MarketWatch

Opinion: This is the earnings metric stock-market investors should focus on

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Skip GAAP and non-GAAP numbers and turn to economic earnings

Getty Images
Are you focusing on the wrong earnings target?

Analysts love to talk about "earnings." If earnings beat expectations, they say it's a reason for the stock to go up. If earnings are lower than expected, the stock should go down. The price-to-earnings ratio is the most common valuation metric in the financial media.

You might think, given their prominence and the fact that the Financial Accounting Standards Board governs their calculation, that "earnings" reflect a company's profits.

Instead, GAAP earnings are subject to a number of accounting loopholes and distortions that cause them to diverge from true cash profits. CFOs themselves admit they frequently exploit these loopholes to prop up earnings and ensure management gets their bonuses.

Management teams have even more leeway to manipulate non-GAAP metrics because there are no rules about how they are calculated. Nevertheless, an increasing number of headlines focus on non-GAAP numbers under the ruse that they provide a more accurate picture of their operations.

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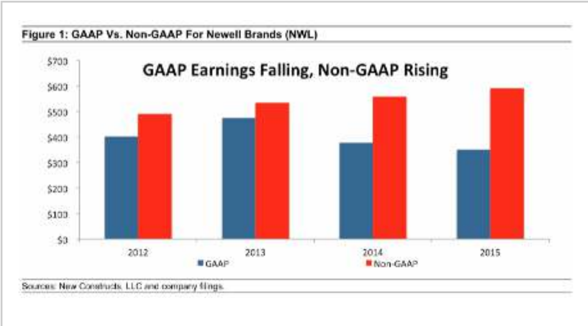
In reality, these metrics serve as a tool to paint the most flattering picture of the company's financials. Figure 1 shows how Newell Brands NWL, +2.15% turned volatile and declining GAAP earnings into steadily growing non-GAAP earnings.

Newell creates this illusion by selectively lumping real operating costs into buckets such as “advisory,” “acquisition and integration,” and “restructuring,” that it excludes from non-GAAP earnings. These exclusions might seem legitimate if they were one-time or unusual, but Newell has incurred restructuring charges for over 15 consecutive years.



Investors who take reported non-GAAP earnings at face value are not doing their due diligence.

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So what’s the right metric for investors?

Investors who want to judge profitability need a metric that

- Reflects the actual economics of the business
- Is comparable across companies
- Has a clear, defined link to shareholder value

Many highly successfully value investors over the past century have noted that the metric on which investors should focus is economic earnings. Economic earnings represent the true value created by the company for investors, removing accounting distortions and accounting for the cost of capital.

Economic earnings are primarily based on a company’s return on invested capital, or ROIC. A number of independent studies have found that ROIC is the most important driver of valuation.

The problem with economic earnings is that they are difficult to calculate. They require analyzing 200-page (or longer) annual and quarterly filings to find the data required to close dozens of accounting loopholes in the reported financial statements. Few investors have the time or expertise to do this much work. Moreover, those detailed filings often come out weeks after the companies’ earnings releases, so many investors have already accepted the misleading numbers at face value and moved on.

The SEC has to take some of the blame here. For too long it has allowed companies to report wholly made up metrics with little-to-no challenge. Recently, the SEC has promised to start cracking down more heavily on misleading non-GAAP metrics.

Sell-side analysts also should be calling companies out on misleading earnings and providing more accurate metrics to investors. However, these analysts are too often concerned with maintaining access to management and avoiding anything that could jeopardize the more lucrative investment-banking business.

Still, the biggest share of the blame has to go to the companies themselves and, specifically, the boards of directors that have a fiduciary responsibility to represent shareholders’ best interests. Executives are always going to try to report results that make themselves look good. It’s up to boards to hold them accountable for creating real shareholder value.

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Instead, as we detail on our report on boards and compensation committees, these watchdogs actually encourage executives to focus on misleading metrics by tying their compensation to measures that don’t create value for shareholders. We have numerous examples of how damaging this form of poor governance can be: going back to Enron, WorldCom, Tyco and, more recently, Valeant VRX, -1.09% as we detail in this report.

Fixing this simple governance issue can help companies deliver outsize returns. Take Home HD, +0.67% as an example. In 2006, the company had lost over 20% of its value in the prior five years despite the fact the U.S. was in the middle of a housing boom. Activist investor Ralph Whitworth came in, forced the company to fix its misleading calculation of ROIC, and made ROIC a key element of executive's bonuses.

In the decade since, Home Depot's stock price is up nearly four times that of the S&P 500 SPX, +0.11% At the end of the day, it is hard to argue against tying executive compensation to the metrics most closely aligned with creating shareholder value.

If corporate boards truly want to represent the interests of their shareholders, they need to tie executive compensation to ROIC and economic earnings and highlight these metrics for investors.

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David Trainer is the CEO of New Constructs, an equity research firm that uses machine learning and natural language processing to parse corporate filings and model economic earnings. New Constructs has a model portfolio of stocks that link executive compensation to ROIC. Sam McBride is an investment analyst at New Constructs.

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