



S&P 500 & Sectors: GAAP vs Core Earnings Update for 3Q23 (Free, Abridged)

Results for Core Earnings and GAAP earnings are very different this quarter and red flags about the quality of reported earnings while also raising the risk of earnings misses in coming quarters. In other words, 4Q23 earnings seasons could be ugly. These results underscore the more stable nature of Core Earnings. Because we remove unusual gains and losses, Core Earnings are not prone to the large swings seen in GAAP Earnings.

This report is an abridged and free version of [S&P 500 & Sectors: GAAP vs Core Earnings Update for 3Q23](#), one of our quarterly series of reports on [fundamental market and sector trends](#). The full reports are available to [Professional](#) and [Institutional](#) members.

The full version of the report analyzes [Core Earnings](#)^{1,2} and GAAP earnings for the S&P 500 and each of its sectors (last quarter's analysis is [here](#)) from 2004 to present.

This report leverages our cutting-edge [Robo-Analyst technology](#) to deliver [proven-superior](#)³ fundamental research and support more cost-effective fulfillment of the [fiduciary duty of care](#).

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GAAP Earnings Rise Is Again Misleading in 3Q23

Our superior fundamental data protects investors from being fooled by misleading trends in un-scrubbed GAAP Earnings. Looking beyond the headlines reveals that the recent changes in GAAP Earnings may be an illusion for three reasons:

1. Unusual gains are artificially elevating GAAP Earnings and cannot persist forever.
2. Core Earnings growing slower suggests GAAP Earnings have less room to rise before normalizing
3. Understated GAAP earnings in prior quarters ([kitchen sink effect](#)) set up easy comps and may cause expectations for future earnings to be too high.

If the rise in GAAP Earnings proves to be an illusion, investors could be in for a tough 4Q23. See Figure 1 in the [full report](#).

Generally Accepted Accounting Distortions

Figure 1 in the [full report](#) shows GAAP Earnings for the S&P 500 meaningfully differ from Core Earnings for the fifth consecutive quarter.

GAAP Earnings⁴ Understate Core Earnings for Nearly Two-Thirds of the S&P 500 (by Market Cap)

62% of the companies in the S&P 500 reported GAAP Earnings that are lower than Core Earnings for the TTM ended 3Q23.

When GAAP Earnings understate Core Earnings, they do so by an average of 70%, per Figure 1.

¹ [The Journal of Financial Economics](#) features the superiority of our Core Earnings in [Core Earnings: New Data & Evidence](#).

² Based on the latest audited financial data, which is the calendar 2Q23 10-Q in most cases. Price data as of 8/15/23.

³ Our research utilizes our [Core Earnings](#), a more reliable measure of profits, as proven in [Core Earnings: New Data & Evidence](#), written by professors at Harvard Business School (HBS) & MIT Sloan and published in [The Journal of Financial Economics](#).

⁴ Overstated companies include all companies with Earnings Distortion >0.1% of GAAP earnings.



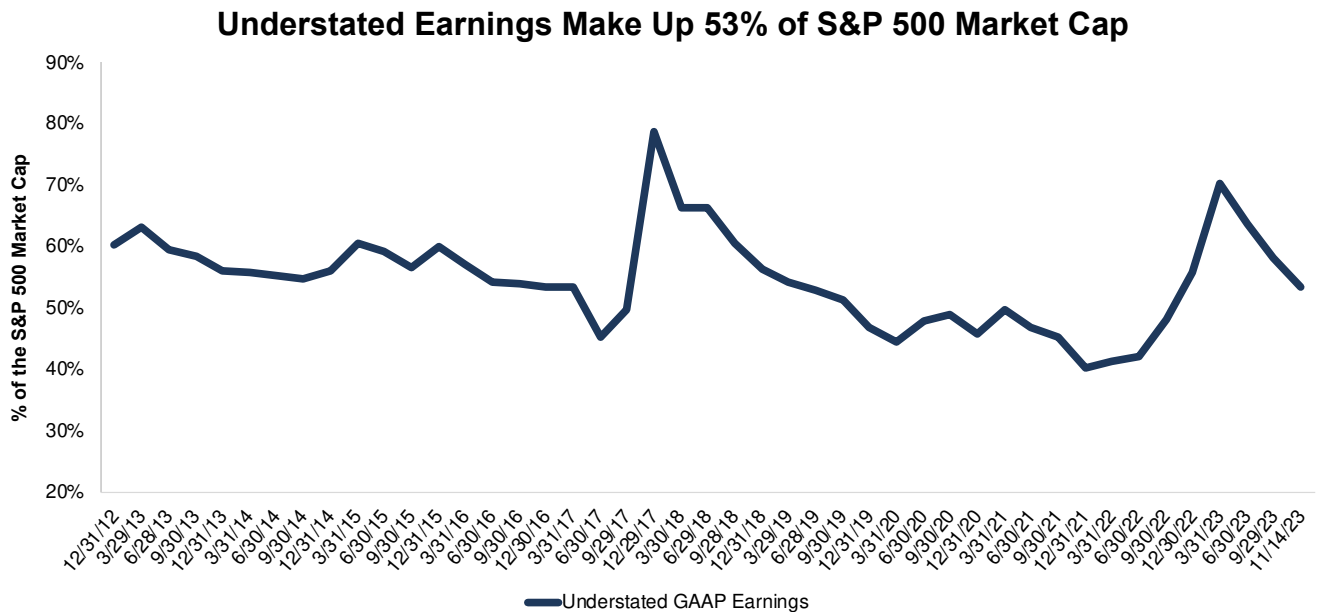
Figure 1: S&P 500 GAAP Earnings Understated by 70% On Average

Understated GAAP Earnings	Understated by >10%	Average Understatement %
312 companies	151 companies	70%

Sources: New Constructs, LLC and company filings.
We use Funds from Operations (FFO) for Real Estate companies rather than GAAP Earnings.

The 312⁵ companies with understated GAAP Earnings make up 53% of the market cap of the S&P 500 as of November 14, 2023. Companies with understated GAAP earnings made up 53% of the S&P 500 market cap in 2Q23 and 56% of the S&P 500 market cap in 3Q22.

Figure 2: Understated Earnings as % of Market Cap: 2012 through 11/14/23



Sources: New Constructs, LLC and company filings.

Key Details on Select S&P 500 Sectors

Six of eleven sectors saw a QoQ rise in Core Earnings through the TTM ended 3Q23.

The Consumer Cyclical sector saw the largest QoQ improvement in Core Earnings.

The Technology sector generates the most Core Earnings. On the flip side, the Real Estate sector has the lowest Core Earnings.

Below we highlight the Industrials sector and a stock with some of the most negative Earnings Distortion (i.e. understated GAAP earnings) in the sector.

Sample Sector Analysis⁶: Industrials Sector

Figure 3 shows Core Earnings for the Industrials sector, at \$163.6 billion, rose 4% QoQ in 3Q23, while GAAP earnings, at \$160.7 billion, fell <1% over the same time.

⁵ 320 companies reported GAAP Earnings below Core Earnings in the TTM ended 2Q23.

⁶ The full version of this report provides analysis for all eleven sectors.



Figure 3: Industrials Core Earnings Vs. GAAP: 2004 – 3Q23



Sources: New Constructs, LLC and company filings.

Our Core Earnings analysis is based on aggregated TTM data for the sector constituents in each measurement period.

The November 14, 2023 measurement period incorporates the financial data from calendar 3Q23 10-Qs, as this is the earliest date for which all the calendar 3Q23 10-Qs for the S&P 500 constituents were available.

GAAP Earnings Understatement Details: Caterpillar (CAT)

Below, we detail the [hidden and reported](#) unusual items overlooked in GAAP Earnings and captured in Core Earnings for Caterpillar (CAT). After adjusting for unusual items, we find that Caterpillar’s Core Earnings of \$10.5 billion, or \$20.27/share are much higher than reported GAAP Earnings of \$9.1 billion, or \$17.62/share.

Caterpillar’s [Stock Rating](#) is Attractive, in part due to its rising [economic earnings](#), high free cash flow yield, and low price-to-economic book value ([PEBV](#)) ratio of 1.0.

Below, we detail the differences between Core Earnings and GAAP Earnings so readers can audit our research.

Figure 4: Caterpillar’s GAAP Earnings to Core Earnings Reconciliation: TTM through 3Q23

	TTM (\$ per share)
GAAP Net Income	\$17.62
– Hidden Unusual Expenses, Net	(\$1.73)
– Reported Unusual Expenses Pre-Tax, Net	(\$1.27)
– Tax Distortion	\$0.35
= Core Earnings	\$20.27

Sources: New Constructs, LLC and company filings.

More details:

Total Earnings Distortion of -\$2.65/share, which equals -\$1.4 billion, is comprised of the following:

Hidden Unusual Expenses Pre-Tax, Net = -\$1.73/per share, which equals -\$892 million and is comprised of:

- [-\\$586 million](#) in Longwall divestiture restructuring costs – Page 39 1Q23 10-Q
- [-\\$255 million](#) in Other restructuring costs in the TTM period based on
 - [-\\$34 million](#) in 3Q23
 - [-\\$19 million](#) in 2Q23
 - [-\\$13 million](#) in 1Q23
 - [-\\$189 million](#) in 4Q23
- [-\\$47 million](#) in employee separation restructuring costs in the TTM period based on



- [-\\$10 million](#) in 3Q23
- [-\\$10 million](#) in 2Q23
- [-\\$12 million](#) in 1Q23
- [-\\$15 million](#) in 4Q23
- -\$4 million in long-lived asset impairment restructuring costs in the TTM period based on
 - [-\\$2 million](#) in 3Q23
 - [-\\$2 million](#) in 2Q23

Reported Unusual Expenses Pre-Tax, Net = -\$1.27/per share, which equals -\$659 million and is comprised of:

- -\$925 million goodwill impairment charge in the TTM based on [-\\$925 million](#) charge reported in 2022 10-K
- -\$624 million contra adjustment for [recurring pension costs](#). These recurring expenses are reported in non-recurring line items, so we add them back and exclude them from Earnings Distortion.
- -\$316 million in foreign exchange losses in the TTM period based on
 - [\\$17 million](#) gain in 3Q23
 - [\\$40 million](#) gain in 2Q23
 - [-\\$72 million](#) loss in 1Q23
 - [-\\$301 million](#) loss in 4Q22
- \$48 million in miscellaneous income in the TTM period based on
 - [\\$12 million](#) income in 3Q23
 - [-\\$30 million](#) loss in 2Q23
 - [\\$4 million](#) income in 1Q23
 - [\\$62 million](#) income in 4Q22
- \$393 million in investment and interest income in the TTM period based on
 - [\\$135 million](#) in 3Q23
 - [\\$96 million](#) in 2Q23
 - [\\$93 million](#) in 1Q23
 - [\\$69 million](#) in 4Q22
- \$765 million in other non-operating income in the TTM period based on
 - \$630 million in net periodic pension and OPEB income, excluding service cost based on
 - [-\\$12 million](#) cost in 3Q23
 - [-\\$12 million](#) cost in 2Q23
 - [-\\$13 million](#) cost in 1Q23
 - [\\$667 million](#) income in 4Q22
 - \$147 million in license fee income based on
 - [\\$37 million](#) in 3Q23
 - [\\$43 million](#) in 2Q23
 - [\\$31 million](#) in 1Q23
 - [\\$36 million](#) in 4Q22
 - -\$12 million in losses on securities based on
 - [\\$6 million](#) in gains in 3Q23
 - [-\\$10 million](#) in losses in 2Q23
 - [-\\$11 million](#) in losses in 1Q23
 - [\\$3 million](#) in gains in 4Q22

[Tax Distortion](#) = \$0.35/per share, which equals \$183 million.

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Disclosure: David Trainer, Kyle Guske II, Italo Mendonça, and Hakan Salt receive no compensation to write about any specific stock, style, or theme.

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Appendix: Calculation Methodology

We derive the Core Earnings and GAAP Earnings metrics above by summing the Trailing Twelve Month individual S&P 500 constituent values for Core Earnings and GAAP Earnings in each sector for each measurement period. We call this approach the “Aggregate” methodology.

The Aggregate methodology provides a straightforward look at the entire sector, regardless of market cap or index weighting and matches how S&P Global (SPGI) calculates metrics for the S&P 500.



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1. Legacy fundamental datasets suffer from significant inaccuracies, omissions and biases.
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3. Our proprietary measures of [Core Earnings](#) and [Earnings Distortion](#) materially improve stock picking and forecasting of profits.

Best Fundamental Data in the World

Forthcoming in [The Journal of Financial Economics](#), a top peer-reviewed journal, [Core Earnings: New Data & Evidence](#) proves our Robo-Analyst technology overcomes material shortcomings in legacy firms’ data collection processes to provide superior [fundamental data](#), [earnings](#) models, and [research](#). More [details](#).

Key quotes from the paper:

- “[New Constructs’] *Total Adjustments* differs significantly from the items identified and excluded from Compustat’s adjusted earnings measures. For example... 50% to 70% of the variation in *Total Adjustments* is not explained by *S&P Global’s (SPGI) Adjustments* individually.” – pp. 14, 1st para.
- “A final source of differences [between New Constructs’ and S&P Global’s data] is due to data collection oversights...we identified cases where Compustat did not collect information relating to firms’ income that is useful in assessing core earnings.” – pp. 16, 2nd para.

Superior Models

A top accounting firm features the superiority of our ROIC, NOPAT and Invested Capital research to Capital IQ & Bloomberg’s in [Getting ROIC Right](#). See the [Appendix](#) for direct comparison details.

Key quotes from the paper:

- “...an accurate calculation of ROIC requires more diligence than often occurs in some of the common, off-the-shelf ROIC calculations. Only by scouring the footnotes and the MD&A [as New Constructs does] can investors get an accurate calculation of ROIC.” – pp. 8, 5th para.
- “The majority of the difference...comes from New Constructs’ machine learning approach, which leverages technology to calculate ROIC by applying accounting adjustments that may be buried deeply in the footnotes across thousands of companies.” – pp. 4, 2nd para.

Superior Stock Ratings

Robo-Analysts’ stock ratings outperform those from human analysts as shown in this [paper](#) from Indiana’s Kelley School of Business. Bloomberg features the paper [here](#).

Key quotes from the paper:

- “the portfolios formed following the buy recommendations of Robo-Analysts earn abnormal returns that are statistically and economically significant.” – pp. 6, 3rd para.
- “Our results ultimately suggest that Robo-Analysts are a valuable, alternative information intermediary to traditional sell-side analysts.” – pp. 20, 3rd para.

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