S&P 500 & Sectors: Core Earnings Vs. GAAP Earnings Thru 2021

GAAP earnings ended 2021 highly overstated. Over the past two years, corporate profits did not decline as much, nor has the rebound been as robust, as GAAP earnings would lead investors to believe.

This report is an abridged version of S&P 500 & Sectors: Core Earnings Vs. GAAP Earnings Thru 2021, one of our quarterly series of reports on fundamental market and sector trends. The full version of the report analyzes Core Earnings[1,2] and GAAP earnings for the S&P 500 and each of its sectors (last quarter's analysis is here). These reports are available to those with a Pro or higher membership or can be purchased below.

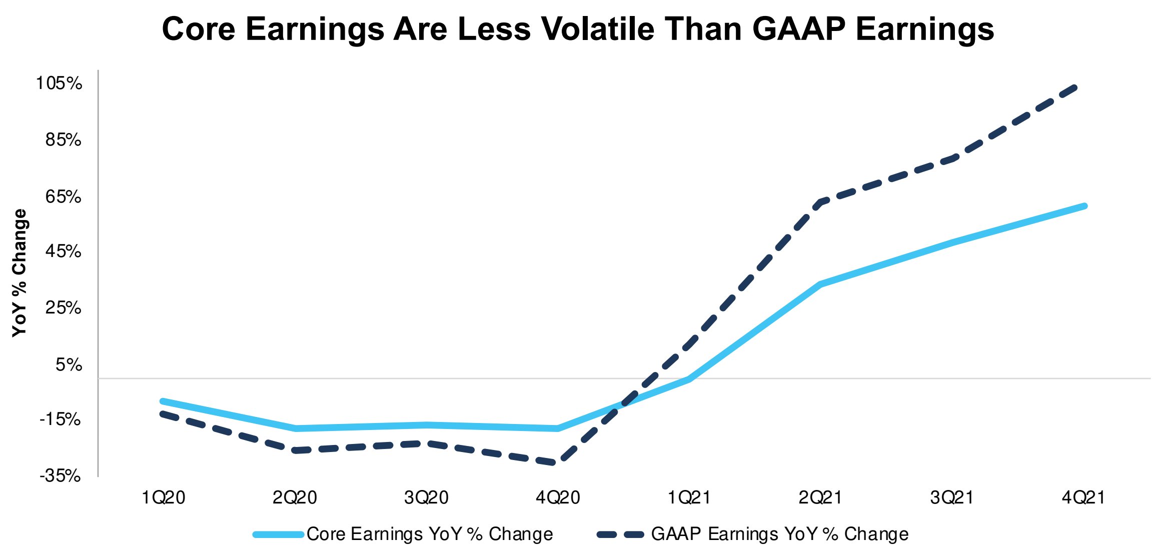
Generally Accepted Accounting Distortions

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

- In 2021, GAAP earnings rose 106% YoY compared to a 61% 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 the end of 2021, Core Earnings of $1.7 trillion are 5% less than GAAP earnings of $1.8 trillion.

Figure 1: S&P 500 Core Earnings Vs. GAAP Earnings YoY Percent Change: 1Q20 – 4Q21



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 March 11, 2022 measurement period incorporates the financial data from calendar 2021 10-K, as this is the earliest date for which all the calendar 2021 10-Ks for the S&P 500 constituents were available.

Our research leverages more reliable fundamental data[3] that overcomes flaws with legacy fundamental datasets to provide a more informed view of the fundamentals of companies and a new source of alpha.

[1] The Journal of Financial Economics features the superiority of our Core Earnings in Core Earnings: New Data & Evidence.
[2] Based on the latest audited financial data, which is the calendar 2021 10-K in most cases.
[3] Three independent studies prove the superiority of our data, models, and ratings. Learn more here.

2021 GAAP Earnings Widely Overstated[4]

For 219 companies in the S&P 500, forty-four percent, GAAP Earnings overstate Core Earnings for calendar year 2021. When GAAP Earnings overstate Core Earnings, they do so by an average of 34%, per Figure 2. The overstatement was more than ten percent of GAAP Earnings for nineteen percent of companies.

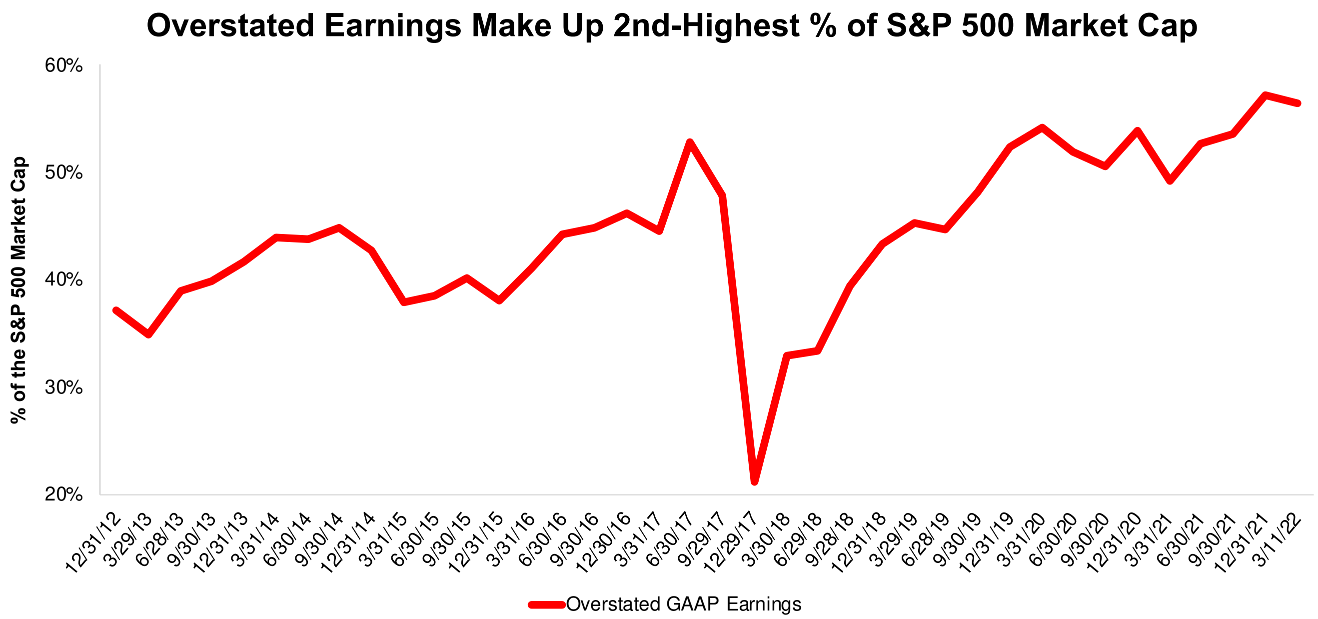
The 219 companies with overstated GAAP earnings make up 56% of the market cap of the S&P 500, which is the second highest percent since 2012 (earliest data available). See Figure 3.

Figure 2: S&P 500 GAAP Earnings Overstated by 34% On Average

Overstated GAAP Earnings	Overstated by >10%	Average Overstatement %
219 companies	95 companies	34%

Sources: New Constructs, LLC and company filings.
We use Funds from Operations (FFO) for Real Estate companies rather than GAAP Earnings.

Figure 3: Overstated Earnings as % of Market Cap: 2012 through 3/11/22



Sources: New Constructs, LLC and company filings.

Key Details on Select S&P 500 Sectors

All eleven sectors of the S&P 500 benefited from a year-over-year (YoY) rise in Core Earnings in 2021, equal to the number of sectors with YoY improvement in the TTM ended 3Q21.

The Energy sector saw the largest YoY improvement in Core Earnings, which rose from -$1.1 billion in 2020 to $84.3 billion in 2021.

The Technology sector generates the most Core Earnings of any sector and grew Core Earnings by 42% YoY in 2021. 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 2021.

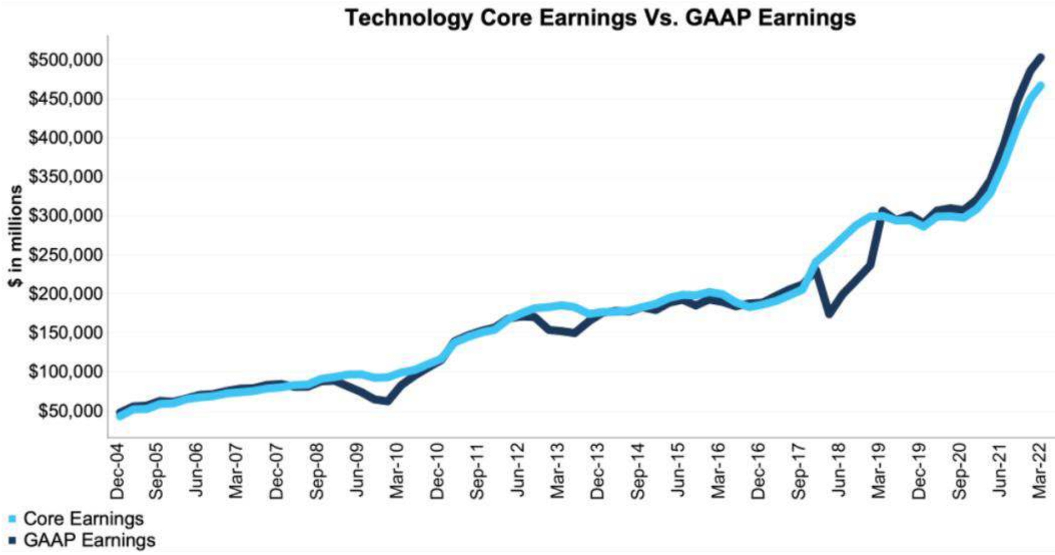
Below we highlight the Technology sector and a stock with some of the most Earnings Distortion (i.e. overstated GAAP earnings) in the sector.

[4] Overstated companies include all companies with Earnings Distortion >0.1% of GAAP earnings.

Sample Sector Analysis[5]: Technology Sector

Figure 4 shows Core Earnings for the Technology sector, at $466.9 billion, rose 42% YoY in 2021, while GAAP earnings, at $503.0 billion, rose 46% over the same time. Earnings power within the Technology sector is unevenly distributed. In 2021, five of the seventy-nine companies in the Technology sector – Apple (AAPL), Alphabet (GOOGL), Microsoft (MSFT), Facebook (FB), and Intel Corporation (INTC) - account for 62% of the sector's total Core Earnings.

Figure 4: Technology Core Earnings Vs. GAAP: 2004 – 2021



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 March 11, 2022 measurement period incorporates the financial data from calendar 2021 10-K, as this is the earliest date for which all the calendar 2021 10-Ks for the S&P 500 constituents were available.

GAAP Earnings Overstatement Details: eBay Inc. (EBAY)

Below, we detail the hidden and reported unusual items that GAAP Earnings misses but that are captured in Core Earnings for eBay Inc. (EBAY). The firm has the ignominious distinction of being the stock with the most Earnings Distortion, and therefore overstated GAAP Earnings in the S&P 500's Technology sector. After adjusting for unusual items, we find that eBay's Core Earnings of -$7.8 million, or -$0.01/share are much worse than reported GAAP Earnings of $13.6 billion, or $20.52/share. eBay Inc.'s Earnings Distortion Score is Strong Miss. Our stock rating for EBAY is Unattractive.

Below, we detail the differences between Core Earnings and GAAP Earnings so readers can audit our research.

Figure 5: eBay's GAAP Earnings to Core Earnings Reconciliation

	2021 ($ per share)
GAAP Net Income	**$20.52**
– Hidden Unusual Gains, Net	$0.48
– Reported Unusual Gains Pre-Tax, Net	$0.14
– Reported Unusual Gains After-Tax, Net	$20.14
– Tax Distortion	($0.23)
= Core Earnings	**($0.01)**

Sources: New Constructs, LLC and company filings.

[5] The full version of this report provides analysis for all eleven sectors.

More details:

Total Earnings Distortion of $20.54/share, which equals $13.6 billion, is comprised of the following:

Hidden Unusual Gains, Net = $0.48/per share, which equals $319 million and is comprised of

- $486 million in gains on an equity investment in KakaoBank – Page 61
- -$7 million pre-tax restructuring charge – Page 113
- -$160 million loss on impairment of equity investment in Paytm Mall – Page 61

Reported Unusual Gains Pre-Tax, Net = $0.14/per share, which equals $90 million and is comprised of

- $90 million in foreign exchange and other gains

Reported Unusual Gains After-Tax, Net = $20.14/per share, which equals $13.4 billion and is comprised of

- $13.4 billion in income from discontinued operations

Tax Distortion = -$0.23/per share, which equals -$149 million

This article originally published on March 30, 2022.

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

Follow us on Twitter, Facebook, LinkedIn, and StockTwits for real-time alerts on all our research.

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.

Our mission is to provide the best fundamental analysis of public and private businesses in the world and make it affordable for all investors, not just Wall Street insiders.

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.

DISCLOSURES

New Constructs®, LLC (together with any subsidiaries and/or affiliates, “New Constructs”) is an independent organization with no management ties to the companies it covers. None of the members of New Constructs’ management team or the management team of any New Constructs’ affiliate holds a seat on the Board of Directors of any of the companies New Constructs covers. New Constructs does not perform any investment or merchant banking functions and does not operate a trading desk.

New Constructs’ Stock Ownership Policy prevents any of its employees or managers from engaging in Insider Trading and restricts any trading whereby an employee may exploit inside information regarding our stock research. In addition, employees and managers of the company are bound by a code of ethics that restricts them from purchasing or selling a security that they know or should have known was under consideration for inclusion in a New Constructs report nor may they purchase or sell a security for the first two days after New Constructs issues a report on that security.

DISCLAIMERS

The information and opinions presented in this report are provided to you for information purposes only and are not to be used or considered as an offer or solicitation of an offer to buy or sell securities or other financial instruments. New Constructs has not taken any steps to ensure that the securities referred to in this report are suitable for any particular investor and nothing in this report constitutes investment, legal, accounting or tax advice. This report includes general information that does not take into account your individual circumstance, financial situation or needs, nor does it represent a personal recommendation to you. The investments or services contained or referred to in this report may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about any such investments or investment services.

Information and opinions presented in this report have been obtained or derived from sources believed by New Constructs to be reliable, but New Constructs makes no representation as to their accuracy, authority, usefulness, reliability, timeliness or completeness. New Constructs accepts no liability for loss arising from the use of the information presented in this report, and New Constructs makes no warranty as to results that may be obtained from the information presented in this report. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. Information and opinions contained in this report reflect a judgment at its original date of publication by New Constructs and are subject to change without notice. New Constructs may have issued, and may in the future issue, other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Those reports reflect the different assumptions, views and analytical methods of the analysts who prepared them and New Constructs is under no obligation to insure that such other reports are brought to the attention of any recipient of this report.

New Constructs’ reports are intended for distribution to its professional and institutional investor customers. Recipients who are not professionals or institutional investor customers of New Constructs should seek the advice of their independent financial advisor prior to making any investment decision or for any necessary explanation of its contents.

This report is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would be subject New Constructs to any registration or licensing requirement within such jurisdiction.

This report may provide the addresses of websites. Except to the extent to which the report refers to New Constructs own website material, New Constructs has not reviewed the linked site and takes no responsibility for the content therein. Such address or hyperlink (including addresses or hyperlinks to New Constructs own website material) is provided solely for your convenience and the information and content of the linked site do not in any way form part of this report. Accessing such websites or following such hyperlink through this report shall be at your own risk.