Hidden Non-Operating Income Is Today's Filing Season Find

For March 1, our forensic accounting needle in a haystack comes from a drilling company with hidden non-operating income.

Get the best fundamental research

Analyst Peter Apockotos found an unusual item in Rowan Company's (RDC) 2018 10-K.

On page 31, RDC discloses that it received a $28 million (3% of revenue) early termination fee from Anadarko Petroleum (APC). RDC received this fee after APC terminated a drilling contract in the second quarter of 2018 that had been scheduled to run for two more months.

This non-recurring income couldn't save RDC from a $347 million GAAP loss in 2018. However, RDC did report a positive adjusted EBITDA, which is, of course, the metric the company highlights to investors and uses as the primary basis for executive bonuses. The Anadarko termination fee accounted for 60% of RDC's $46 million adjusted EBITDA in 2018.

As we learned from Lending Club's (LC) 10-K, as well as many other firms, adjusted EBITDA excludes real recurring costs. It's only fair to assume that companies using this metric would also exclude non-recurring income. The fact that they don't is more reason for investors not to trust adjusted EBITDA. Investors need to see the conflict between honest reporting and executive pay. Keeping non-recurring income in the numbers boosts reported profitability and helps executives hit their bonus targets.

The Power of the Robo-Analyst

We analyzed 175 10-K filings yesterday (a new single day record for us), from which our Robo-Analyst[1] technology collected 19,543 data points. Our analyst team used this data to make 4,041 forensic accounting adjustments with a dollar value of $1.4 trillion. The adjustments were applied as follows:

- 1,551 income statement adjustments with a total value of $90 billion
- 1,765 balance sheet adjustments with a total value of $611 billion
- 725 valuation adjustments with a total value of $735 billion

We believe this research is necessary to fulfill the Fiduciary Duty of Care. Ernst & Young's white paper, "Getting ROIC Right", demonstrates how these adjustments contribute to meaningfully superior models and metrics.

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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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[1] Harvard Business School features the powerful impact of our research automation technology in the case New Constructs: Disrupting Fundamental Analysis with Robo-Analysts.

New Constructs® - Research to Fulfill the Fiduciary Duty of Care

Ratings & screeners on 3000 stocks, 450 ETFs and 7000 mutual funds help you make prudent investment decisions.

New Constructs leverages the latest in machine learning to analyze structured and unstructured financial data with unrivaled speed and accuracy. The firm's forensic accounting experts work alongside engineers to develop proprietary NLP libraries and financial models. Our investment ratings are based on the best fundamental data in the business for stocks, ETFs and mutual funds. Clients include many of the top hedge funds, mutual funds and wealth management firms. David Trainer, the firm's CEO, is regularly featured in the media as a thought leader on the fiduciary duty of care, earnings quality, valuation and investment strategy.

To fulfill the Duty of Care, research should be:

1. **Comprehensive** - All relevant publicly-available (e.g. 10-Ks and 10-Qs) information has been diligently reviewed, including footnotes and the management discussion & analysis (MD&A).
2. **Un-conflicted** - Clients deserve unbiased research.
3. **Transparent** - Advisors should be able to show how the analysis was performed and the data behind it.
4. **Relevant** - Empirical evidence must provide tangible, quantifiable correlation to stock, ETF or mutual fund performance.

Value Investing 2.0: Diligence Matters: Technology is Key to Value Investing With Scale

Accounting data is only the beginning of fundamental research. It must be translated into economic earnings to truly understand profitability and valuation. This translation requires deep analysis of footnotes and the MD&A, a process that our robo-analyst technology empowers us to perform for thousands of stocks, ETFs and mutual funds.

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