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The Uniform Accounting Monthly Report | September 30, 2022

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

Presented to the UAFRS Advisory Council

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Banks are far from your typical business

Mitsubishi Group is a classic Japanese conglomerate.

Also known as “Keiretsu” in Japanese, it is a series of cross-shareholdings that form a complicated corporate structure under a single business group.

Mitsubishi has a host of businesses under its umbrella. Arguably best known for its motor vehicles, at least in the United States, Mitsubishi also manufactures toasters… and Nikon cameras. It also runs an aircraft business, sells specialty chemicals and industrial gasses, develops real estate, manufactures generators, and does much, much more.

While assessing the performance of the group’s combined activities would be a sufficiently difficult activity, there is one area of the group that makes it nearly impossible.

Mitsubishi also operates a bank.

Its banking arm, logically, is very different from the other operating parts of its business.

While those may be different in terms of what they sell and how they are run, at least they are fairly consistent in how they record their finances. For banks, on the other hand, the balance sheet is completely flipped.

While most companies make their money off their assets, banks make their money off their liabilities or the deposits that they subsequently loan out.

To a bank, this loan becomes an asset. Banks make money from the spread of their lending business. This is the difference between the interest received from loans and the interest paid to depositors.

In general, the ability of a business to invest its capital into operating assets and in turn see incremental operating returns allows it to create long-term value.

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That's part of the reason why Uniform Return on Assets (Uniform ROA) is the backbone of how we value most companies. Evaluating the return on a company's operating assets, or in essence, its invested capital, gives a picture of the company's operating profitability, or true earning power.

However, evaluating a bank on the basis of Uniform ROA would not make as much sense. As stated above, the assets of a bank are not akin to the assets of an operating company.

Instead, we must use Uniform Return on Equity (Uniform ROE) to value banks. The equity is the invested capital the bank actually needs to be able to run its business, since it is what allows it to accumulate the deposits of others that it then loans out.

Therefore, Uniform ROE is how banks see incremental returns. Evaluating based on this metric gives a more accurate understanding of a bank's underlying operating performance.

The Mitsubishi Group is a tremendous example of the complexity of modern companies and how one single firm could be involved in so many different and unrelated activities. It also shows how banks and bank-like operations are not always separate from regular operating businesses.

So, how then, would you value a company that has both operating entities and a banking entity?

Unlike Mitsubishi, whose complicated cross-holding structure avoids a true parent-subsidiary relationship, there are a host of other companies, notably American automotive companies as an example, that have banking entities embedded in the overall corporate structure.

Also known as a financial subsidiary, these entities are allowed to engage in certain financial activities that the parent company itself is not allowed to, including lending, participation in underwriting, securities, and insurance activities.

While companies may have different forms of financial subsidiaries, it is critical to always consider "operating" financial subsidiaries in any corporate performance analysis. These are the financial subsidiaries that are vital in sustaining the day-to-day operations of the regular business (e.g the auto company). Without them, the "regular" business would not be able to operate as efficiently.

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This subsidiary must be considered in the evaluation of the entire company. However, since a financial subsidiary operates more like a bank, it should not be added to the balance sheet in the same way a run-of-the-mill subsidiary would.

Simply adding the assets of the financial subsidiary into the parent company's balance sheet would distort ROA calculations, leading to a material over or understatement of true earning power. Counting the operating financial subsidiary's assets as traditional assets is misleading because those assets more closely resemble the parent company's liabilities.

Instead, we must focus on evaluating the combined firm's return on invested capital. For the parent company, this invested capital is effectively its asset base, and why ROA is appropriate. For the financial subsidiary, it is effectively its equity value, and why ROE suffices.

As such, the adjustment is fairly straightforward. To incorporate the financial subsidiary, simply add its equity value, the difference between its assets and liabilities, to the parent company's balance sheet as a long-term operating asset.

Given that the operating financial subsidiary is necessary for the business to function, it should be assumed to be a part of the long-term recurring functions of the overall entity.

Meanwhile, the combination of a bank-like invested capital base and an operating company invested capital base, gives a more level playing field from which to evaluate the combined corporate capital base.

This adjustment allows for a better understanding of the combined entity's profitability. It also allows investors to compare companies with financial subsidiaries to those without them interchangeably. That would be impossible if you were trying to compare a bank to an operating company.

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There is a long line of firms, from various sectors, where as-reported assets do not represent economic reality due to the misrepresentation of financial subsidiary assets.

This month, we highlight three companies wherein the full inclusion of financial subsidiary assets as operating assets limit the reliability of the firm's reported asset-based ratios:

•Snap-on Incorporated, a tools and equipment manufacturer for the transportation industry;
•The Boeing Company, a leading aircraft manufacturer and defense company;
•General Motors, a legacy American auto manufacturing giant.

In the pages and charts below, we show the difference between the adjusted financial subsidiary equity and reported financial subsidiary assets for these firms and the difference between as-reported GAAP Assets and UAFRS-based Assets.

While all of the 130+ adjustments have been applied, we home 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.

SNA – Snap-on Incorporated

Since 2019, SNA has seen increasingly robust profitability, driven by strength in homebuilding markets (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. 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.

SNA share prices appreciated materially in value, rising from $150 at the start of 2019 to over $220 by the end of 2021, a 43% gain (Exhibit 1b). That said, according to as-reported metrics, SNA appeared to be a firm that had remained stagnant, with stable, corporate-average levels of profitability over the same time period. This steady performance implies the firm's stock price positive movements are wholly unwarranted.

However, using Uniform Accounting, we can more accurately account for the performance of financial subsidiaries, which need to be evaluated more like banks than traditional operating businesses. Under as-reported metrics, financial subsidiary assets are counted as regular assets, despite acting similarly to liabilities, which can result in overstated total assets, and in turn, artificially deflate profitability measures (Exhibit 1c).

UAFRS-adjusted metrics paint a significantly different picture of SNA, as Uniform ROA climbed from an already robust 19% in 2019 to even stronger 23% levels by 2021, suggesting that the increase in the firm's stock price has likely been justified.

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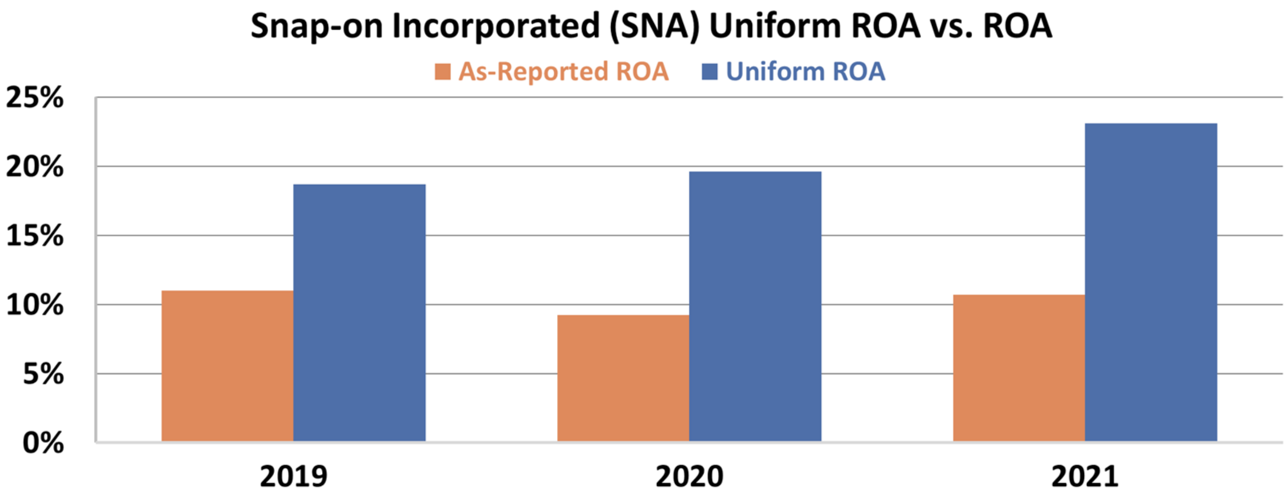
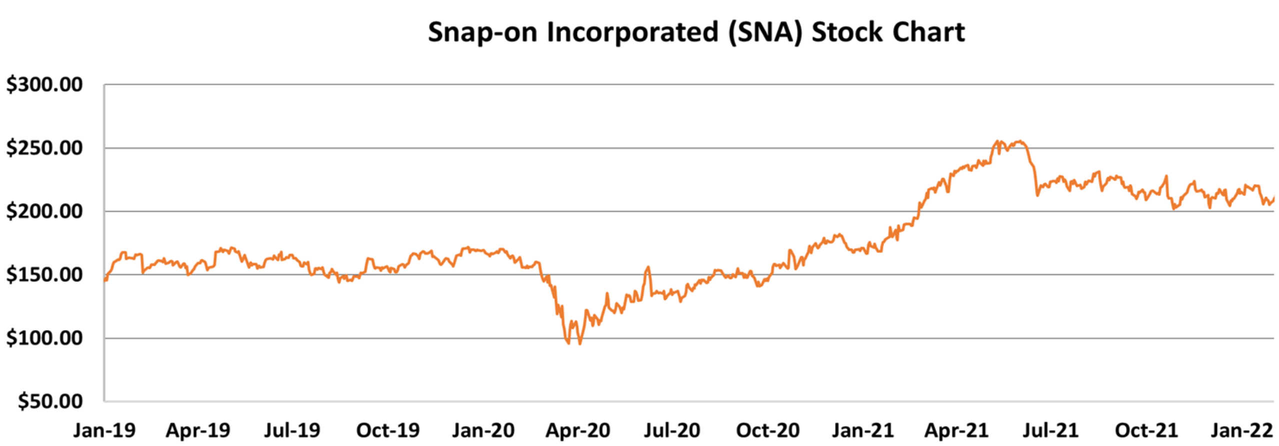
Exhibit 1a



Sources: UAFRS, CaptialIQ

Exhibit 1b



Source: CapitalIQ

Exhibit 1c

SNA - Snap-on Incorporated	2020	2021	2022
Uniform Operating Financial Subsidiary Equity	1146.9	726.8	968.3
As-reported Financial Subsidiary Assets	2096.8	2162.2	2156.1
Uniform Net Assets	3757.9	3324.6	3725.9
Total Assets	5693.5	6557.3	6759.7
% Variance	51.5%	97.2%	81.4%
Uniform ROA	18.7%	19.6%	23.1%
As-Reported ROA	11.0%	9.2%	10.7%
Uniform ROA vs ROA - Variance	7.7%	10.4%	12.4%

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BA – The Boeing Company

Prior to a steep drop off in performance caused by controversies around aircraft safety, and then the impact of the pandemic, BA saw material improvements in profitability from 2016 to 2018 (Exhibit 2a).

Reflecting this UAFRS-based earnings trend, 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 profitability that only marginally improved, remaining near cost-of-capital levels. 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.

BA shares rose from $130/share at the beginning of 2016 to over $310/share by the end of 2018, a 135%+ increase (Exhibit 2b). That said, according to as-reported metrics, BA appears to be a firm which saw only slight improvement in profitability, with as-reported ROA rising from a paltry 4% in 2016 to just 5% in 2018. 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 more accurately account for the performance of financial subsidiaries, which need to be evaluated more like banks than traditional operating businesses. Under as-reported metrics, financial subsidiary assets are counted as regular assets, despite acting similarly to liabilities, which can result in overstated total assets, and in turn, artificially deflate profitability measures (Exhibit 2c).

UAFRS-adjusted metrics paint a significantly different picture of BA where Uniform ROA jumped from 12% to over 20% during the same three-year period. This earning trend more clearly justifies the firm's stock price performance.

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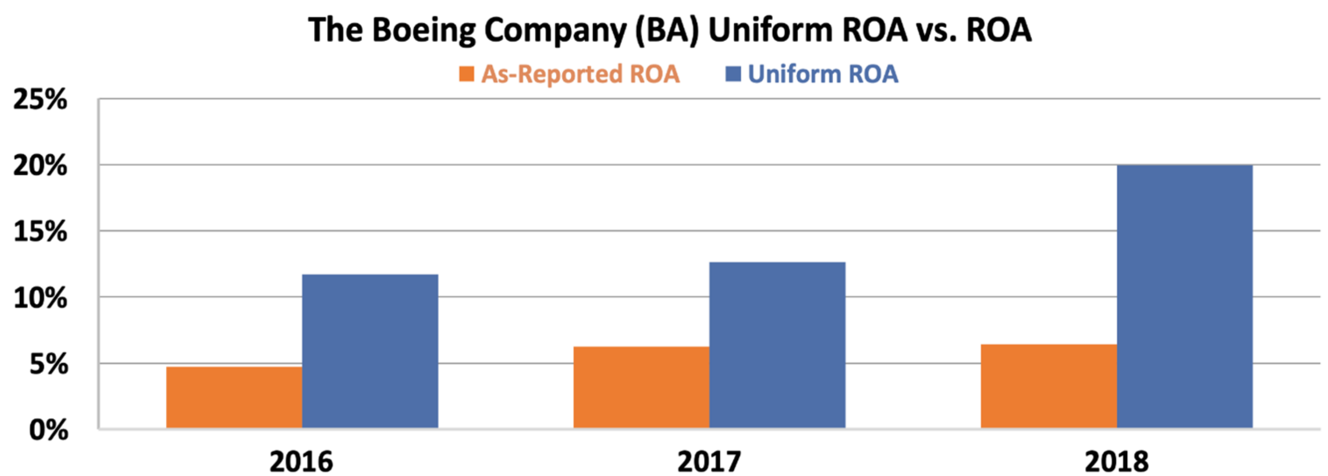
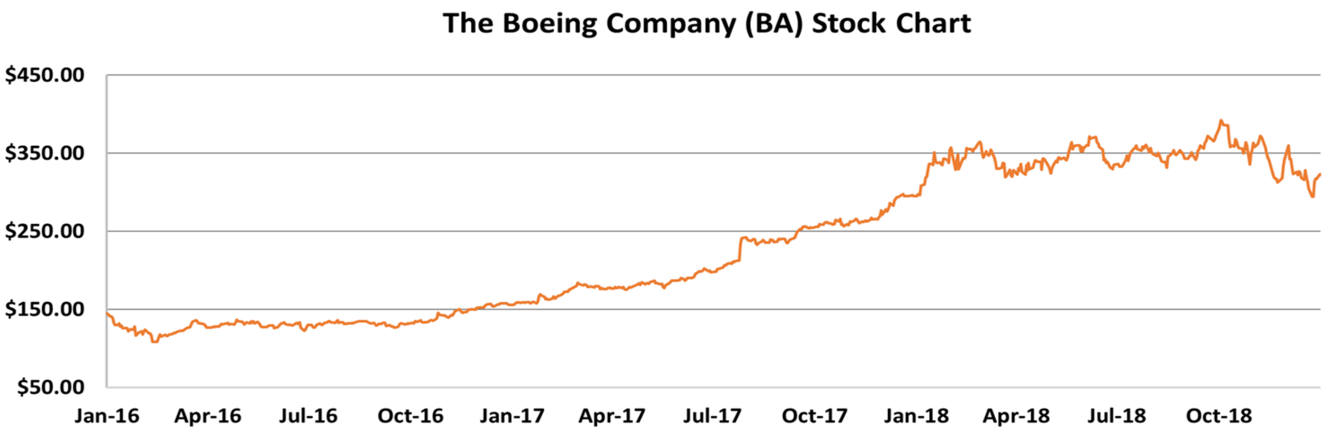
Exhibit 2a



Sources: UAFRS, CaptialIQ

Exhibit 2b



Source: CapitalIQ

Exhibit 2c

BA - The Boeing Company	2016	2017	2018
Uniform Operating Financial Subsidiary Equity	661.0	542.0	378.0
As-reported Financial Subsidiary Assets	4201.0	3065.0	2878.0
Uniform Net Assets	57396.3	54803.0	52255.3
Total Assets	89997.0	112362.0	117359.0
% Variance	56.8%	105.0%	124.6%
Uniform ROA	11.7%	12.6%	20.0%
As-Reported ROA	4.7%	6.2%	6.4%
Uniform ROA vs ROA - Variance	7.0%	6.4%	13.5%

GM – General Motors Company

Between 2017 and 2021, GM saw profitability improve materially, finally eclipsing cost of capital levels (Exhibit 3a).

To accompany this trend in Uniform-calculated earnings, the firm's stock price dramatically rose, with the exception of a dip in 2020 due to pandemic-related headwinds.

Meanwhile, GAAP earnings have remained fairly stagnant over this same time period, portraying the firm as one that has failed to see any improvement in its operating fundamentals. Faulty accounting treatment distorts the economic reality of the firm's performance.

Since 2017, GM shares have seen material appreciation, rising from $38/share at the beginning of 2017 to $60/share at the end of 2021 (Exhibit 3b), an almost 60% increase. That said, according to as-reported metrics, GM appears to be a firm with stagnant profitability, as ROA remained at weak sub-3% levels. This does not appear to be a firm with performance that would justify its rising stock price.

However, using Uniform Accounting, we can more accurately account for the performance of financial subsidiaries, which need to be evaluated more like banks than traditional operating businesses. Under as-reported metrics, financial subsidiary assets are counted as regular assets, despite acting similarly to liabilities, which can result in overstated total assets, and in turn, artificially deflate profitability measures (Exhibit 3c).

UAFRS-adjusted metrics paint a different picture of GM, where Uniform ROA rose from 5% in 2017 to 7% in 2021, eclipsing its cost of capital. These improving profitability metrics better explain the rationale behind the firm's stock price appreciation over this time period.

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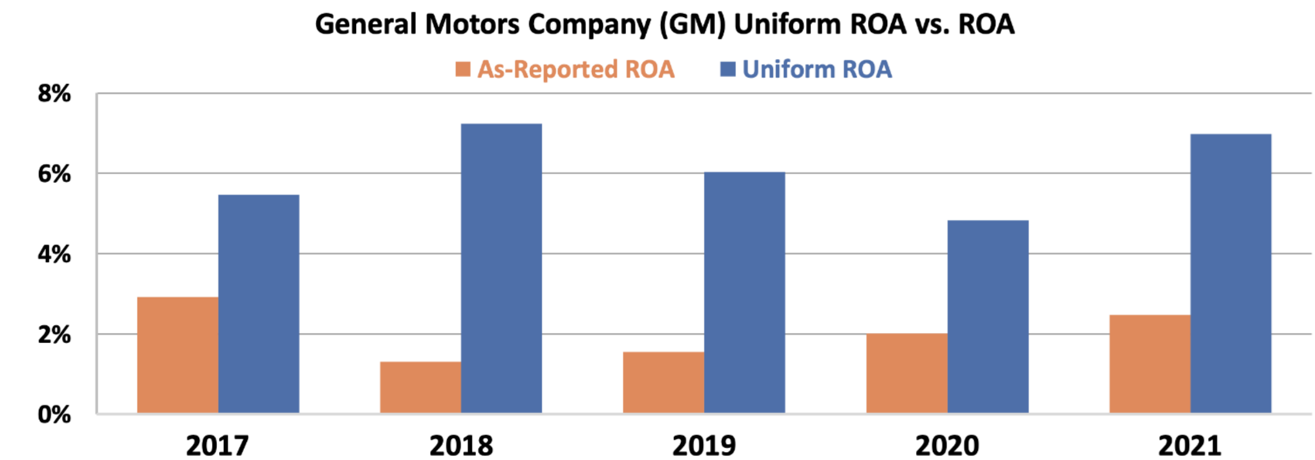
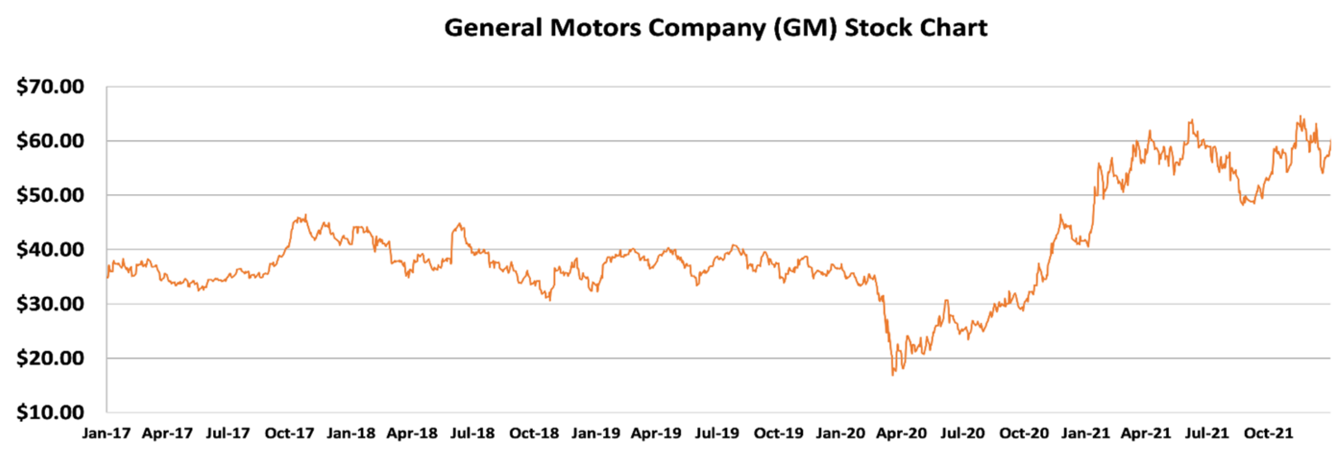
Exhibit 3a



Sources: UAFRS, CaptialIQ

Exhibit 3b



Source: CapitalIQ

Exhibit 3c

GM - General Motors Company	2017	2018	2019	2020	2021
Uniform Operating Financial Subsidiary Equity	13404.0	14938.0	15166.0	17003.0	18826.0
As-reported Financial Subsidiary Assets	94061.0	105855.0	104104.0	109428.0	111387.0
Uniform Net Assets	74569.5	77267.8	86350.1	89010.0	99291.6
Total Assets	212482.0	227339.0	228037.0	235194.0	244718.0
% Variance	184.9%	194.2%	164.1%	164.2%	146.5%
Uniform ROA	5.5%	7.2%	6.0%	4.8%	7.0%
As-Reported ROA	2.9%	1.8%	1.8%	2.3%	3.0%
Uniform ROA vs ROA - Variance	2.5%	5.5%	4.3%	2.5%	4.0%

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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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