



The Real Earnings Season Starts Now: Time to Read the Footnotes

Quarterly earnings season may be winding down, but the real earnings season – annual 10-K filing season – is ramping up.

Quarterly earnings reports provide investors with limited and [often misleading](#) data. In “[Core Earnings: New Data and Evidence](#),” professors from Harvard Business School (HBS) and MIT Sloan empirically demonstrate that corporate managers manipulate earnings by burying gains & losses in footnotes. Only by reading all of the [financial footnotes](#) and MD&A, which are only in annual 10-K reports, can investors analyze true [core earnings](#).

This report highlights one firm that looks more profitable than its GAAP results indicate and demonstrates how GAAP net income growth doesn't lead to increased market cap.

Get the best fundamental research

Footnotes Help Us Find Undervalued Companies

After analyzing its 65 page 2019 10-K last week, Kimberly-Clark (KMB)¹ looks even more profitable than GAAP earnings suggest.

Here's why: the following [hidden](#) unusual expenses cause GAAP earnings to understate core earnings:

- [\\$235 million](#) in incremental depreciation – Page 33
- [\\$111 million](#) and [\\$96 million](#) in other exit costs – Page 33
- [\\$31 million](#) in charges for workforce reductions – Page 33

Each of these charges are related to KMB's 2018 Global Restructuring Program. In addition, we found the following [reported](#) non-operating expense:

- [\\$91 million](#) in nonoperating expense reported on the income statement – Page 24

The company reported \$2.2 billion in GAAP net income, but our adjustments show that they earned \$2.5 billion in net operating profit after-tax ([NOPAT](#)) and \$2.3 billion in core earnings in 2019. After uncovering these details, we upgraded KMB to a Very Attractive [rating](#) due to its improved profitability and undervalued stock price.

All the media buzz during “earnings” season tends to push investors into shortsighted trades. We help long-term investors create a durable competitive advantage by reading thousands of 10-Ks so they can invest with the level of diligence they've always wanted but could not get without the help of our new [Robo-Analyst technology](#).

GAAP Earnings Don't Affect Valuation – In the Long Term

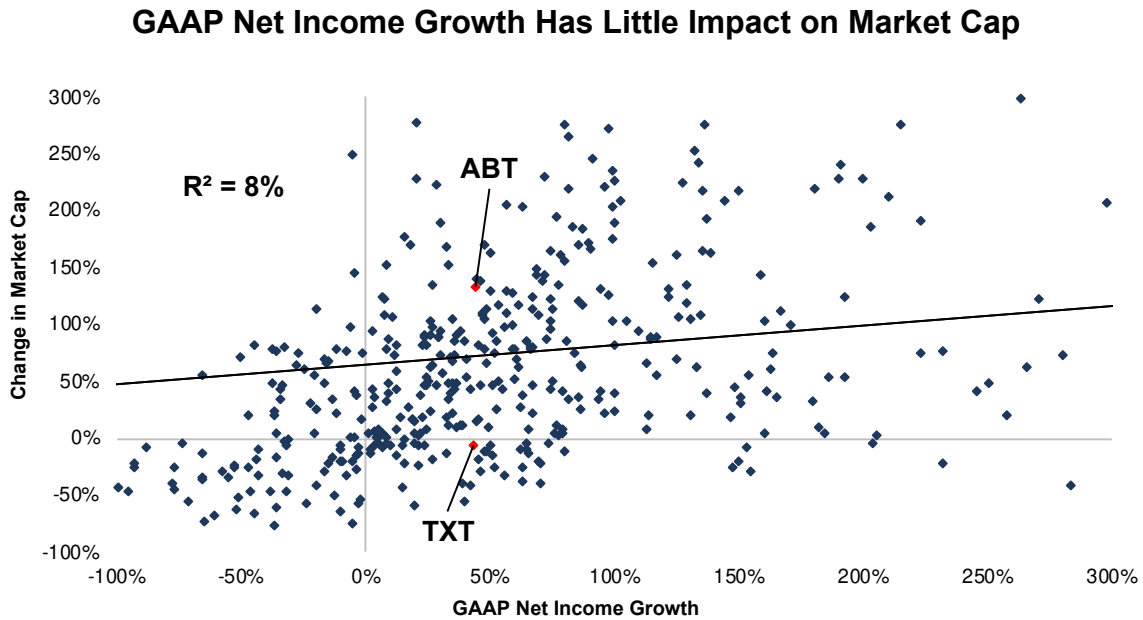
Figure 1 shows that GAAP net income growth since 2014 has almost no impact on the change in market cap for companies in the S&P 500 since 2014.²

¹ Kimberly-Clark (KMB) was originally featured as a Long Idea in [November 2017](#) (+27% vs. S&P 500 up 30%).

² Figure 1 excludes companies for which we don't have data going back five years or whose GAAP net income five years prior is negative. After these exclusions, the regression analysis contains 467 companies.



Figure 1: GAAP Net Income Growth and Change in Market Cap Since 2014

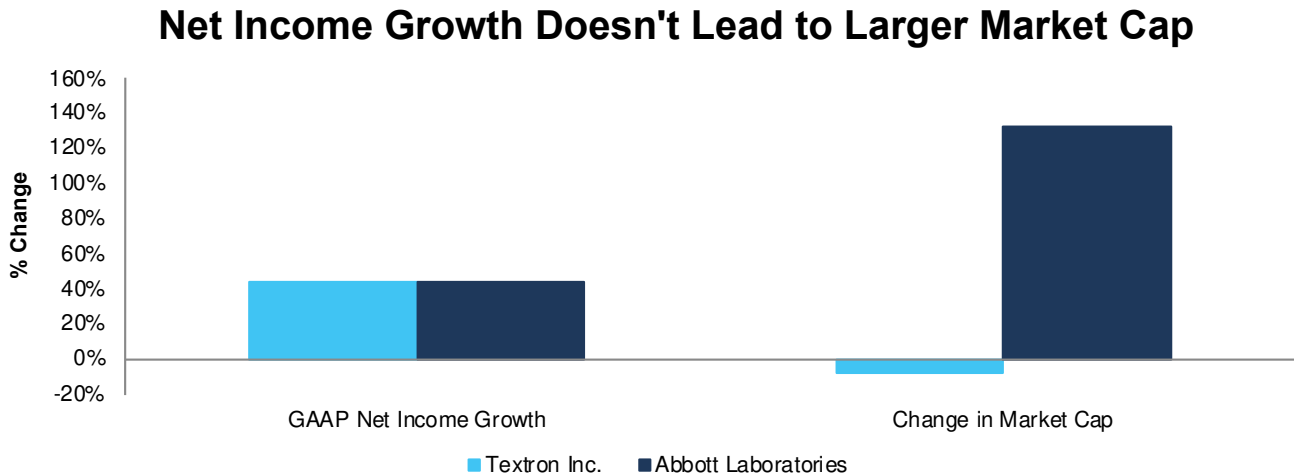


Sources: New Constructs, LLC and company filings.

Finding Truth in the Footnotes: ABT vs TXT

Note that Abbott Laboratories (ABT) and former Danger Zone pick [Textron Inc.](#) (TXT) have each grown GAAP net income by 44% since 2014. However, ABT's market cap has more than doubled while TXT's has fallen by 8%, per Figure 2.

Figure 2: ABT & TXT's GAAP Net Income Growth Vs. Change in Market Cap Since 2014



Sources: New Constructs, LLC and company filings.

[Non-operating income](#) and [expenses](#) included in operating earnings distort both firms' GAAP earnings growth. For instance, ABT's 2018 GAAP net income understated the true profitability of the firm due to:

1. \$111 million in net hidden non-operating expense
 - a. Includes items found only in the footnotes such as [\\$37 million](#) in restructuring charges recorded in SG&A and [\\$32 million](#) in amortization charges related to inventory step-ups



- 2. \$777 million in net reported non-operating expense included in operating earnings

Over the trailing twelve months (TTM), we identified \$27 million in net hidden non-operating expense and \$524 million in net reported non-operating expense that cause ABT’s GAAP earnings to understate NOPAT.

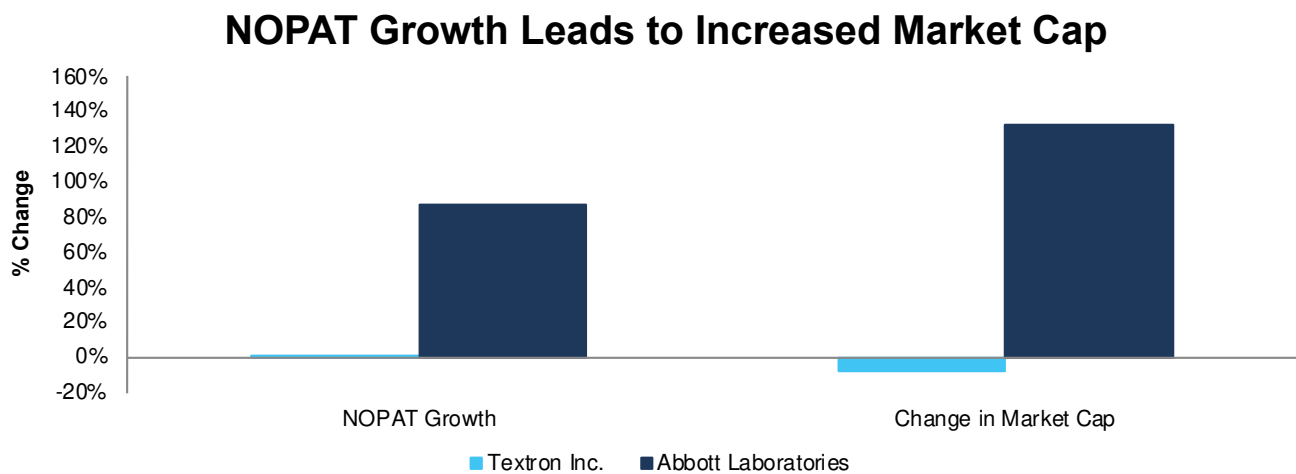
On the other hand, Textron’s 2018 GAAP net income overstated its true profitability due to:

- 1. [\\$15 million](#) in net hidden non-operating income related to [prior service cost \(credit\)](#)
- 2. [\\$444 million](#) in reported non-operating income related to the sale of a business segment

Over the trailing twelve months, we identified \$15 million in net hidden non-operating income and \$26 million in net reported non-operating income that cause TXT’s GAAP earnings to overstate NOPAT.

When we strip out accounting distortions, ABT’s NOPAT has grown by 87% since 2014 while TXT’s NOPAT is flat over the same time, per Figure 3.

Figure 3: ABT & TXT’s NOPAT Growth Vs. Change in Market Cap Since 2014



Sources: New Constructs, LLC and company filings.

Cash is a fact. Earnings are an opinion. Investors who base their investment decisions on accounting earnings put their portfolios at risk. Advisors who make investment recommendations without performing proper due diligence are not fulfilling their [fiduciary responsibilities](#).

Leveraging Machine Learning to Provide Footnotes Diligence at Scale

ROIC is much better than GAAP earnings at [explaining changes in valuation](#). Unfortunately for investors, it is [very difficult to calculate accurately](#). It’s not enough to read financial statements. A rigorous calculation of ROIC must account for items that are buried in hundreds of pages of footnotes.

For a human analyst, performing this level of analysis on just a handful of companies is a daunting task. Applying that level of rigor to thousands of companies is downright impossible – until now. The professors of the HBS & MIT Sloan paper mentioned earlier said of our database of footnotes adjustments:

“To our knowledge, this is the most comprehensive dataset that captures what a fundamental analyst would be likely to identify as transitory or non-operating earnings items in detailed analyses of firms’ 10- Ks.” Pp. 9-10

We use machine learning and natural language processing to automate the analysis of corporate filings. Our statistical comparison engine, which has been trained on over 120,000 human-verified filings and grows more sophisticated every day, can filter through SEC filings to recognize and tag important data, automatically building company models.

Of course, human analysts remain a vital part of the process. From mid-February through the end of March, our expert team of analysts will be coming in early and staying late to validate the data and models built by the machine and interpret unusual items that cannot be automatically processed.



This combination of computerized processing power and human expertise allows us to provide investors with the most accurate research from the “real” earnings season. Harvard Business School featured the powerful impact of our [Robo-Analyst technology](#) in the case study “[New Constructs: Disrupting Fundamental Analysis with Robo-Analysts](#).” This [paper](#) compares our analytics on a mega cap company to Bloomberg and Capital IQ (SPGI) in a detailed appendix.

Best of all, our partnerships with [TD Ameritrade](#), [E*TRADE](#), [Refinitiv/Thomson Reuters](#), [Interactive Brokers](#) and [EY](#) enable us to deliver our investment ratings and research on over 10,000 stocks, ETFs and mutual funds to millions of self-directed investors, financial advisors, and corporate executives.

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Footnotes adjustments matter. We are the ONLY source.

We provide ratings, models, reports & screeners on U.S. 3,000 stocks, 700 ETFs and 7,000 mutual funds.

HBS & MIT Sloan research reveals that:

- **Markets are inefficiently assessing earnings because no one reads the footnotes.**
- **Corporate managers hide gains/losses in footnotes to manage earnings.**
- **Our technology brings the material footnotes data to market for the first time ever.**

Combining human expertise with NLP/ML/AI technologies ([featured by Harvard Business School](#)), we shine a light in the dark corners (e.g. footnotes) of hundreds of thousands of financial filings to unearth critical details.

The HBS & MIT Sloan paper, [Core Earnings: New Data and Evidence](#), shows how our superior data drives uniquely comprehensive and independent debt and equity research.

This [paper](#) compares our analytics on a mega cap company to other major providers. The Appendix details exactly how we stack up.

Learn [more](#).

Quotes from HBS & MIT Sloan professors on our research:

Get better research:

“...the NC dataset provides a novel opportunity to study the properties of non-operating items disclosed in 10-Ks, and to examine the extent to which the market impounds their implications.” – page 20

Pick better stocks:

“Trading strategies that exploit cross-sectional differences in firms’ transitory earnings produce abnormal returns of 7-to-10% per year.” – Abstract

Avoid losses from using other firms’ data:

“...many of the income-statement-relevant quantitative disclosures collected by NC do not appear to be easily identifiable in Compustat...” – page 14

Build better models:

“Core Earnings [calculated using New Constructs’ novel dataset] provides predictive power for various measures of one-year-ahead performance...that is incremental to their current-period counterparts.” – page 4

Exploit market inefficiencies:

“These results ... suggest that the adjustments made by analysts and Compustat to better capture core earnings are incomplete. Moreover, the non-core items identified by NC produce a measure of core earnings that is incremental to alternative measures of operating performance in predicting an array of future income measures.” – page 26

Fulfill fiduciary duties:

“An appropriate measure of accounting performance for purposes of forecasting future performance requires detailed analysis of all quantitative performance disclosures detailed in the annual report, including those reported only in the footnotes and in the MD&A.” – page 33-34



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