New Accounting Rules Limit Transparency and Harm Investors

Check out this week's Danger Zone interview here and here with Chuck Jaffe of Money Life.

The focus of this report is on recent GAAP and SEC rule changes made in the name of reduced complexity and simplification, but we think are harmful to average investors.

The purpose of the Financial Accounting Standards Board (FASB) is to write and update Generally Accepted Accounting Principles (GAAP) or the rules that govern how publicly-traded companies report their financials. The role of the Securities and Exchange Commission (SEC) is to enforce those rules.

The integrity of the capital markets relies on the FASB and the SEC to do their jobs well. If FASB does not ensure that financial disclosures provide investors the information needed to make informed decisions or the SEC does not enforce compliance with GAAP's disclosure rules, investors lose.

During my tenure on FASB's Investor Advisory Committee, it was clear that companies often have more influence on FASB and the SEC than individuals because companies can consolidate more resources and present a more unified voice than investors. In addition, many of the potentially most influential investors prefer less informative financial disclosures because poorer disclosures further enhance their already-strong information advantages. The goal of this report is to raise awareness for both regulators and investors of how these recent changes in disclosures affect average investors.

With the SEC's Disclosure Update and Simplification (Release No. 33-10532; 34-83875; IC 33206; File No. S7-15-16) and FASB's Accounting Standards Update (ASU) 2017-12, these regulators reduce the disclosure requirements for companies and make it more difficult for investors to analyze the true financial health of publicly-traded companies. Investors unaware of these changes are in the Danger Zone.

Background on The Changes

Both the changes made by the SEC and the FASB are intended to reduce the cost of filing for reporting entities, FASB parlance for companies, by eliminating what the SEC considers redundant or unimportant disclosures. However, the changes eliminate two important disclosures – amortization of capitalized interest and hedge ineffectiveness – which investors need to accurately assess earnings and cash flow.

SEC Reduced Disclosure Amendment

Effective November 18, 2018, the SEC adopted amendments to disclosure requirements that "have become redundant, duplicative, overlapping, outdated, or superseded, in light of other Commission disclosure requirements, U.S GAAP, or changes in the information environment."

Through this amendment, the SEC eliminated the requirement that companies report the ratio of earnings to fixed charges exhibit. This exhibit contains a specific line item, amortization of capitalized interest, which is a non-operating expense included in operating earnings. We remove this expense when calculating after-tax operating profit (NOPAT) because it is related to the financing of a company's operations, not the operations themselves, to provide a more accurate measure of normal, recurring profits.

Most of the time, interest costs are immediately expensed and (for non-financial companies) reported as non-operating. However, in certain cases where debt is used to finance a long-term asset, accrued interest can be capitalized on the balance sheet and expensed as amortization over time. As a result, GAAP allows the cost of interest to be classified as an operating expense, despite the fact that it is really a financing cost.

The SEC specifically noted in its final rule that:

"Certain components commonly used in the ratio of earnings to fixed charges, such as the portion of lease expense that represents interest and the amortization of capitalized interest, are not readily available elsewhere."

Despite its acknowledgement that the exhibit contained material information not contained elsewhere, the SEC still decided to remove requirements to disclose this information.

ASU 2017-12

Effective for all public entities for fiscal years beginning December 15, 2018, ASU 2017-12 amended the hedge accounting recognition and presentation requirements. The stated goals of this change were to "provide users with a more complete picture of the effect of hedge accounting on an entity's income statement and balance sheet" and to "ease the operational burden of applying hedge accounting by allowing more time to prepare hedge documentation."

Through this amendment, firms are no longer required to separately measure and report hedge ineffectiveness. Hedge ineffectiveness is the degree to which a hedge fails to correlate with the underlying asset or forecasted transaction prices. For example, if a company hedged against falling commodity prices through a derivative contract, but then both the price of the commodity and the derivative fell, it would record a loss due to hedge ineffectiveness.

Hedge ineffectiveness was previously presented on the income statement in the period deemed ineffective. For non-financial companies, ineffectiveness is excluded from our calculation of NOPAT because it is a portion of the derivative contract that does not hedge the underlying asset and therefore serves no operating purpose. Accordingly, we classify ineffectiveness gains as non-operating income. If ineffectiveness is a loss, we still classify as a non-operating item, and we also classify as a write-down, which impacts reported assets and our calculation of invested capital.

The new amendment will cause significant reduction in the disclosure of hedge ineffectiveness. What would have been separately delineated as ineffectiveness will now be buried in other comprehensive income (OCI) until the entire hedge is recognized out of OCI and onto the income statement. When the hedge is re-classified from OCI into net earnings, it will be reported within the same line item as the hedged items, with no distinction between the ineffective and effective portion. This lack of delineation reduces transparency and analytical value of the financial statements.

As with the SEC's change above, this FASB amendment appears to prioritize reducing reporting entities' burdens over providing investors with valuable disclosures.

Impact of These Changes

Figure 1 shows the five companies with the largest amortization of capitalized interest adjustment overall, and the five with the largest value as a percent of NOPAT. With the removal of this disclosure, we will no longer be able to make this adjustment for the majority of firms going forward.

Figure 1: Biggest Amortization of Capitalized Interest Adjustments in 2018

Ticker	Name	Amortization of Capitalized Interest ($mm)	% of NOPAT	Risk/Reward Rating
Largest Adjustment ($ value)				
LEN	Lennar Corporation	$301	19%	Neutral
KBH	KB Home	$203	48%	Attractive
PHM	PulteGroup Inc.	$172	15%	Attractive
DHI	D.R. Horton, Inc.	$131	8%	Attractive
BA	The Boeing Company	$92	1%	Unattractive
Largest Adjustment as % of NOPAT				
KBH	KB Home	$203	48%	Attractive
MTH	Meritage Homes Corp	$75	29%	Neutral
TMHC	Taylor Morrison Home Corp	$82	27%	Neutral
MDC	MDC Holdings, Inc.	$65	26%	Neutral
LEN	Lennar Corporation	$301	19%	Neutral

Sources: New Constructs, LLC and company filings

These companies, while largely homebuilders, are hardly the only ones whose reported earnings are affected by amortization of capitalized interest. In the past three years, our analysts, leveraging our Robo-Analyst technology, identified 327 amortization of capitalized interest adjustments across 166 different companies. In these three years, amortization of capitalized interest adjustments totaled $8.2 billion.

Many of the companies in Figure 1 are homebuilders, and the amortization of capitalized interest charge is materially greater in this industry than in others. As such, homebuilders have historically disclosed these charges in a section separate from the exhibit eliminated by the SEC. While positive for transparency, we would still prefer the SEC require all companies to present important financial information. Instead, the SEC is choosing to leave it up to management teams, which history shows are not afraid to exploit GAAP to manipulate earnings.

Figure 2 shows the five companies with the largest hedge ineffectiveness NOPAT adjustment and the five with the largest value as a percent of NOPAT.

Figure 2: Biggest Hedge Ineffectiveness Adjustments Over Past Three Years

Ticker	Name	Hedge Ineffectiveness ($mm)	% of NOPAT	Risk/Reward Rating	Fiscal Year
Largest Adjustment ($ value)					
AMAT	Applied Materials	($19)	<1%	Neutral	2018
BTI	British American Tobacco	($10)	<1%	Attractive	2018
MMM	3M Company	($7)	<1%	Neutral	2017
CCK	Crown Holdings	($7)	1%	Neutral	2016
ADM	Archer Daniels Midland	($6)	<1%	Neutral	2016
Largest Adjustment as % of NOPAT					
NOV	National-Oilwell Varco	($2)	19%	Unattractive	2018
DK	Delek U.S. Holdings	($3)	4%	Neutral	2016
VOXX	VOXX International	$(0.2)	3%	Unattractive	2017
NTCT	NetScout Systems	($0.1)	2%	Unattractive	2016
TEX	Terex Corporation	($2)	2%	Unattractive	2017

Sources: New Constructs, LLC and company filings

In the past three years, we identified 50 NOPAT adjustments for hedge ineffectiveness across 34 companies. These adjustments totaled $182 million.

Figure 3 shows the five companies with the largest hedge ineffectiveness invested capital adjustment and the five with the largest value as a percent of invested capital. As can be seen, these adjustments are, on average, smaller than many of the other adjustments we make. However, in our experience, adjustments can go from immaterial to very material in any given reporting period.

Figure 3: Biggest Hedge Ineffectiveness Adjustments Over Past Three Years

Ticker	Name	Hedge Ineffectiveness ($mm)	% of Invested Capital	Risk/Reward Rating	Fiscal Year
Largest Adjustment ($ value)					
MSFT	Microsoft Corporation	$389	<1%	Neutral	2017
GOOGL	Alphabet, Inc.	$381	1%	Neutral	2016
MSFT	Microsoft Corporation	$354	1%	Neutral	2016
SNP	China Petroleum & Chemical	$288	<1%	Attractive	2018
GE	General Electric Company	$263	<1%	Unattractive	2016
Largest Adjustment as % of Invested Capital					
REG	Regency Centers Corp	$41	1%	Unattractive	2016
MSFT	Microsoft Corporation	$354	1%	Neutral	2016
GOOGL	Alphabet, Inc.	$381	1%	Neutral	2016
MSFT	Microsoft Corporation	$389	<1%	Neutral	2017
HRL	Hormel Foods Corp	$15	<1%	Neutral	2016

Sources: New Constructs, LLC and company filings

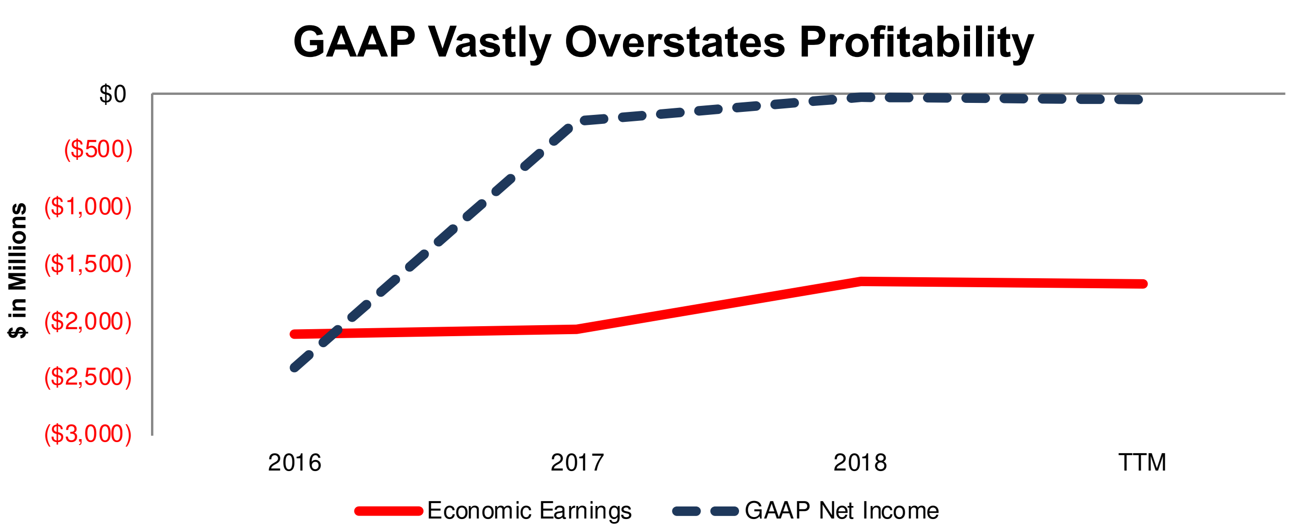
In the past three years, we identified 148 invested capital adjustments for hedge ineffectiveness losses as write-downs across 96 different companies. In these three years, hedge ineffectiveness adjustments totaled $2.8 billion.

One Risky Company to Avoid Today: National-Oilwell Varco (NOV: $22/share) – Unattractive Rating

National-Oilwell Varco (NOV) is one of the 34 companies with hedge ineffectiveness items hidden in operating earnings and has the largest adjustment as a percent of NOPAT. The $2 million adjustment is found on page 68 of NOV's 2018 10-K and represents 19% of NOV's 2018 NOPAT. By removing this gain, we can begin to calculate NOV's true profitability, which is not improving as fast as GAAP would indicate.

Since 2016, NOV's economic earnings, the true cash flows of the business, have improved, from -$2.1 billion to -$1.7 billion TTM, but remain highly negative. GAAP net income improved -$2.4 billion to -$40 million over the same time, per Figure 4.

Figure 4: NOV's GAAP Overstates Improvement in the Business



Sources: New Constructs, LLC and company filings

The disconnect between GAAP net income and economic earnings stems largely from 2016, when NOV recognized a nearly $1 billion write-down related to goodwill and intangible asset impairment. We remove this non-operating expense to calculate the true recurring profits of the business.

In 2018, the largest adjustment made to calculate NOV's NOPAT was $156 million in change in reserves. NOV decreased its inventory reserves from $800 million in 2017 to $644 million in 2018. We remove this "income" as it does not reflect the ongoing operations of the business, and is instead subject to management's discretion and in some cases, manipulation.

Despite the slight improvement noted above, NOV's profitability is not enough to create shareholder value. It's ROIC of 0% TTM is well below the firm's weighted average cost of capital of 7.3%. However, the expectations baked into the stock price imply significant value creation moving forward.

Shares Are Overvalued: We use our reverse DCF model to quantify the future cash flow expectations baked into the current stock price

To justify its current price of $22/share, NOV must achieve 7% NOPAT margins (average of past 10 years, compared to 0.2% TTM) and grow NOPAT by 76% compounded annually for the next eight years. See the math behind this dynamic DCF scenario. This scenario assumes a 6% compounded annual revenue growth rate, but due to the large increase in NOPAT margin, implied NOPAT growth is significantly higher. Keep in mind, NOV's 2018 NOPAT of $11 million was equal to its NOPAT in 1999, when the stock had a market cap of just $914 million compared to $8.6 billion today.

Even if NOV can achieve 4% NOPAT margins (half of its 10-year average but well above 0.2% TTM) and grow revenue by 6% compounded annually (which would equate to 48% NOPAT CAGR) for the next decade, the stock is worth just $7/share today – a 69% downside. See the math behind this dynamic DCF scenario.

Not the First Time Disclosure Requirements Harmed Investors

Unfortunately, this disclosure reduction is not the only instance of the SEC allowing reduction of disclosures valuable to investors. As recently as June 2018, the SEC proposed to raise a market cap limit on which firms are required to disclose the auditor's opinion on their internal controls for financial reporting. As we outlined in our report, "SEC Raises Risks for Small Cap Investors", this change would allow (at the time) an estimated 966 additional companies to avoid this important disclosure.

More Technology Not Less Disclosures Is the Answer

There's no question that the growing volume of financial disclosures can be overwhelming to the average investor. However, the answer to this problem is not to reduce disclosures, especially since the growing complexities of businesses require more granular disclosures than ever. The answer to this problem is to leverage more technology to parse and analyze financial filings and disclosures more efficiently. Regulators are already under enough pressure to fulfill their obligations with limited resources. Without more technological support, we understand how there might be a natural tendency to want to reduce the disclosures they are required to review.

There's no question that new technologies can aid regulators' enforcement and analytical responsibilities. These new technologies enable machines, such as the Robo-Analyst featured by Harvard Business School, to perform certain tasks so humans can focus on higher level problems.

For example, we use machine learning and natural language processing tools to flag amortization of capitalized interest, hedge ineffectiveness, or other red flags hidden in the footnotes. These tools could help regulators better leverage human resources and protect the integrity of the capital markets.

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Disclosure: David Trainer, Kyle Guske II, and Sam McBride receive no compensation to write about any specific stock, style, or theme.

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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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