement. They are accounting events that are meant to be unusual or infrequent.

Special items cover a variety of transactions and they often act as a “catch-all” bucket. Examples include severance packages to terminated employees from shutting down a business, legal or restructuring charges, and gains and losses from assets sales, among others.

Because of the one-off and often large nature of these items they can cause high volatility in a company’s earnings. As such, many analysts and accountants are wary of these line items.

In fact, there’s a popular sentiment that they are used to manipulate investors by artificially inflating or deflating profits as needed.

However, special items can be and often are legitimate. It is normal for businesses to experience one-time events that are not expected to have an ongoing effect on income.

For example, Mastercard was a part of a sweeping antitrust settlement in 2018, also impacting the likes of Visa, Bank of America, and J.P. Morgan. While this was obviously bad for the business in the short-term, it did not represent an ongoing problem for the business.

At the time, Mastercard hadn’t seen a large, multi-billion legal settlement since 2008. And it hasn’t had one since. This clearly indicates it is unusual for the business to see huge legal challenges, which means the settlement should be considered a valid special item.

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Global Payment is another example of a company with legitimate special items.

It acquired TSYS Payment Solutions in late 2019 for \$26 billion, marking its largest acquisition ever. Merging two complex payment processing leaders is an arduous task, and as a result, the firm recognized restructuring charges of a few hundred million dollars in subsequent years as it was integrating the operations of its former rival into its legacy systems.

A \$40 billion market cap firm, Global Payments' previous largest acquisition was a comparatively small \$4 billion, and before that, it only had one acquisition ever that topped \$1 billion.

Since Global Payments is not a frequent acquirer of companies of TSYS's size, these restructuring costs are not something the firm would be expected to see again anytime soon. As such, they could reasonably be considered special items.

Special items, when defined correctly, are truly unusual events for a business. So, when these types of transactions are included in a firm's financials, meant to convey the operating reality of a firm, it can cause volatility and limit earnings quality, which in turn affects the quality of analysis.

In fact, according to the findings from Earnings Quality: Evidence from the Field, an often-cited study of earnings derived from interviews and surveys of CFOs and standard setters, special items can be a key detractor from earnings quality.

Specifically, "[earnings quality] relates to earnings that are free from special or one-time items...[and] high quality earnings are essentially free of the items that would make them unsustainable."

Since non-recurring expenses do not come from a firm's actual operating business, the after-tax effect of these special items should be added back to the company's earnings so as to not distort the operating profitability with unnecessary volatility.

That said, there are cases when special items aren't actually special. As mentioned earlier, accountants and analysts often wary of these line items, and rightfully so, because they can be used for potentially nefarious reasons.

In some cases, special items are an attempt to reclassify cost of goods sold or SG&A expenses as non-recurring, when in fact, there is an obvious repeating nature.

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It can be a red flag when a company reports special items year after year. When special items are added back indiscriminately, it becomes difficult to gauge the company’s performance across time and any potential instability becomes less apparent.

Items that are recurring in nature, meaning they show up at least three years in a row are typically related to the operational nature of the business, which makes them incorrectly classified as special or unusual. Given this scenario, they should be subtracted from the company’s earnings.

A prime example of a firm putting down what seems to be recurring items as special is Pfizer.

Pfizer has seen multi-billion dollar or near-billion dollar restructuring charges each year since before 2000. Meanwhile, in each of the past eight years, Pfizer has been involved in multi-million-dollar lawsuit/litigation settlements and has taken a substantial asset write-downs in each year since 2009.

Just take a look at a snapshot of the firm’s reported special items from 2010-2016 yourself...

PFE - Pfizer Inc.	2010	2011	2012	2013	2014	2015	2016
Restructuring Charges	(3,145.0)	(3,802.0)	(2,502.0)	(1,580.0)	(646.0)	(534.0)	(2,365.0)
Asset Writedown	(2,002.0)	(834.0)	(835.0)	(803.0)	(413.0)	(621.0)	(945.0)
Legal Settlements	(1,723.0)	(784.0)	(2,220.0)	1,307.0	(993.0)	(975.0)	(510.0)

For Pfizer, these special items are by no means “special.” They are in fact the opposite—it’s an unusual year when the firm does not take any.

As a result, since these recurring expenses are from the firm’s actual operations, the after-tax effect of these special items needs to be included in the analysis of a firm’s company earnings. Or else, the firm may be unfairly rewarded for its unorthodox accounting treatment.

While special items can be legitimate in the case of true, one-time expenses, when companies are too liberal with their special items, it can inflate profitability levels.

Therefore, while removing special items in general is critical in removing undue volatility, for some companies, to get an accurate understanding of true operating performance, the recurring, material special items must also be separated and included in earnings analysis.

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There is a long line of firms from various sectors where as-reported earnings do not represent economic reality due to the misrepresentation of special items or recurring special items in the operating earnings number.

This month, we highlight three companies wherein special items reduce the reliability of the firm's reported earnings and earnings-based ratios:

- CMC Materials, a global supplier to semiconductor manufacturers and pipeline operators;
- Chemours, a leading performance chemical manufacturer and distributor;
- and
- Xerox, a leading printing company.

In the pages and charts below, we show special items adjusted for an after-tax effect, as well as recurring special items, resultant from the firm's actual operating business, added back in to the company's financials, and the difference between as-reported GAAP Net Income 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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[CCMP](#) – CMC Materials, Inc.

Since 2018, bolstered by its acquisition and integration of KMG Chemicals, CMC Materials has seen material and steady improvements in its profitability. (Exhibit 1a).

Reflecting this UAFRS-based earnings trend, the firm has seen a material appreciation in its stock price, showcasing how the firm has capitalized on its major acquisition, better capturing tailwinds as a supplier of critical materials to semiconductor manufacturers.

Meanwhile, GAAP earnings have declined over this same time period, misleading investors into believing the firm has been unable to extract value from these sector tailwinds. This as-reported performance would suggest the firm's stock price rise has been wholly unwarranted.

Since the beginning of 2019, [CCMP](#) share prices have increased materially in value, rising from approximately \$90/share to nearly \$200/share, an almost 110% rise (Exhibit 1b). That said, according to as-reported metrics, [CCMP](#) appeared to be a firm with middling and generally declining profitability, going from above-corporate average levels at its peak to near cost-of-capital returns in recent years. This supposed uninspiring performance should not warrant the firm's materially positive stock price movements.

However, using Uniform Accounting, we can identify distortions such as an inconsistent consideration of the impact of special items on the income statement of a firm, which has materially understated the ongoing operating profitability for CMC Materials. (Exhibit 1c).

UAFRS-adjusted metrics paint a significantly different picture of [CCMP](#), where Uniform ROA improved from 17% in 2018 to highly robust 32% levels in 2021, more than doubling, suggesting that the healthy appreciation in the firm's stock price has likely been justified.

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Exhibit 1a

CMC Materials (CCMP) Uniform ROA vs. ROA

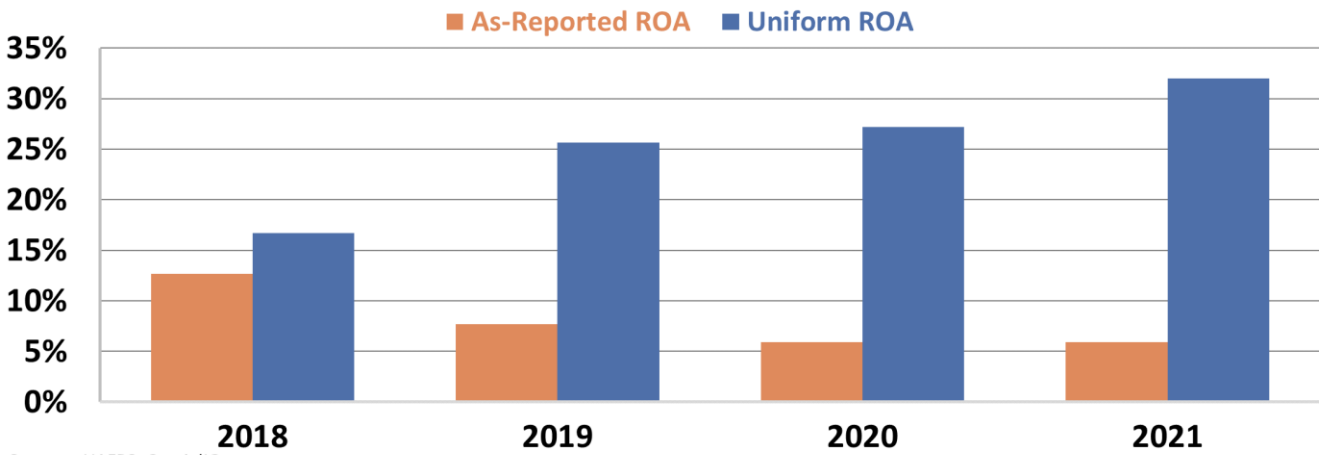


Exhibit 1b

CMC Materials (CCMP) Stock Chart

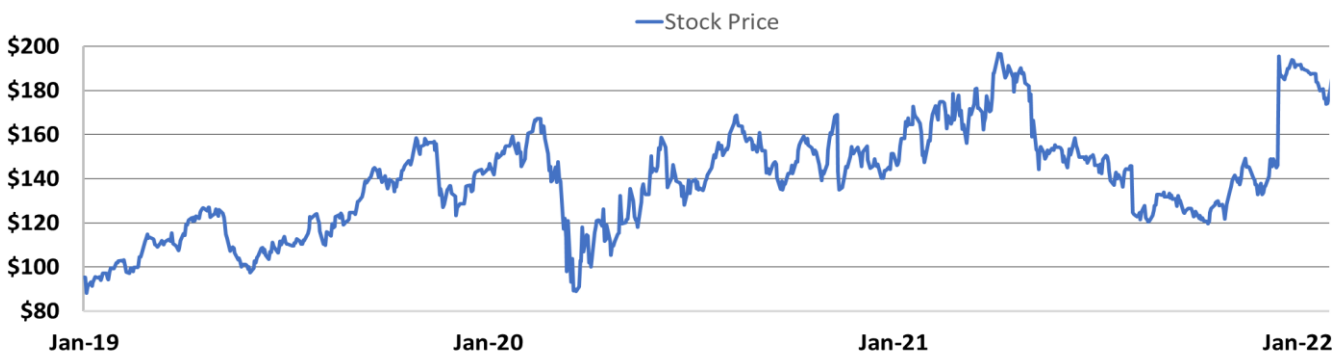


Exhibit 1c

CCMP - CMC Materials, Inc.	2018	2019	2020	2021
Special Items adjusted after-tax effect	15.1	-78.6	-2.8	-243.1
Recurring Special Items to include in earnings	0.0	0.0	0.0	0.0
Uniform Earnings	108.8	227.8	257.9	308.1
Net Income	110.0	39.2	142.8	-68.6
% Variance	1.2%	-82.8%	-44.6%	-122.3%
Uniform ROA	16.7%	25.6%	27.2%	32.0%
As-Reported ROA	12.7%	7.7%	5.9%	5.9%
Uniform ROA vs ROA - Variance	4.0%	17.9%	21.3%	26.1%

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[CC](#) – The Chemours Company

Over the past few years Chemours has seen stagnant operating profitability, hovering near cost-of-capital levels, with a dip in 2020 resulting from pandemic-related setbacks (Exhibit 2a).

To accompany this, since the start of 2019, the firm's stock price has moved in the same direction as its Uniform-calculated returns, flat over the course of two years, with a pandemic-related dip in 2020 to boot.

Meanwhile, GAAP earnings show a firm that has consistent improvements in its profitability in recent years. This seemingly encouraging performance fails to explain the firm's paltry stock price results, displaying how current accounting standards enable a dislocation between economic reality and as-reported performance.

Since 2019, [CC](#) shares have remained essentially flat around \$30/share, aside from a noticeable dip in 2020 attributable to pandemic-related headwinds (Exhibit 2b). That said, according to as-reported metrics, [CC](#) appears to be a firm which saw material improvements in profitability, with as-reported ROA expanding steadily from below cost-of-capital 4% levels to 6% by 2021. According to as-reported metrics, this does not appear to be a firm deserving of lackluster performance, rather a company whose stock should be increasing significantly.

However, using Uniform Accounting, we can identify distortions such as an inconsistent consideration of the impact of special items, and specifically recurring special items, on the income statement of a firm, which has inaccurately captured the operating profitability for Chemours. (Exhibit 2c).

UAFRS-adjusted metrics paint a significantly different picture of [CC](#), where Uniform ROA stayed essentially flat over the same three-year time frame, maintaining 6% profitability levels from 2019-2021, aside from a slight pandemic related dip in 2020. This earning trend justifies the firm's stock price performance.

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Exhibit 2a

The Chemours Company (CC) Uniform ROA vs. ROA

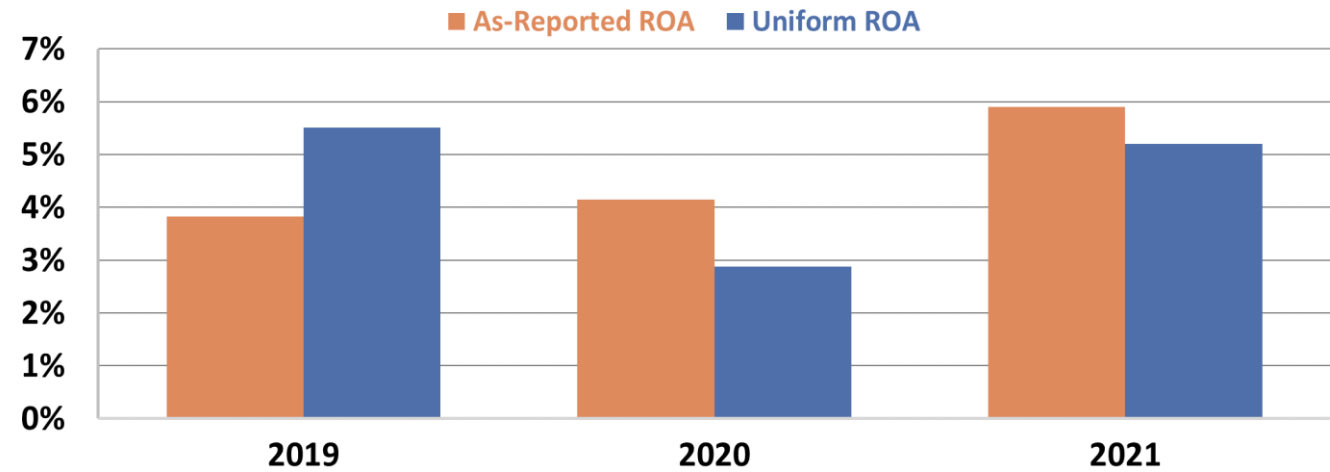


Exhibit 2b

The Chemours Company (CC) Stock Chart

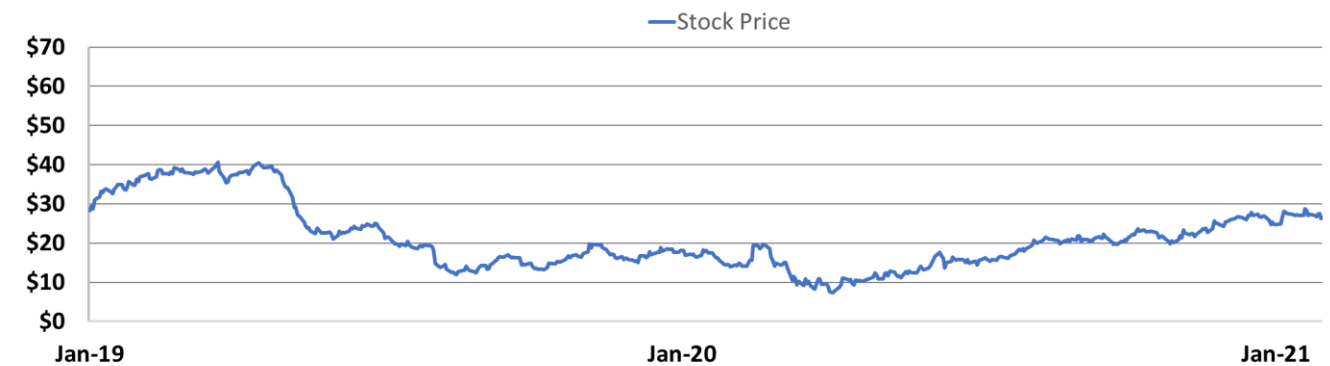


Exhibit 2c

CC - The Chemours Company	2019	2020	2021
Special Items adjusted after-tax effect	-366.5	-57.8	80.0
Recurring Special Items to include in earnings	-69.8	-25.7	-10.8
Uniform Earnings	604.8	307.3	579.2
Net Income	-52.0	219.0	608.0
% Variance	-108.6%	-28.7%	5.0%
Uniform ROA	5.5%	2.9%	5.5%
As-Reported ROA	3.8%	4.1%	5.9%
Uniform ROA vs ROA - Variance	1.7%	-1.3%	-0.4%

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[XRX](#) – Xerox Corporation

For years, Xerox was a household name in the technology sector, but as the demand for printers diminished with the rise of digital communication, so has the firm's profitability. Since reaching a peak in 2014, Xerox has seen steady declines in profitability and growth. (Exhibit 3a).

To accompany this trend in Uniform-calculated earnings, the firm's stock price has plummeted, steadily declining from 2014 through the end of 2018.

Meanwhile, GAAP earnings have increased over this same timeframe, portraying Xerox as a firm that seems to have improved its profitability over the past 5+ years. Faulty accounting treatment of material items distort the economic reality of the firm's performance.

After reaching a multi-year peak in 2014, [XRX](#)'s share price saw a dramatic fall, collapsing from approximately \$35/share to about \$20/share in 2019, representing about a 45% depreciation in value (Exhibit 3b). Yet, according to as-reported metrics, [XRX](#) was a firm that likely warranted the opposite, with as-reported ROA starting to improve from lowly 2%-3% levels towards at least the cost-of-capital.

However, using Uniform Accounting, we can identify distortions such as an inconsistent consideration of the impact of special items, and specifically recurring special items, on the income statement of a firm, which has inaccurately captured the operating profitability for Xerox. (Exhibit 3c).

UAFRS-adjusted metrics paint a significantly different picture of [XRX](#), where Uniform ROA dropped considerably from 11% peaks in 2014 to just 6% in 2018. This deterioration in fundamentals implies that the firm's stock price depreciation was likely warranted.

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Exhibit 3a

Xerox (XRX) Uniform ROA vs. ROA

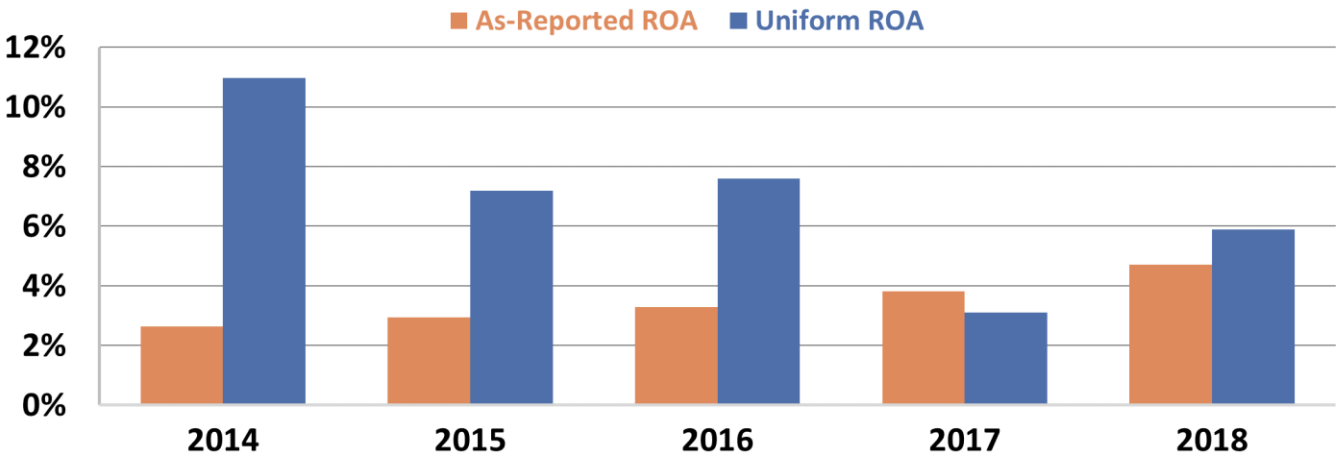


Exhibit 3b

Xerox (XRX) Stock Chart



Exhibit 3c

XRX - Xerox Holdings Corporation	2014	2015	2016	2017	2018
Special Items adjusted after-tax effect	-137.7	-16.0	-1309.1	-69.8	-109.8
Recurring Special Items to include in earnings	-85.9	-22.1	-168.4	-185.1	-93.1
Uniform Earnings	1592.9	961.1	747.4	309.1	554.6
Net Income	448.0	-471.0	195.0	361.0	1353.0
% Variance	-71.9%	-149.0%	-73.9%	16.8%	144.0%
Uniform ROA	11.0%	7.2%	7.6%	3.1%	5.9%
As-Reported ROA	2.6%	2.9%	3.3%	3.8%	4.7%
Uniform ROA vs ROA - Variance	8.3%	4.2%	4.3%	-0.7%	1.2%

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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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