Core Earnings Are More Reliable Than GAAP Earnings

This report is an abridged and free version of S&P 500 & Sectors: Core Earnings Vs. GAAP Earnings Through 3Q21, one of the reports in our quarterly series on fundamental market and sector trends, which is available to Pro and higher members. More free reports are available here.

The full version of the report analyzes the Core Earnings[1,2] and GAAP earnings of the S&P 500 and each of its sectors (last quarter's analysis is here).

These reports leverage more reliable fundamental data[3] that overcomes flaws with legacy fundamental datasets to provide a more informed view of the fundamentals and valuations of companies and sectors. Our Earnings Distortion research has been shown to generate a new source of alpha.

Learn more about the best fundamental research

Core Earnings Are More Reliable than GAAP Earnings

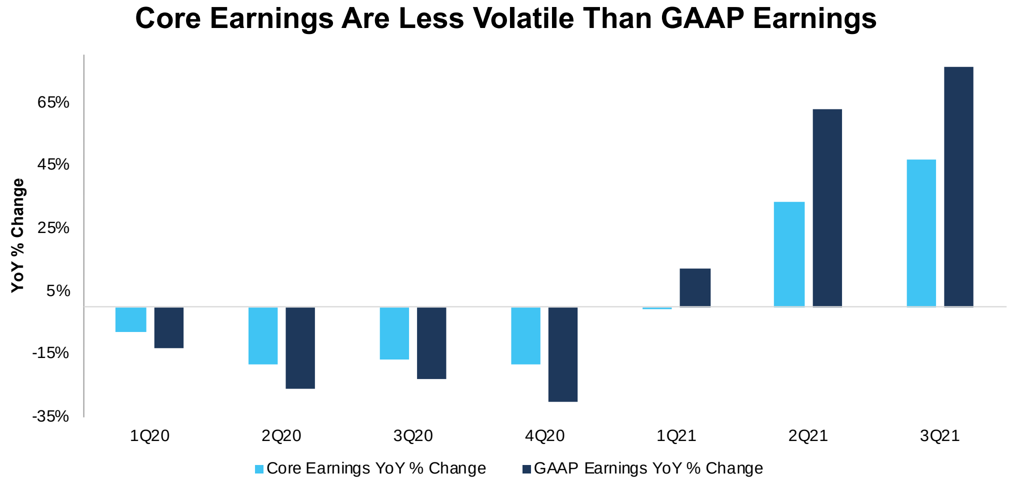
Corporate profits did not decline as much, nor has the rebound been as robust, as GAAP earnings led investors to believe over the last ~18 months.

Figure 1 shows Core Earnings, which adjust for unusual gains/losses, are less volatile than GAAP earnings. For instance:

- In 2021, GAAP earnings rose 81% through 3Q21 compared to a 46% rise for Core Earnings.
- In 2020, GAAP earnings fell 30% YoY compared to an 18% fall for Core Earnings.

At the end of 2020, Core Earnings of $1.1 trillion were 21% higher than GAAP earnings of $877 billion. Now, at $1.5 trillion, Core Earnings are 3% less than GAAP earnings of $1.6 trillion.

Figure 1: S&P 500 Core Earnings Vs. GAAP Earnings YoY Percent Change: 1Q20 – 3Q21



Sources: New Constructs, LLC and company filings.
Our Core Earnings analysis is based on aggregated TTM data for the sector constituents in each measurement period.
The November 16, 2021 measurement period incorporates the financial data from calendar 3Q21 10-Qs, as this is the earliest date for which all the calendar 3Q21 10-Qs for the S&P 500 constituents were available.

[1] Only Core Earnings enable investors to overcome the flaws in legacy fundamental data and research, as proven in Core Earnings: New Data & Evidence, written by professors at Harvard Business School (HBS) & MIT Sloan for The Journal of Financial Economics.
[2] The most recent Core Earnings and GAAP Earnings values are based on the latest audited financial data, which is the calendar 3Q21 10-Q for most companies.
[3] Three independent studies prove the superiority of our data, models, and ratings. Learn more here.

Key Details on Select S&P 500 Sectors

Within the S&P 500, all eleven sectors of the S&P 500 benefited from a year-over-year (YoY) rise in Core Earnings in 3Q21, widening the improvement from nine sectors in the second quarter.

The Energy sector saw the largest YoY percentage improvement in Core Earnings, which rose from $1.3 billion in 3Q20 to $34.5 billion in 3Q21.

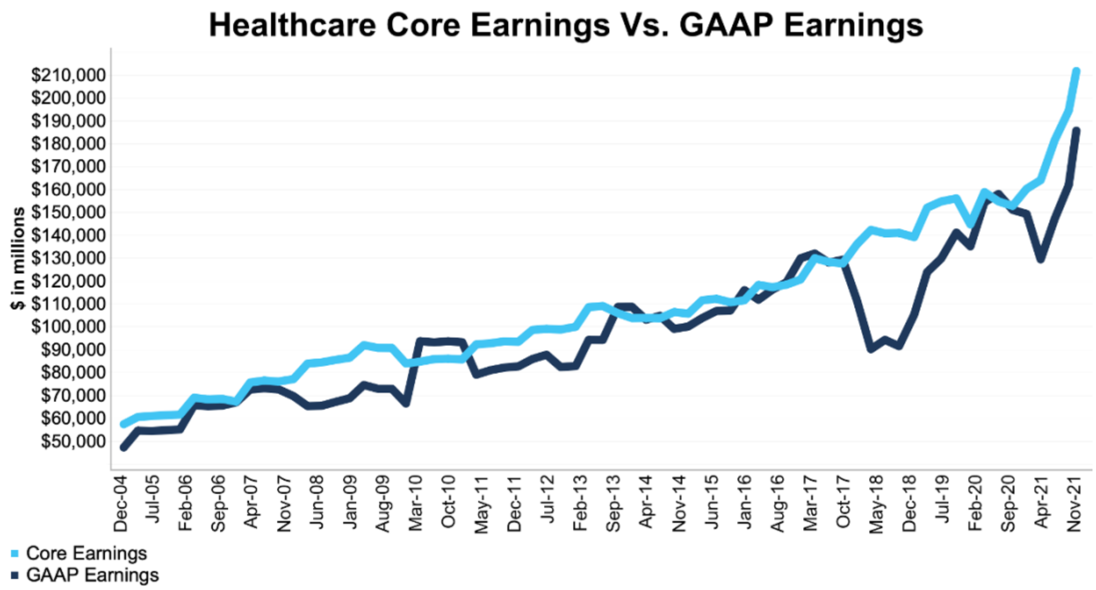
The Technology sector generates the most Core Earnings of any sector and grew Core Earnings by 44% YoY in 3Q21. On the flip side, the Real Estate sector has the lowest Core Earnings, and the Consumer Non-cyclicals sector had the weakest YoY growth in 3Q21.

Below we highlight the Healthcare sector and a stock with some of the most Earnings Distortion in the sector.

Sample Sector Analysis[4]: Healthcare Sector

Figure 2 shows Core Earnings for the Healthcare sector, at $211.8 billion, rose 32% YoY in 3Q21, while GAAP earnings, at $185.8 billion, rose 24% over the same time. The consistent rise in demand for healthcare helps drive continued Core Earnings growth over the years.

Figure 2: Healthcare Core Earnings Vs. GAAP: 2004 – 3Q21



Sources: New Constructs, LLC and company filings.
Our Core Earnings analysis is based on aggregated TTM data for the sector constituents in each measurement period.
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Core Earnings Distortion Details: AbbVie Inc. (ABBV)

Below, we detail the hidden and reported unusual items that aren't captured in GAAP Earnings but are captured in Core Earnings for AbbVie Inc., a stock with some of the most negative Earnings Distortion in the Healthcare sector. After adjusting for unusual items, we find that AbbVie's Core Earnings of $8.70/share are 107% greater than reported GAAP Earnings of $4.19/share. AbbVie's Earnings Distortion Score is Beat. Our stock rating for ABBV is Neutral.

Figure 3 details the differences between Core Earnings and GAAP Earnings so readers can audit our research.

[4] The full version of this report provides analysis for every sector like what we show for this sector.

Figure 3: AbbVie's GAAP Earnings to Core Earnings Reconciliation

	TTM ($ per share)
GAAP Net Income	**$4.19**
- Hidden Unusual Expenses, Net	($0.51)
- Reported Unusual Expenses Pre-Tax, Net	($4.68)
- Reported Unusual Expenses After-Tax, Net	($0.04)
- Tax Distortion	$0.72
Core Earnings	**$8.70**

Sources: New Constructs, LLC and company filings.

More details:

Hidden Unusual Expenses, Net = -$0.51/per share, which equals -$911 million and is comprised of:

- -$719 million in hidden restructuring expenses in the TTM based on
  - In 3Q21
    - -$2 million in severance and employee benefits recorded in cost of products sold
    - -$44 million in other integration charges recorded in cost of products sold
    - -$18 million in other integration charges recorded in R&D
    - -$88 million in other integration charges record in SG&A
  - In 2Q21
    - -$25 million in other integration charges recorded in cost of products sold
    - -$18 million in other integration charges recorded in R&D
    - -$12 million in severance and employee benefits recorded in SG&A
    - -$75 million in other integration charges record in SG&A
  - In 1Q21
    - -$6 million in severance and employee benefits recorded in cost of products sold
    - -$15 million in other integration charges recorded in cost of products sold
    - -$51 million in other integration charges recorded in R&D
    - -$17 million in severance and employee benefits recorded in SG&A
    - -$50 million in other integration charges record in SG&A
  - In 4Q20
    - -$27 million in severance and employee benefits recorded in cost of products sold
    - -$50 million in severance and employee benefits recorded in R&D
    - -$97 million in severance and employee benefits recorded in SG&A
    - -$5 million in other integration charges recorded in cost of products sold
    - -$44 million in other integration charges recorded in R&D
    - -$59 million in other integration charges record in SG&A
    - -$15 million in "Other restructuring" charges
- -$195 million in acquisition related expenses in the TTM based on -$781 million in acquisition related expense in 2020
- $3 million in amortization of prior service costs in the TTM based on
  - $1 million in 3Q21
  - $1 million in 1Q21
  - <$1 million in 4Q20

Reported Unusual Expenses Pre-Tax, Net = -$4.68/per share, which equals -$8.3 billion and is comprised of:

- -$6.9 billion in reported "other expense" in the TTM based on
  - -$21 million expense in 3Q21
  - -$2.7 billion expense in 2Q21
  - $395 million income in 1Q21
  - -$4.6 billion expense in 4Q20
- -$432 million in reported "other operating expense" in the TTM based on
  - -$500 million expense in 3Q21
  - $68 million gain in 2Q21

- -$857 million in acquired in-process R&D in the TTM based on
    - -$390 million in 3Q21
    - -$97 million in 2Q21
    - -$70 million in 1Q21
    - -$300 million in 4Q20
- $73 million contra adjustment for recurring pension costs. These recurring expenses are reported in non-recurring line items, so we add them back and exclude them from Earnings Distortion.
- -$52 million in foreign exchange loss in the TTM based on
    - -$12 million in 3Q21
    - -$14 million in 2Q21
    - -$9 million in 1Q21
    - -$17 million in 4Q20

Reported Unusual Expenses After-Tax, Net = -$0.04/per share, which equals -$73 million and is comprised of:

- -$73 million in earnings allocated to participating securities in the TTM based on
    - -$21 million in 3Q21
    - -$17 million in 2Q21
    - -$24 million in 1Q21
    - -$11 million in 4Q20

Tax Distortion = $0.72/per share, which equals $1.3 billion

- We remove the tax impact of unusual items on reported taxes when we calculate Core Earnings. It is important that taxes get adjusted so they are appropriate for adjusted pre-tax earnings.

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

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Appendix: Calculation Methodology

We derive the Core Earnings and GAAP Earnings metrics above by summing the Trailing Twelve Month individual S&P 500 constituent values for Core Earnings and GAAP Earnings in each sector for each measurement period. We call this approach the “Aggregate” methodology.

The Aggregate methodology provides a straightforward look at the entire sector, regardless of market cap or index weighting and matches how S&P Global (SPGI) calculates metrics for the S&P 500.

It's Official: We Offer the Best Fundamental Data in the World

Many firms claim their research is superior, but none of them can prove it with independent studies from highly-respected institutions as we can. Three different papers from both the public and private sectors show:

1. Legacy fundamental datasets suffer from significant inaccuracies, omissions and biases.
2. Only our "novel database" enables investors to overcome these flaws and apply reliable fundamental data in their research.
3. Our proprietary measures of Core Earnings and Earnings Distortion materially improve stock picking and forecasting of profits.

Best Fundamental Data in the World

Forthcoming in The Journal of Financial Economics, a top peer-reviewed journal, Core Earnings: New Data & Evidence proves our Robo-Analyst technology overcomes material shortcomings in legacy firms' data collection processes to provide superior fundamental data, earnings models, and research. More details.

Key quotes from the paper:

- "[New Constructs'] *Total Adjustments* differs significantly from the items identified and excluded from Compustat's adjusted earnings measures. For example… 50% to 70% of the variation in *Total Adjustments* is not explained by *S&P Global's (SPGI) Adjustments* individually." – pp. 14, 1st para.
- "A final source of differences [between New Constructs' and S&P Global's data] is due to data collection oversights…we identified cases where Compustat did not collect information relating to firms' income that is useful in assessing core earnings." – pp. 16, 2nd para.

Superior Models

A top accounting firm features the superiority of our ROIC, NOPAT and Invested Capital research to Capital IQ & Bloomberg's in Getting ROIC Right. See the Appendix for direct comparison details.

Key quotes from the paper:

- "…an accurate calculation of ROIC requires more diligence than often occurs in some of the common, off-the-shelf ROIC calculations. Only by scouring the footnotes and the MD&A [as New Constructs does] can investors get an accurate calculation of ROIC." – pp. 8, 5th para.
- "The majority of the difference…comes from New Constructs' machine learning approach, which leverages technology to calculate ROIC by applying accounting adjustments that may be buried deeply in the footnotes across thousands of companies." – pp. 4, 2nd para.

Superior Stock Ratings

Robo-Analysts' stock ratings outperform those from human analysts as shown in this paper from Indiana's Kelley School of Business. Bloomberg features the paper here.

Key quotes from the paper:

- "the portfolios formed following the buy recommendations of Robo-Analysts earn abnormal returns that are statistically and economically significant." – pp. 6, 3rd para.
- "Our results ultimately suggest that Robo-Analysts are a valuable, alternative information intermediary to traditional sell-side analysts." – pp. 20, 3rd para.

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We believe every investor deserves to know the whole truth about the profitability and valuation of any company they consider for investment. More details on our cutting-edge technology and how we use it are here.

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