Special Charges Distorting Profitability Are Today's Filing Season Find

For March 4, 2020, our forensic accounting needle in a haystack comes from special charges hidden in operating earnings of a pizza restaurant operator and franchisor.

Analyst Robbie Woodward found unusual items in Papa John's International's (PZZA) 2019 10-K.

On Page 100, PZZA discloses $41.3 million in special charges hidden in PZZA's General and administrative expenses. These charges include:

- $27.5 million of marketing fund investments
- $5.9 million of legal and advisory fees related to Starboard Value's investment into the company
- $5.6 million of a one-time mark-to-market adjustment related to Starboard's exercise of an option to purchase additional preferred stock
- $2.4 million of severance costs for PZZA's former CEO and the termination of a license agreement

After adjusting for all reported and hidden unusual items, we find that PZZA's 2019 core earnings[1] of $19 million reveal a much different picture of the firm's profitability than its GAAP net income of -$8 million.

PZZA's understated earnings earn the stock our "Beat" Earnings Distortion Score (as featured on CNBC Squawk Box), which means PZZA is more likely to beat consensus expectations. Despite its likelihood to beat earnings in the short-term, PZZA earns an Unattractive Risk/Reward rating, which focuses on the long-term, primarily due to its expensive stock price.

The Power of the Robo-Analyst

We have analyzed 364 10-K and 10-Q filings since February 27, 2020, from which our Robo-Analyst[2] technology collected 41,596 data points. Our analyst team made 8,550 forensic accounting adjustments with a dollar value of $3.7 trillion. The adjustments were applied as follows:

- 3,436 income statement adjustments with a total value of $226 billion
- 3,609 balance sheet adjustments with a total value of $1.5 trillion
- 1,505 valuation adjustments with a total value of $1.9 trillion

No Substitute for Diligence

Our technology enables us to deliver diligence on fundamentals at a previously impossible scale. We believe this research is necessary to uncover the true profitability of a firm and make sound investment decisions. "Core Earnings: New Data and Evidence," a recent paper from professors at Harvard Business School and MIT Sloan, shows how our adjustments create a measure of core earnings that is more predictive of future earnings than comparable metrics from Compustat and IBES.

Only by reading through the footnotes and making adjustments to reverse accounting distortions can investors and advisors alike get beyond the noise and get the truth about earnings and valuation.

This article originally published on March 4, 2020.

[1] In Core Earnings: New Data & Evidence, professors at Harvard Business School (HBS) & MIT Sloan empirically show that our measure of "core earnings" is superior to "Street Earnings" from Refinitiv's IBES, owned by Blackstone (BX) and Thomson Reuters (TRI), and "Income Before Special Items" from Compustat, owned by S&P Global (SPGI).

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

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

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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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