Accounting Standards Review: May 2022

This report gives investors the scoop on what's happening at the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) and how newly issued accounting standards updates (ASUs) affect fundamental research.

Each of these ASUs will affect how companies report financial information, and we detail the impact on our financial models below. Get more details on other recent ASUs, and their impact on our models, here.

ASU 2022-02 – Financial Instruments – Credit Losses (Topic 326)

This update addresses two problems brought up during the post implementation review of ASU 2016-13, Financial Instruments – Credit Losses (Topic 326).

The two key issues addressed in this update are:

1. Troubled Debt Restructurings (TDR) by Creditors
    a. ASU 2016-13 required entities to measure and record the lifetime expected credit losses on an asset upon origination or acquisition. As a result, credit losses from loans modified as TDRs have been incorporated into the allowance for credit losses. Additional designation of a loan modification as a TDR has since been deemed "unnecessarily complex." The new update eliminates the prior guidance for TDRs and now requires entities to apply loan refinancing and restructuring guidance to determine whether a modification results in a new loan or a continuation of an existing loan.
2. Vintage Disclosures – Gross Write-offs.
    a. A public business entity must now disclose current-period gross write-offs by year of origination for financing receivables and net investment in leases. This disclosure was not required under the old standard.

Companies who have already adopted 2016-03 will apply this new update prospectively and there will be no changes to our current model given that we accounted for this adjustment in the period when the company adopted the standard. Companies have an option to apply a modified retrospective transition method, which would result in a cumulative-effect adjustment to retained earnings in the period of adoption. If a company chooses the retrospective transition method, we will update our company model with this cumulative adjustment. Specifically, we will include the cumulative amount in a company's year-over-year change in Loss Reserves in the period the new standard is adopted, which will impact a company's net operating profit after-tax (NOPAT) in that same period.

The amendments in this update are effective for fiscal years beginning after December 15, 2022 and create no changes to our models, outside of those companies that choose to apply a modified retrospective transition.

ASU 2022-01 – Derivatives and Hedging (Topic 815): Fair Value Hedging

This update addresses questions that remained following the adoption of ASU 2017-12, Derivatives and Hedging (Topic 815), which aimed to improve hedge accounting to better portray the economic results of an entity's risk management activities. This update builds upon ASU 2017-12 and:

1. Expands the current last-of layer method to allow multiple hedged layers within a single closed portfolio. The "last-of-layer" method will now be renamed the "portfolio layer" method.
2. Expands the scope of the portfolio layer method to include non-prepayable financial assets.
3. Provides additional guidance on accounting for and disclosure of hedge basis adjustments under the new portfolio layer method.

4. Specifies how hedge basis adjustments should be considered when determining credit losses for the assets included in the closed portfolio.

These amendments for hedge accounting better reflect the effects of risk management activities in financial statements. The amendments in this update are effective for fiscal years beginning after December 15th, 2022 and create no changes to our models.

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

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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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