New Constructs®
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DILIGENCE PAYS 3/27/17

Filing Season Finds: Week Of March 20-24

Our latest featured stock is a large cap home improvement retailer with a flattering ROIC calculation.

We pulled this highlight from last week's research of 127 10-K filings, from which our robo-analyst technology collected 16,552 data points. Our analyst team used this data to make 2,964 forensic accounting adjustments with a dollar value of $1.7 trillion. Those adjustments were applied as follows:

- 1,279 income statement adjustments with a total value of $141 billion
- 1,196 balance sheet adjustments with a total value of $668 billion
- 489 valuation adjustments with a total value of $843 billion

Figure 1: Filing Season Diligence

	Filings Parsed	Data Points Collected	# of Adjustments	Total Value of Adjustments ($Billions)
Last Week	127	16,552	2,964	$1,652
Filing Season Total	2,007	277,651	47,227	$15,029

Sources: New Constructs, LLC and company filings.

Fewer filings are coming in on a daily basis as filing season winds down, so we are no longer providing daily updates on our research. However, we will still be highlighting significant finds for our readers. Follow us on Twitter and check out the hashtag #filingseasonfinds for regular updates on our research.

Every year in this six-week stretch from mid-February through the end of March we parse and analyze roughly 2,000 10-Ks to update our models for companies with a 12/31 fiscal year end. This effort is made possible by the combination of expertly trained human analysts with what we call the "Robo-Analyst." The Robo-Analyst uses machine learning and natural language processing to automate much of the parsing process.

A Fiduciary Level of Diligence

Our technology enables us to deliver fundamental diligence at a previously impossible scale. We believe that in time investors will come to demand this level of diligence when it comes to their investment advice.

Only by reading through the footnotes and making adjustments to reverse accounting distortions can advisors go beyond the suitability standard and provide a fiduciary level of diligence to their clients.

One Company To Watch In 2017

We've praised Home Depot (HD) in the past for its decision to tie executive compensation to return on invested capital (ROIC). The company's 10-K, filed last week and parsed by analyst Peter Apockotos, gives us a chance to evaluate the accuracy of its ROIC calculation.

HD discloses its ROIC calculation on page 23 of its 10-K. To get net operating profit after tax (NOPAT), HD simply eliminates interest expense and then makes an income tax adjustment. There is no effort to account for non-operating items in the footnotes.

Fortunately, this does not throw off the calculation too much, as HD rarely buries non-operating items in the footnotes. Only 19% of companies have fewer earnings adjustments than HD.

On the invested capital side, HD has more significant issues. The company uses average debt plus equity to calculate invested capital, an all-too-common method with serious drawbacks.

Using debt plus equity does not hold management responsible for the $800 million in accumulated asset write-downs incurred over the years, or the nearly $900 million in accumulated other comprehensive loss.

Most importantly, though, it leaves out the company's substantial off-balance sheet debt. HD has $7.5 billion in operating lease obligations with a present value of $5.7 billion. These leases are economically equivalent to debt and assets on the balance sheet—and in fact companies will soon be required to account for them on the balance sheet—but HD excludes them from its calculation of invested capital.

When we adjust for all these hidden forms of invested capital, we see that HD earned an ROIC of 23% last year, well below its reported number of 31%. HD is still a great company, and it earns our Attractive rating, but its reported ROIC calculation is overly flattering.

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Disclosure: David Trainer, Peter Apockotos, and Sam McBride receive no compensation to write about any specific stock, sector, style, or theme.

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How New Constructs Creates Value for Clients

We find it. You benefit. Cutting-edge technology enables us to scale our forensic accounting expertise across 3000+ stocks. We shine a light in the dark corners of SEC filings so our clients can make safer, more informed decisions.

Our stock rating methodology instantly informs you of the quality of the business and the fairness of the stock's valuation. We do the diligence on earnings quality and valuation so you don't have to.

In-depth risk/reward analysis underpins our ratings. Our rating methodology grades every stock, ETF, and mutual fund according to what we believe are the 5 most important criteria for assessing the quality of an equity. Each grade reflects the balance of potential risk and reward of buying that equity. Our analysis results in the 5 ratings described below. Very Attractive and Attractive correspond to a "Buy" rating, Very Dangerous and Dangerous correspond to a "Sell" rating, while Neutral corresponds to a "Hold" rating.

QUESTION: Why shouldn't fund research be as good as stock research? Why should fund investors rely on backward-looking price trends?

ANSWER: They should not.

Don't judge a fund by its cover. Take a look inside at its holdings and understand the quality of earnings and valuation of the stocks it holds. We enable you to choose the best fund based on its stock-picking merits so you do not have to rely solely on backward-looking technical metrics.

The drivers of our forward-looking fund ratings are Portfolio Management (i.e. the aggregated ratings of its holdings) and Total Annual Costs. The Total Annual Costs Rating (details here) captures the all-in cost of being in a fund over a 3-year holding period, the average period for all fund investors.

Our Philosophy About Research

Accounting data is not designed for equity investors, but for debt investors. Accounting data must be translated into economic earnings to understand the profitability and valuation relevant to equity investors. Respected investors (e.g. Adam Smith, Warren Buffett and Ben Graham) have repeatedly emphasized that accounting results should not be used to value stocks. Economic earnings are what matter because they are:

1. Based on the complete set of financial information available.
2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

Additional Information

Incorporated in July 2002, New Constructs is an independent publisher of investment research that provides clients with consulting and research services. We specialize in quality-of-earnings, forensic accounting and discounted cash flow valuation analyses for all U.S. public companies. We translate accounting data from 10Ks into economic financial statements, i.e. NOPAT, Invested Capital, and WACC, to create economic earnings models, which are necessary to understand the true profitability and valuation of companies. Visit the Free Archive to download samples of our research. New Constructs is a BBB accredited business and a member of the Investorside Research Association.

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