Decoding Complex Footnotes to Get Ford's True Earnings

Check out this week's Danger Zone interview with Chuck Jaffe of Money Life.

This report details how we handle the very complex disclosure of unusual items from Ford's (F: $7/share) 2006 10-K and underscores the importance of rigorous analysis of footnotes to understanding true core earnings.

We chose these disclosures because the authors of Core Earnings: New Data and Evidence recently asked us about them as part of preparing to submit the paper to a peer-reviewed journal. Specifically, they wanted details about the location of the unusual items in the filings because S&P Global (SPGI) was unable to provide the location of these unusual items in any of its datasets.

This report highlights the advantages and expertise of our Robo-Analyst, which enables us to find non-recurring items like the ones featured in this report, across thousands of companies in a matter of seconds. Investors using legacy data providers, or worse yet, using only reported numbers, in their fundamental analysis are in the Danger Zone this week.

While this example is from 2006, we scale this diligence across ~2,900 actively traded stocks with historical data going back to 1998. During this year's filing season (February 17-March 31) alone, our Robo-Analyst parsed and analyzed 2,522 10-Ks and 10-Qs and collected over 254,000 data points. Our analyst team used this data to make 40,617 core earnings and balance sheet adjustments with a dollar value of $19 trillion.

Impact of Unusual Items: Net $4.9 Billion Impact on Reported Results

In 2006, Ford's earnings distortion, or the unusual gains/losses that must be stripped out to calculate true core earnings totaled -$4.9 billion (3% of revenue) in 2006, or -$2.61/share. Ford's true core earnings in 2006 were -$4.10/share compared to -$6.72/share in reported GAAP EPS.

Below is our core earnings to GAAP net income reconciliation, which we provide for all stocks under coverage.

Core Earnings: -$7,705

+ Earnings Distortion from Hidden Total Restructuring Expenses, Net: **-$8,698**
+ Earnings Distortion from Hidden Legal, Regulatory, and Insurance Related Expenses, Net: **$110**
+ Earnings Distortion from Hidden Derivative Related Expenses, Net: **$43**
+ Earnings Distortion from Hidden Non-Recurring Pension Expenses, Net: **$815**
+ Earnings Distortion from Reported Other Financing Expenses, Net: **$1,478**
+ Income Tax Distortion: **$1,612**
+ Earnings Distortion from Reported Loss/(Gain) from Discontinued Operations After-tax, Net: **$2**

= **GAAP Net Income: -$12,613**

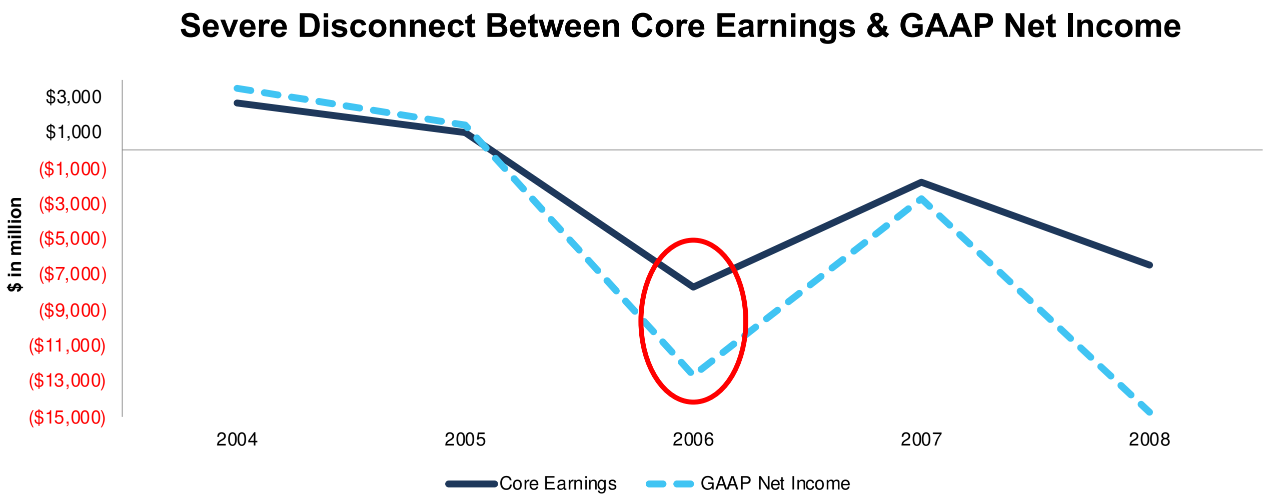
Why Footnotes Matter: $8 Billion in Hidden Unusual Items

We know from Operating Lease Disclosures: Best & Worst Practices, that companies do not always comply with FASB standards or disclose financial data in a consistent manner.

Investors looking only at reported GAAP net income would be led to believe that Ford's 2006 results were significantly worse than the true recurring profits of the business. As noted above, and shown in Figure 1, Ford reported GAAP net income of -$12.6 billion in 2006, which included multiple write-downs in what could be described as a "kitchen-sink year."

In the same year, core earnings, while still negative, were just -$7.7 billion. Earnings distortion from hidden items alone totaled -$8 billion, or -$4.26/share.

Figure 1: Ford's Core Earnings Vs. GAAP Net Income: 2004-2008



Sources: New Constructs, LLC and company filings

Discerning Duplicate Disclosures in MD&A and Footnotes

In many cases, companies bury unusual and non-operating items that impact reported profits in both the management discussion & analysis (MD&A) and footnotes, thereby making it more difficult for analysts to figure out which charges should affect earnings. Ford discloses many unusual items, i.e. "special items," in a table on page 41 of its 2006 10-K, in the MD&A.

This table, seen in Figure 2, provides a list of the items included in "Income/(loss) before income taxes" that Ford does not consider indicative of the ongoing operations of the business. Highlighted in Figure 2 are ten non-operating items that must be analyzed in more detail and accounted for to calculate Ford's core earnings.

Figure 2: Ford's "Special Items" Table on Page 41 of 2006 10-K

Included in *Income/(loss) before income taxes* are items we do not consider indicative of our ongoing operating activities ("special items"). The following table details 2006, 2005, and 2004 special items by segment or business unit (in millions):

	2006	2005	2004
Automotive Sector			
Ford North America			
Jobs Bank Benefits and personnel-reduction programs (a)	$ (4,760)	$ (401)	$ —
Pension curtailment charges	(2,741)	—	—
Fixed asset impairment charges	(2,200)	—	—
U.S. plant idlings (primarily fixed-asset write-offs)	(281)	—	—
Visteon-related charges (primarily valuation allowance against employee-related receivables) (b)	—	(468)	(600)
Fuel-cell technology charges	—	(116)	(182)
Divestiture of non-core business (Beanstalk Group, LLC)	—	(59)	—
Changes in state non-income tax law	—	85	—
Total Ford North America	(9,982)	(959)	(782)
Ford South America			
Legal settlement relating to social welfare tax liability	110	—	—
Ford Europe			
Personnel-reduction programs	(84)	(510)	(49)
Premier Automotive Group ("PAG")			
Jaguar and Land Rover fixed asset impairment charges	(1,600)	(1,300)	—
Personnel-reduction programs/Other	(378)	(245)	(110)
Ford Asia Pacific and Africa/Mazda			
Personnel-reduction programs	(103)	(33)	—
Mazda pension transfer	115	—	—
Divestiture of non-core business (certain Australia dealerships)	—	14	(81)
Other Automotive			
Divestiture of non-core businesses (primarily related to Kwik-Fit Group Limited)	—	152	17
Total Automotive Sector	(11,922)	(2,881)	(1,005)
Financial Services Sector			
Divestiture of non-core business (The Hertz Corporation ("Hertz"))	—	1,499	—
Property clean-up settlement	—	—	45
Total	$ (11,922)	$ (1,382)	$ (960)

Sources: New Constructs, LLC and company filings

Three of the unusual items are found only within this table, as detailed below:

1. $4.8 billion non-operating expense related to Jobs Bank Benefits and personnel-reduction programs
2. $281 million in asset write-downs related to U.S. plant idlings
3. $110 million in non-operating income related to a legal settlement relating to social welfare tax liability

These non-operating items increased GAAP net losses by $4.9 billion, or $2.63/share.

Footnotes Provide Necessary Context When Building Our Valuation Models

The seven other non-operating items in Figure 2 are missing key context needed to discern their impact on NOPAT and invested capital and ensure we are not double-counting any items. We have to go to the footnotes to get the necessary context.

Below, we'll detail where we found each of these items and how we adjust for them to calculate core earnings.

- **Pension curtailment charges of $2.741 billion**

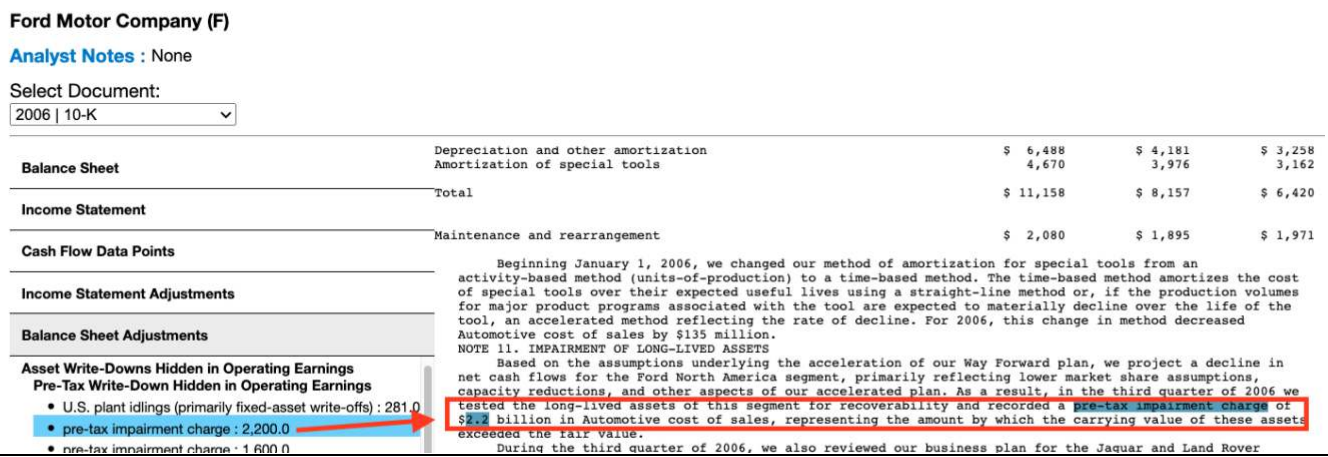
We determined this charge is already included within "interest income and other non-operating income/(expense), net" reported on the income statement. During 2006, companies could report pension curtailment charges within either operating or non-operating items, so the disclosure is very inconsistent between companies.

When making any adjustment, we first try to find specific disclosures in the financial statements before analyzing the MD&A and footnotes. When there is no additional information to be found in the MD&A or footnotes, as in this case, we have to make a judgment call as to whether this item is captured in an operating or non-operating item on the income statement. In this situation, we assume this item is bundled in a non-operating item on the income statement for two reasons: (1) the non-operating item on the income statement increased by an amount close to the pension curtailment charge over the prior period and (2) counting this non-recurring pension charge as hidden in another operating item, e.g. SG&A, causes an unusually large change in the operating line item. In other words, our model shows us that including the charge in the non-operating income statement item results in a more normal trend in the values of non-operating and operating items on the income statement.

- **Fixed asset impairment charges of $2.2 billion**

Critical context for this asset impairment charge is found on page FS-21 (page 103 overall). The charge, equal to $1.17/share, was recorded in Automotive cost of sales and represented the amount by which the carrying value of the assets exceeded the fair value. We remove this non-operating expense from COGS.

Figure 3: $2.2 Billion Fixed Asset Impairment Charge: Page FS-21 of Ford's 2006 10-K

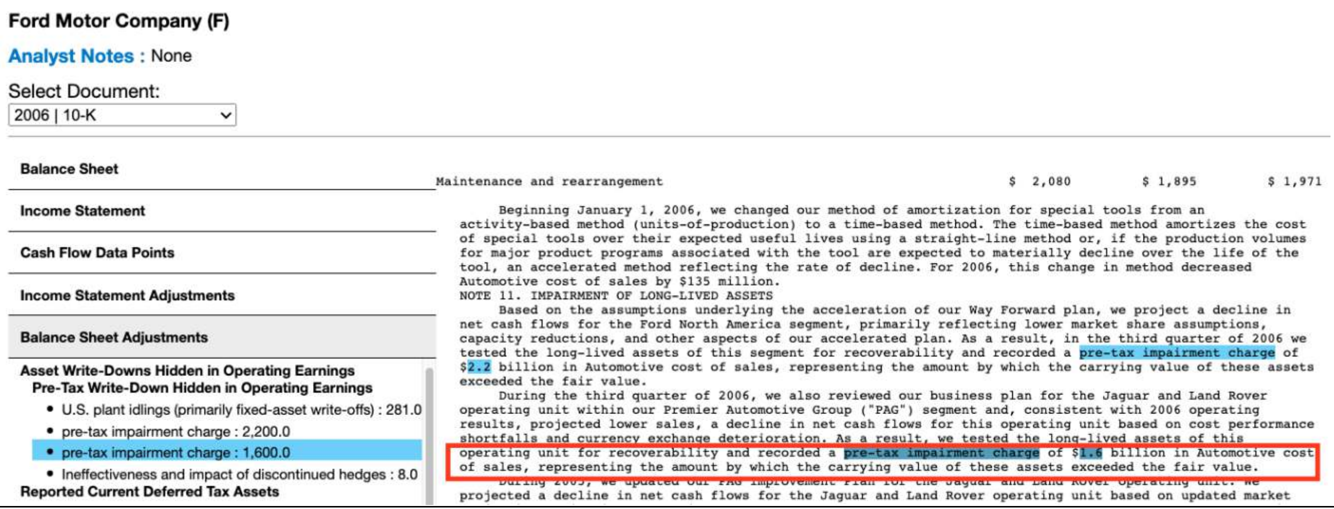


Sources: New Constructs, LLC and company filings

- **Jaguar and Land Rover fixed asset impairment charges of $1.6 billion**

Additional information on this asset impairment charge can also be found on page FS-21 (page 103 overall). This charge ($0.85/share) is also recorded in Automotive cost of sales and artificially increased Ford's cost of sales. We also remove this charge from COGS.

Figure 4: $1.6 Billion Jaguar & Land Rover Asset Impairment Charge: Page FS-21 of Ford's 2006 10-K



Sources: New Constructs, LLC and company filings

The last four items are all pension related and accounted for in our model with information collected from the pension section of Ford's footnotes (begins on Page FS-44, page 126 overall).

- **Personnel-reduction programs/Other of $378 million**
- **Mazda pension transfer income of $115 million**
- **Personnel-reduction programs of $103 million**

- **Personnel-reduction programs of $84 million**

Even though each individual value doesn't specifically match a value on the pension section, we know that pension expenses have to be included within the Net Period Benefit Costs table. For instance, the personnel-reduction program charges are included in the Separation Programs items on Page FS-47 (page 129 overall).

In general, we avoid collecting pension charges from locations other than the pension section of a firm's footnotes because the footnotes consistently provide the best disclosure. Doing so would double count these charges and provide an inaccurate assessment of Ford's true core earnings.

Figure 5: Pension Charges: Page FS-47 of Ford's 2006 10-K

Pension Data

- Prior service cost/ (credit) : ($815.00)

Non-Operating Net Periodic Benefit Costs Hidden in Operating Items

- Interest cost : $1,396.00
- Interest cost : $2,004.00
- Interest cost : $2,431.00
- Expected return on assets : ($3,379.00)
- Expected return on assets : ($1,643.00)
- Expected return on assets : ($479.00)
- (Gains) /losses and other : $99.00
- (Gains) /losses and other : $568.00
- (Gains) /losses and other : $763.00
- Allocated costs to Visteon : $6.00

Non-Recurring Net Periodic Benefit Costs in Non-Operating Items

- Separation programs : $84.00
- Separation programs : $263.00
- Separation programs : $440.00
- Loss from curtailment : $3.00
- Loss from curtailment : $206.00
- Loss from curtailment : $2,535.00

Net Periodic Benefit Cost

- Net expense : $1,614.00
- Net expense : $2,183.00
- Net expense : $3,250.00

the benefit established by the law. We provide retiree drug benefits that exceed the value of the benefits that will be provided by Medicare Part D, and our retirees' out-of-pocket costs are less than they would be under Medicare Part D. Therefore, we have concluded that our plan is at least "actuarially equivalent" to the Medicare Part D plan and that we will be eligible for the subsidy. We have reflected the impact of the subsidy by reducing our 2006, 2005, and 2004 expense by $270 million, $290 million, and $250 million, respectively. Beginning in 2008, the U.S. salary health care plan will no longer be eligible for the subsidy receipt under Medicare Part D.

The measurement date for substantially all of our worldwide postretirement benefit plans is December 31. Our expense for defined benefit pension and OPEB benefits was as follows (in millions):

	Pension Benefits						Health Care and Life Insurance		
	U.S. Plans			Non-U.S. Plans					
	2006	2005	2004	2006	2005	2004	2006	2005	2
Service cost	$ 680	$ 734	$ 636	$ 704	$ 630	$ 554	$ 617	$ 710	$
Interest cost	2,431	2,398	2,445	1,396	1,408	1,332	2,004	2,188	
Expected return on assets	(3,379)	(3,363)	(3,219)	(1,643)	(1,633)	(1,651)	(479)	(500)	
Amortization of:									
Prior service cost/(credit)	444	500	501	120	126	117	(815)	(245)	
(Gains)/losses and other	99	102	23	568	352	204	763	893	
Separation programs	440	97	26	263	422	78	84	1	
Loss from curtailment	2,535	--	--	206	--	--	3	--	
Allocated costs to Visteon	--	(84)	(107)	--	--	--	6	(246)	
Net expense	$ 3,250	$ 384	$ 305	$ 1,614	$ 1,305	$ 634	$ 2,183	$ 2,801	$

FS - 47

Sources: New Constructs, LLC and company filings

Diligence Scaled Across ~5600 Companies

As shown above, investors cannot always rely on tables in the MD&A to get an accurate assessment of core earnings, even when it appears a company discloses unusual items in a useful table. Further investigation of footnotes is often required.

It is important to note that we've spent over 15 years endowing our Robo-analyst technology with the insights and expertise of a sophisticated analyst. Unlike the legacy data providers, we are not blindly collecting data for the sake of collecting data. Instead, our focus is on providing the most comprehensive and accurate models for our clients. As a result, we bring a much higher level of attention and expertise to the data collection process.

By leveraging our Robo-Analyst technology, we're able to provide the rigorous footnotes & MD&A analysis above across ~2,900 actively traded stocks and ~2,700 inactive stocks. This unmatched diligence shines a light in the dark corners of financial filings (i.e. footnotes) and provides clients with more accurate measures of earnings and valuation.

One of the ways, we package this diligence is in our Earnings Distortion Scores, which measure the likelihood of a company to miss expectations in the next quarter.

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

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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:

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- **Corporate managers hide gains/losses in footnotes to manage earnings.**
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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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