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**DILIGENCE PAYS** 9/17/20

# Kitchen-Sink Effect In the Spotlight

Record write-downs in 2020 created a huge "kitchen-sink effect" for the S&P 500, and this report highlights a company exploiting COVID, as so many companies do, to manage earnings.

**Learn more about the best fundamental research**

This reports provides a specific company example of how our cutting-edge technology sees through these accounting tricks and provides our clients with a cleaner and more comprehensive measure of core earnings[1].

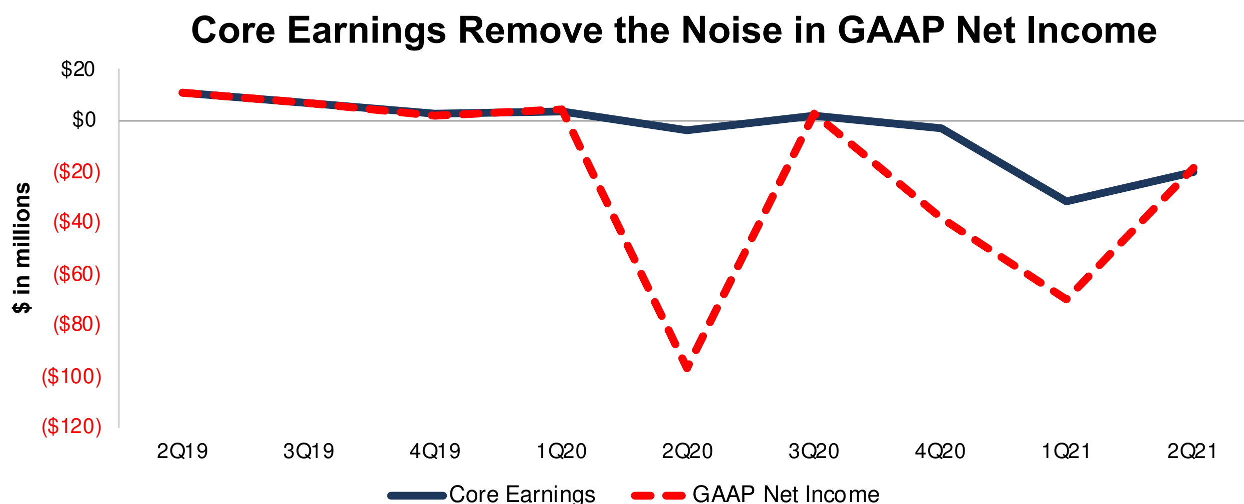
Analyst Hunter Anderson found an unusual reported and hidden write-down treatment in J. Jill's (JILL) 1Q and 2Q 10-Q's, which resulted in an accounting gain.

**J. Jill's Kitchen-Sink Quarter's Effect on Fundamentals**

In fiscal 1Q21, the kitchen-sink quarter, J. Jill reported a GAAP net loss of -$70 million, in large part due to multiple write-downs related to the COVID-19 pandemic. We remove write-downs in our calculation of core earnings, which reveals J. Jill's core earnings were -$32 million in fiscal 2Q21. A similar disconnect between GAAP net income and core earnings occurred in fiscal 2Q20 when J. Jill recorded large goodwill and intangible asset impairments.

Figure 1 illustrates the volatile nature of GAAP net income compared core earnings, and the sharp increase in GAAP net income post the kitchen-sink quarter.

**Figure 1: J. Jill's Core Earnings Vs. GAAP Net Income: Fiscal 2Q19 – 2Q21**




Sources: New Constructs, LLC and company filings.

The disconnect in earnings in 1Q21 stems from multiple write-downs, including:

- $27 million impairment of long-lived assets
- $18 million impairment of goodwill
- $7 million impairment of intangible assets

[1] Our core earnings are a superior measure of profits, as demonstrated in Core Earnings: New Data & Evidence a paper by professors at Harvard Business School (HBS) & MIT Sloan. The paper empirically shows that our data is superior to "Operating Income After Depreciation" and "Income Before Special Items" from Compustat, owned by S&P Global (SPGI).



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The recipient of this report is directed to read these disclosures.

These write-downs, which total $52 million (9% of total assets in 2Q20), also reduce the carrying value of assets on the balance sheet and can improve traditional financial ratios, a flaw we highlighted in Don't Get Misled by Return on Equity. We include write-downs in our calculation of invested capital, the denominator in our return on invested capital (ROIC) calculation, to hold management accountable for capital stewardship.

**Kitchen Sinking Helps Boost the Income Statement in the Following Quarter**

In J. Jill's fiscal 2Q21 (period ended August 1, 2020), J. Jill recorded a $1.3 million gain on its operating lease liabilities due to its decision to close certain retail stores.

- $0.9 million of this gain related to leases included in the write-downs in fiscal 1Q21
- $0.4 million related to the adjustment to the right-of-use asset and operating lease lability of leases not previously impaired and was hidden in selling, general, and administrative expenses.

By writing down assets in one quarter, and thereby reducing the carrying value, the firm can more easily book an accounting gain in subsequent quarters. Furthermore, without diligent review of footnotes, investors would be none the wiser to the $0.4 million benefit that artificially reduced SG&A expenses.

**No Substitute for Diligence**

The risk of owning JILL may be well known by most investors, given the firm's auditor, PricewaterhouseCoopers, issued a going concern opinion in the fiscal 2020 10-K, but the unusual items hidden in filings are not. While the impact on overall net income is minimal, J. Jill reported a GAAP net loss of $19 million in 2Q20, we adjust for all unusual items on the income statement and balance sheet. Without doing so, you'll never know when an adjustment will materially impact a firm's true fundamentals, and in turn, its valuation.

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.

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*Disclosure: David Trainer, Hunter Anderson, 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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