A Misleading ROIC Calculation Is Today's Filing Season Find

For March 6, our forensic accounting needle in a haystack comes from a restaurant that excludes nearly half of its invested capital from its ROIC calculation.

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Analyst Devyn Delange found an unusual item in Cheesecake Factory's (CAKE) 2018 10-K.

On page 5, CAKE discloses that it targets a company-level return on invested capital (ROIC) of 15%. We found this target interesting since our model shows CAKE has never earned a 15% ROIC. In fact, the company has only earned an ROIC above 10% in one year out of the past 20.

The divergence between CAKE's internal target and our own best-in-class numbers comes from the company's $703 million in off-balance sheet debt due to operating leases, which are disclosed on page 64. When accounted for, this off-balance sheet debt accounts for 46% of CAKE's invested capital in our calculation.

CAKE does not account for leases in its invested capital calculation, which explains why the company claims it earned a 14% ROIC in 2018 when our model shows it earned an 8% ROIC.

As we've written about before, companies will soon be required to account for operating leases on the balance sheet. When that new rule comes into effect, CAKE will have to make a choice: Either change its calculation to ignore lease assets on the balance sheet or admit that it is not as profitable as it has claimed.

We think more managers should focus on ROIC, but using the wrong numbers undermines much of the benefit of focusing on ROIC. Accordingly, managers (and boards of directors) should leverage independent 3rd-party experts, like us, to calculate and track ROIC for them and their peers.

The Power of the Robo-Analyst

We analyzed 54 10-K filings yesterday, from which our Robo-Analyst[1] technology collected 5,120 data points. Our analyst team used this data to make 938 forensic accounting adjustments with a dollar value of $313 billion. The adjustments were applied as follows:

- 378 income statement adjustments with a total value of $28 billion
- 392 balance sheet adjustments with a total value of $158 billion
- 168 valuation adjustments with a total value of $127 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, Devyn Delange, and Sam McBride receive no compensation to write about any specific stock, sector, style, or theme.

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

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

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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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