



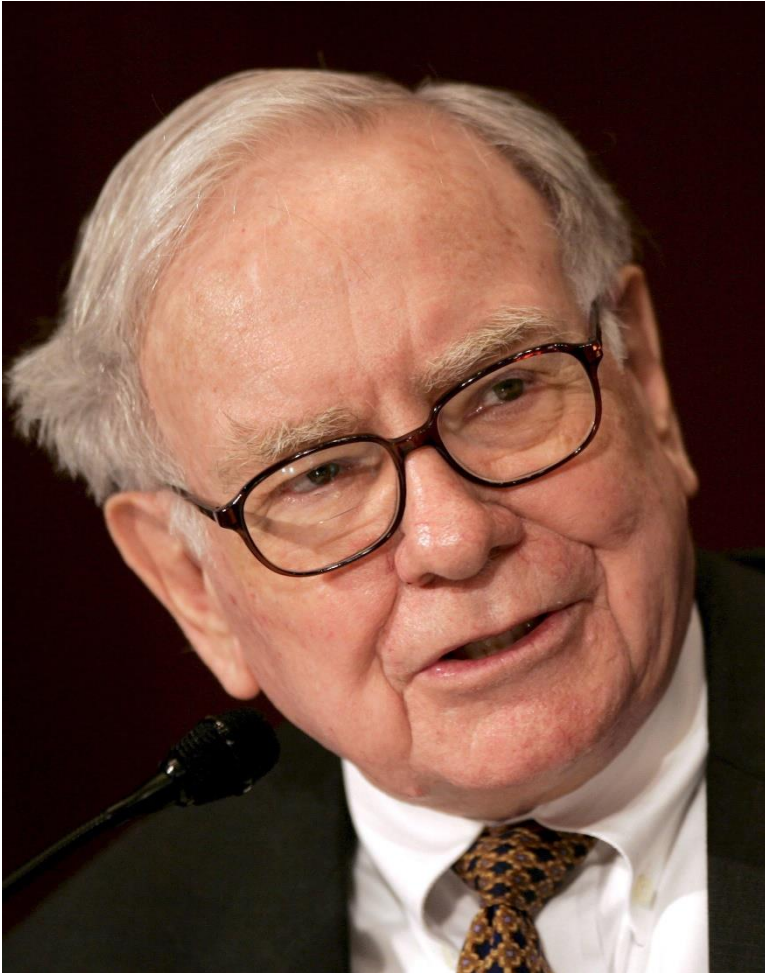
VALENS RESEARCH

The Dark Side of Financial Statement Analysis And the Impact of UAFRS on Equity and Credit Investing

Professor Joel Litman
January 2017

Valens Securities, Inc. and The Institute of Strategy & Valuation
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“To be successful,
you should concentrate on
the world of companies,
not arcane accounting
mathematics.”

- Buffett

The Statement of Cash Flows

The Statement of Cash Flows

Operations

Investing

Financing

You have \$200 for a business

December 1, 2012

December 31, 2012

December 31, 2013

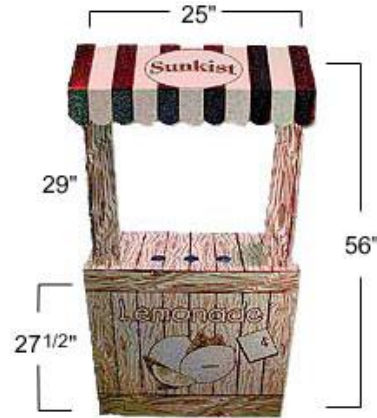


You invest all \$200 into current assets and PP&E

December 1, 2012



December 31, 2012



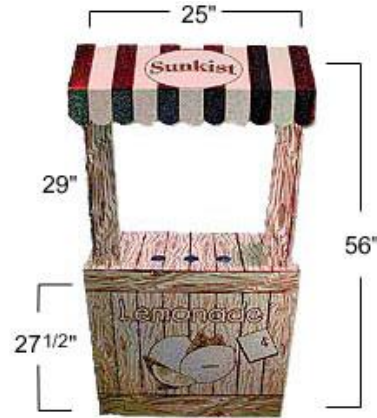
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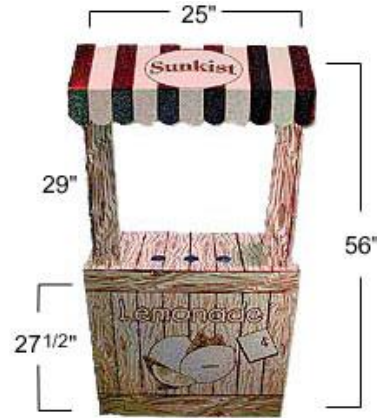
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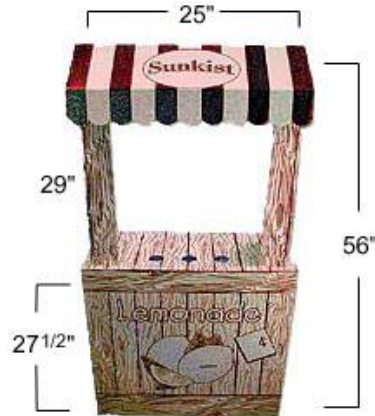
How much cash have you invested in the business?

You invest all \$200 into current assets and PP&E

December 1, 2012



December 31, 2012



December 31, 2013

How much cash have you invested in the business?

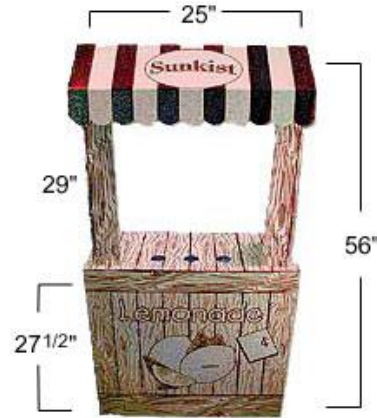
How much cash have you generated from operations?

What do the financials represent at 12/31/12?

December 1, 2012



December 31, 2012



December 31, 2013

Statement of Cash Flows:

Cash Flows for Investing Activities

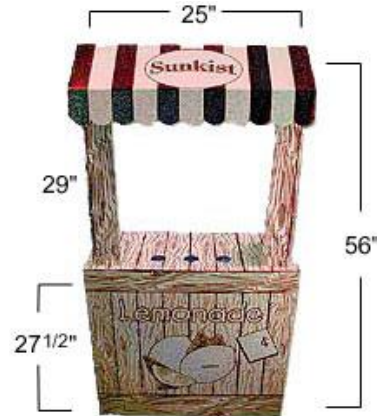
(100)

What do the financials represent at 12/31/12?

December 1, 2012



December 31, 2012



December 31, 2013

Statement of Cash Flows:

Cash Flows for Investing Activities

(100)

Cash Flows from Operations

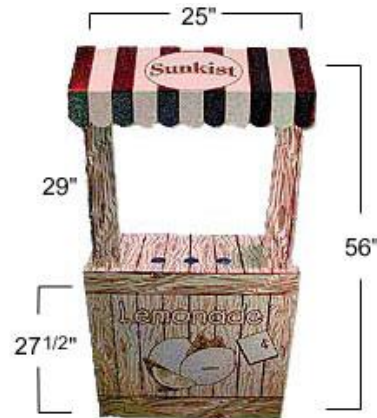
(100)

You sell off \$100 of working capital for \$100

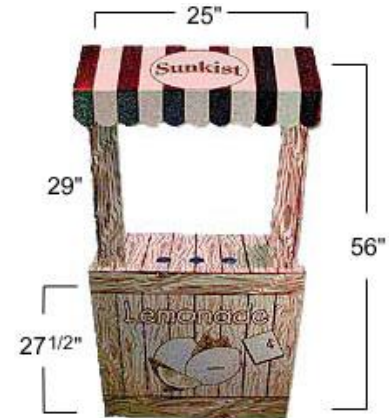
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December 31, 2012



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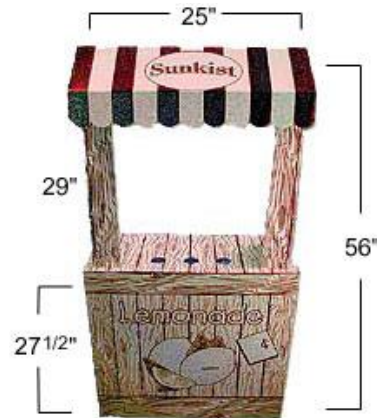


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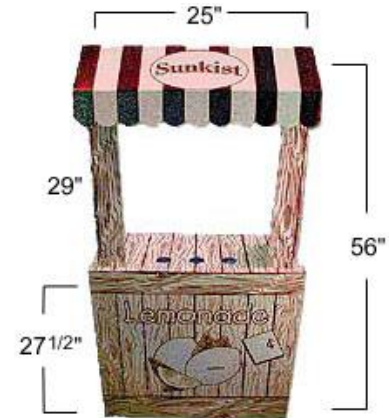
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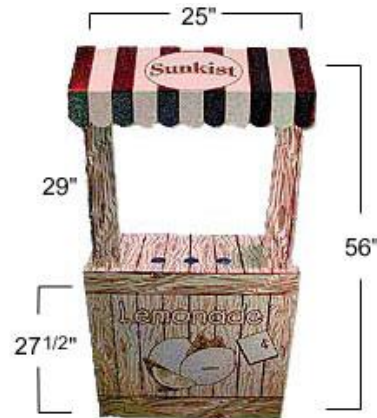


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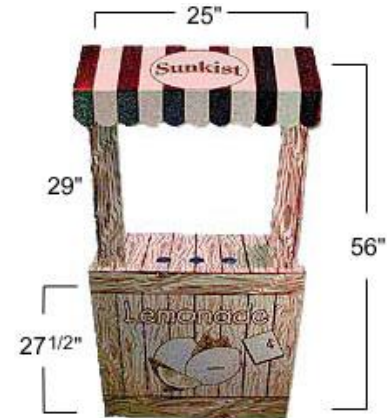
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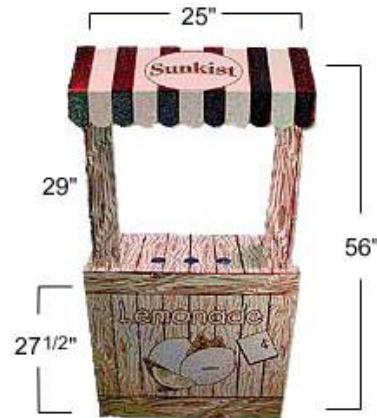
Cash generated?

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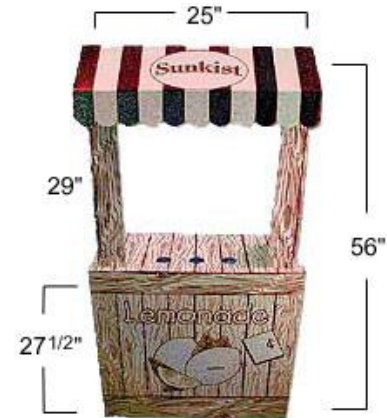
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Cash generated?

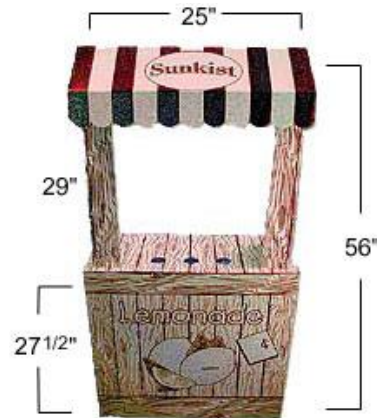
What reported?

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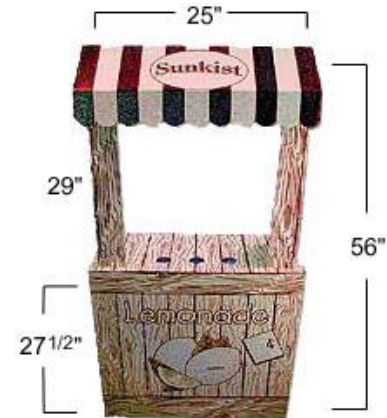
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Statement of Cash Flows:

Cash Flows for Investing Activities (100)

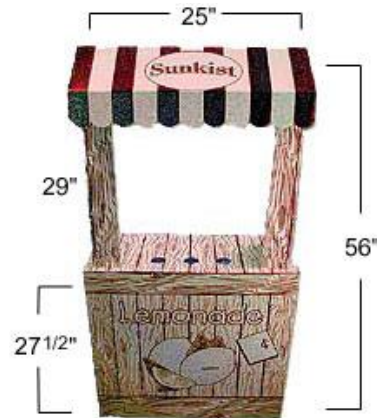
Cash Flows from Operations (100)

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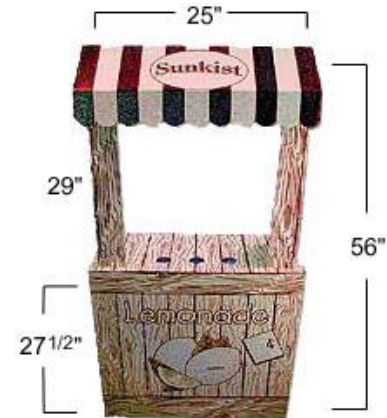
December 1, 2012



December 31, 2012



December 31, 2013



Statement of Cash Flows:

Cash Flows for Investing Activities (100)

Cash Flows from Operations (100) + 100

Restating the Statement of Cash Flows

- Cash Flows From/For Operations
 - Changes in working capital
 - Rental expense, R&D
 - Pension “expense”
 - Interest expense

- Cash Flows From/For Investing
 - All of the above
 - Others

- Cash Flows From/For Financing
 - Dividends
 - Off-balance sheet debt
 - Others

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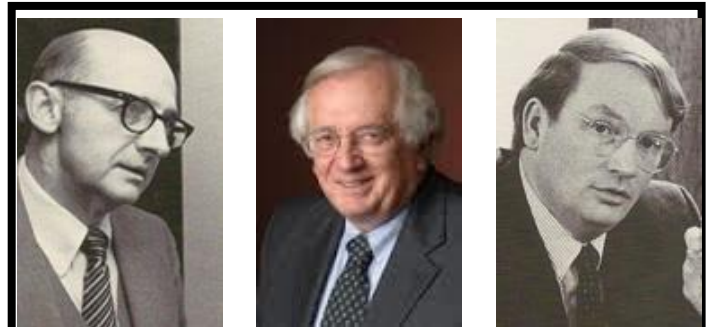
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**Lauver,
Leisenring
& Sweiringa**

Restating the Statement of Cash Flows

- Cash Flows From/For Operations
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- *“None...aptly named”*
- *“Inconsistencies”*
- *“Undesirable”*
- *“Misleading”*
- *“Misunderstood”*

“The misperception is
you are investing in the
stock market, not
companies.”

-- Charles Brandes



Incomparable M&A Accounting

Far more than just goodwill

Acquirer

- ▶ Book value assets
- ▶ R&D expensed
- ▶ Full year sales
- ▶ Full year earnings
- ▶ Full year cash flows

Acquired

- ▶ “Fair value” assets
- ▶ R&D capitalized
- ▶ Partial year sales
- ▶ Partial year earnings
- ▶ Partial year cash flows

AT&T Acquisition of DirecTV (Closed 7/24/2015)

	End of Year Reported Value	Understatement Per GAAP Accounting	Unreported % of EoY
Net Income	13,345	987	7%
Revenue	146,801	19,028	13%
Gross PP&E	306,227	12,857	4%

Source: Valens Research, CapIQ, Company Financials

Incomparable M&A Accounting

Far more than just goodwill

Acquirer

Acquired

▶ Book value assets

▶ “Fair value” assets

▶ R&D expensed

▶ R&D capitalized

▶ Full year sales

▶ Partial year sales

▶ Full year earnings

▶ Partial year earnings

▶ Full year cash flows

▶ Partial year cash flows

Acquisitions Occuring By Quarter 2014 & 2015

	% of Acquisitions
Q1	25%
Q2	30%
Q3	13%
Q4	33%

Source: Valens Research, CapIQ

“Incomparable M&A Accounting”
stems from mid-year M&A, especially Q4

**Becton, Dickinson and Company
Acquisition of CareFusion (Closed 3/17/2015)**

	End of Year Reported Value	Understatement Per GAAP Accounting	Unreported % of EoY
Net Income	695	226	33%
Revenue	10,282	1,878	18%
Gross PP&E	8,277	643	8%

Source: Valens Research, CapIQ, Company Financials

Acquisitions Greater than 10% of Market Cap

	# Companies	% of Companies
Top 300	80	27%
Top 200	51	26%
Top 150	37	25%
Top 100	19	19%
Top 50	12	24%

Source: Valens Research, CapIQ

Even in a slow M&A environment,
noticeable distortions at 1 out of 4 companies

Acquisitions Greater than 25% of Market Cap

	# Companies	% of Companies
Top 300	44	15%
Top 200	32	16%
Top 150	24	16%
Top 100	13	13%
Top 50	8	16%

Source: Valens Research, CapIQ

Even in a slow M&A environment,
very material distortions at 1 out of 7 companies

“In the zeal to satisfy consensus earnings estimates...

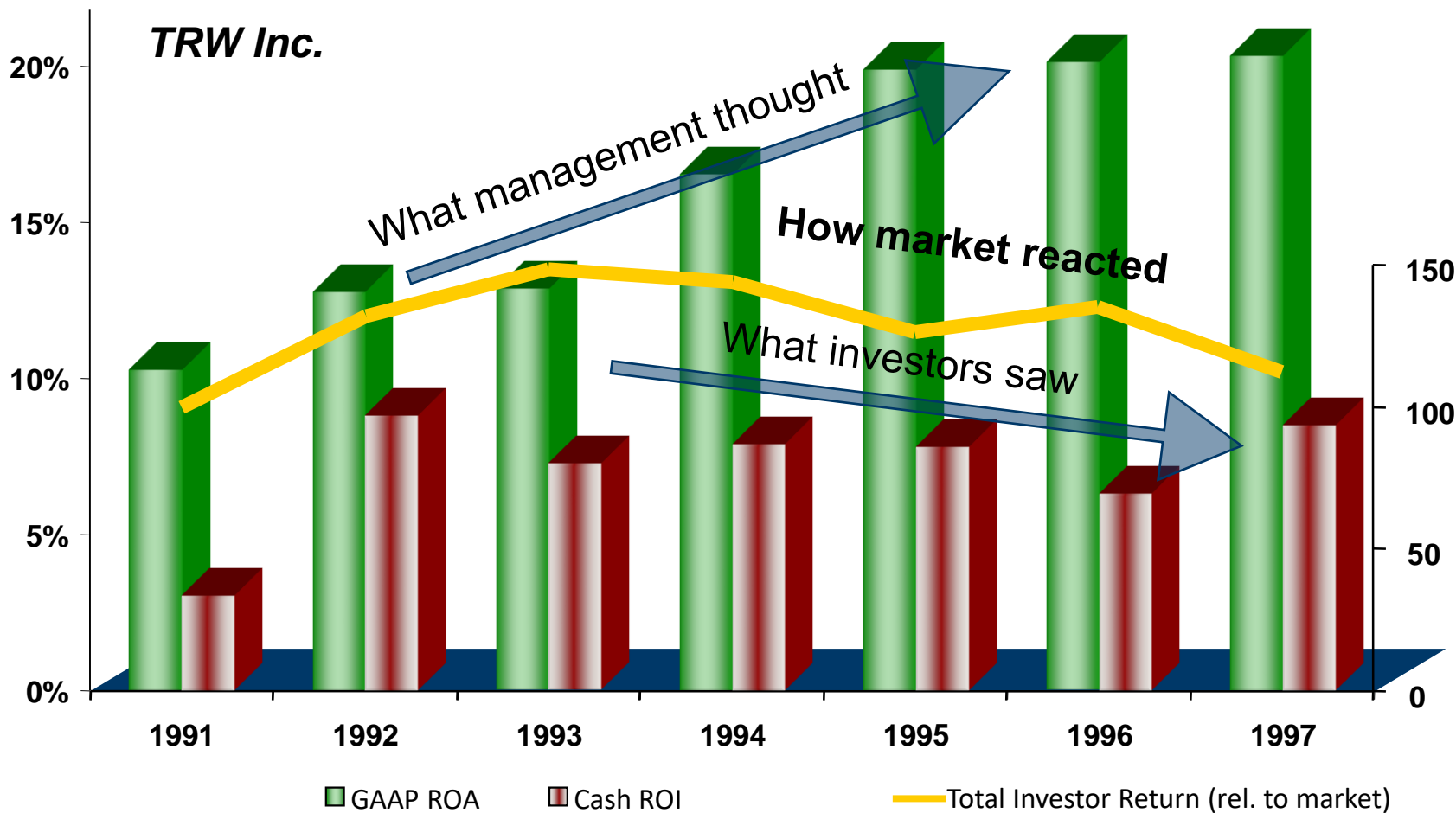
wishful thinking may be winning the day over faithful representation...

We are witnessing an erosion in the quality of earnings, and therefore, the quality of financial reporting.”

Arthur Levitt, Chairman, SEC
September 1998



TRW and 6 Million Shares

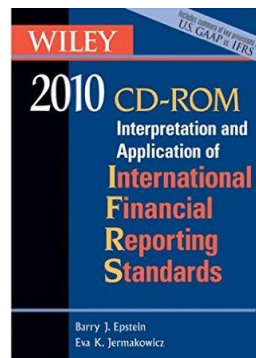
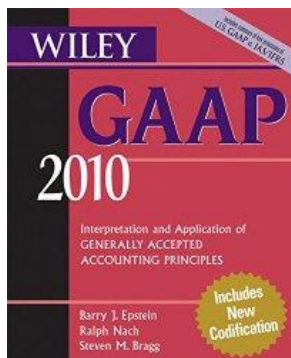




“...the FASB and the IASB have jointly made progress on converging U.S. GAAP and IFRS.

A transition of this magnitude is likely to prove to be a challenge and could, for those not prepared, easily result in misapplication...

The fact that IFRS provides more opportunity for the application of judgment... only adds to the risk for those not fully ready for this undertaking.” -- Epstein



Cadbury Schweppes: 1996 – Dr. Pepper Acquisition

	ROA'	EPS	Price/ Earnings	Price/ Book	RONA
Base Case (UK GAAP)	5.98%	.35	14.94	3.82	8.86
Goodwill Capitalized & Amortized over 40 Years (US)	5.98%	.31	16.87	1.61	8.08
Goodwill Capitalized & Amortized over 4 years (DEU)	5.98%	(.05)	NM	1.86	(1.05)

“The misperception is
you are investing in the
stock market, not
companies.”

-- Charles Brandes



Fixing the financial reporting disaster of GAAP and IFRS: Uniform Adjusted Financial Reporting Standards



- Earnings
- Book Assets
- ROE, RONA, ROA
- CAPX
- Price
- Price-to-Book
- Price-to-earnings

Fixing the financial reporting disaster of GAAP and IFRS: Uniform Adjusted Financial Reporting Standards



- Earnings $\rightarrow E' = \text{UAFRS earnings}$
- Book Assets $\rightarrow A' = \text{UAFRS assets}$
- ROE, RONA, ROA $\rightarrow \text{ROA}'$ (UAFRS-adjusted)
- CAPX $\rightarrow \text{Asset}' \text{ Growth}$ (UAFRS-adjusted CAPX)
- Price $\rightarrow \text{Enterprise value, } V'$ (UAFRS-adjusted)
- Price-to-Book $\rightarrow V/A'$ (UAFRS-based P/B)
- Price-to-earnings $\rightarrow V/E'$ (UAFRS-based P/E)

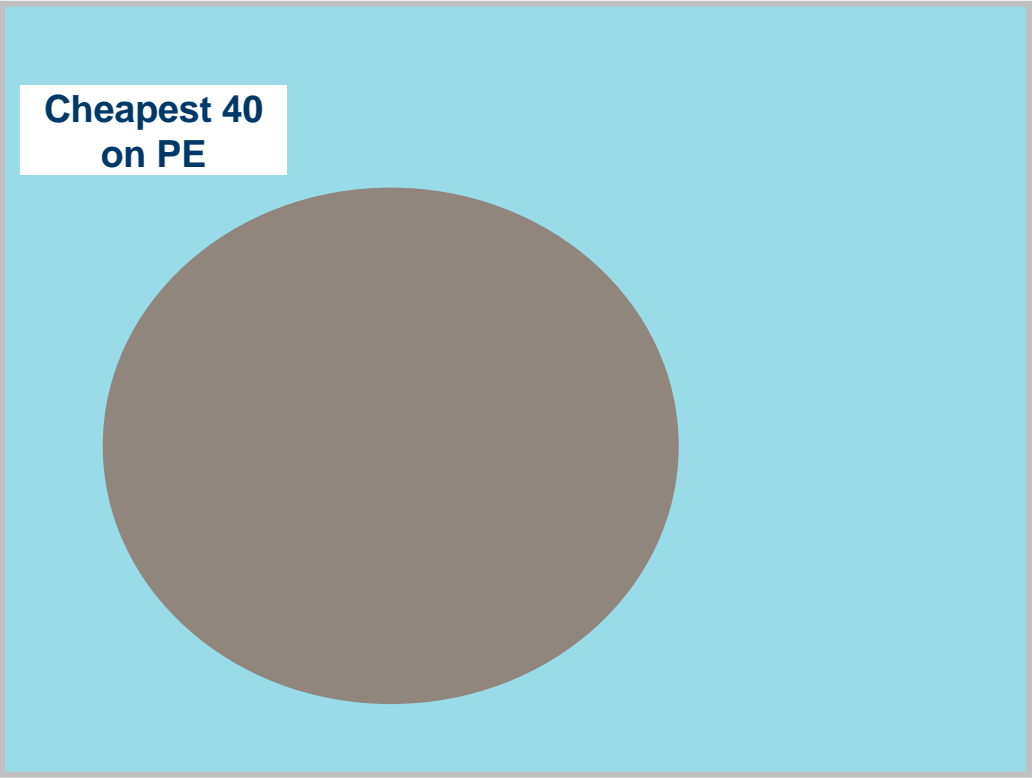
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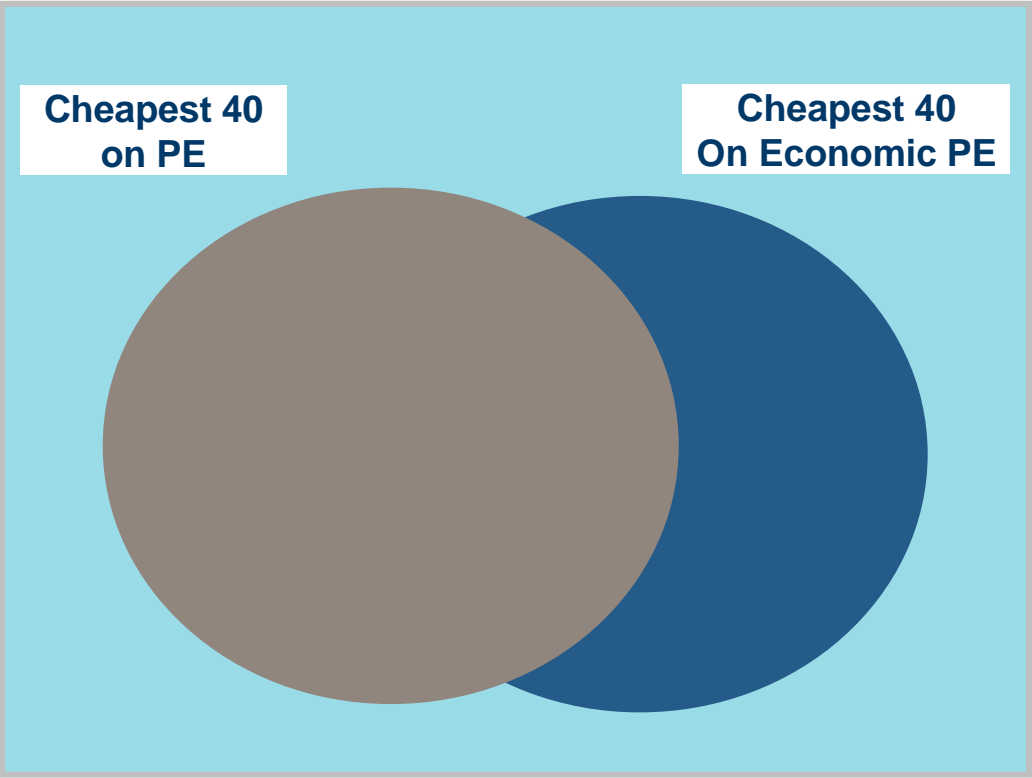
Cheapest PE versus cheapest Adjusted PE

200 Companies in Mainland China



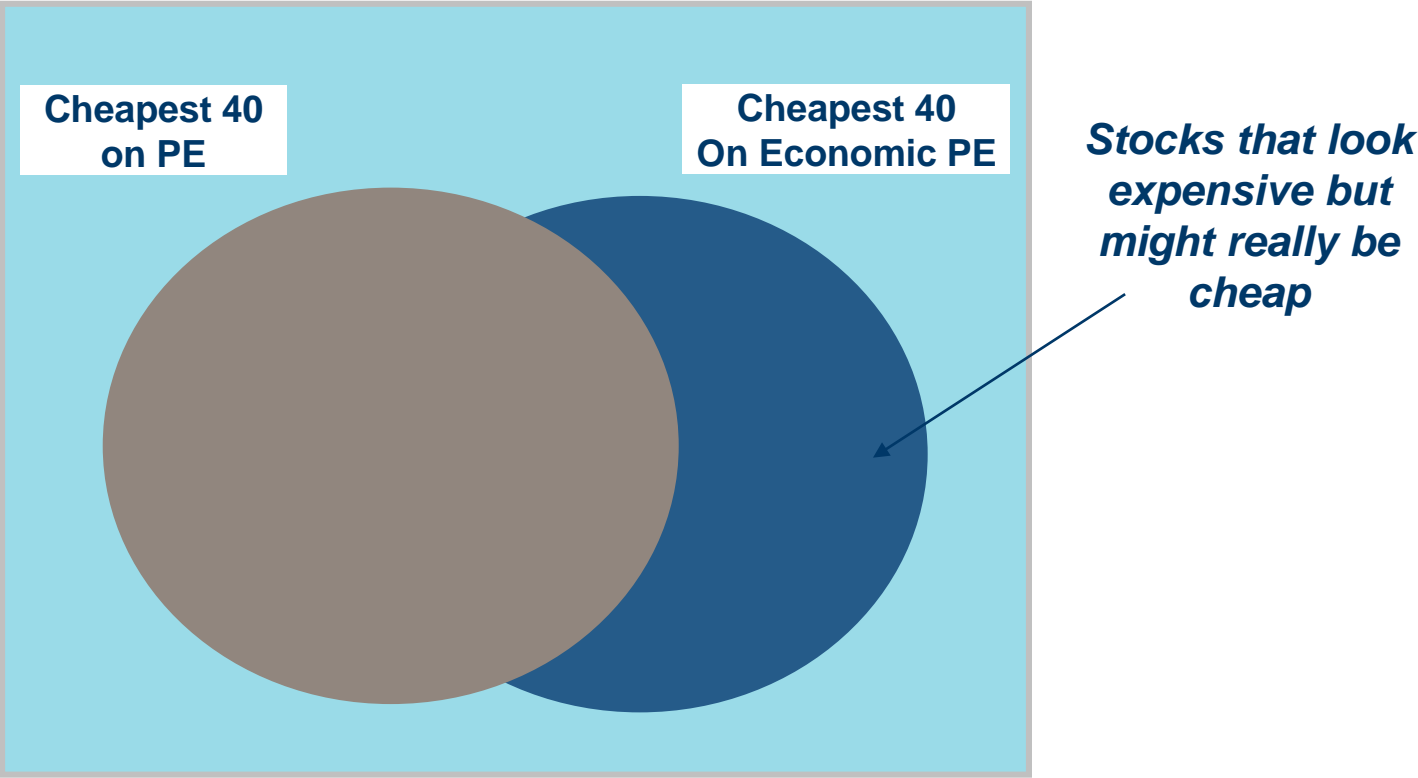
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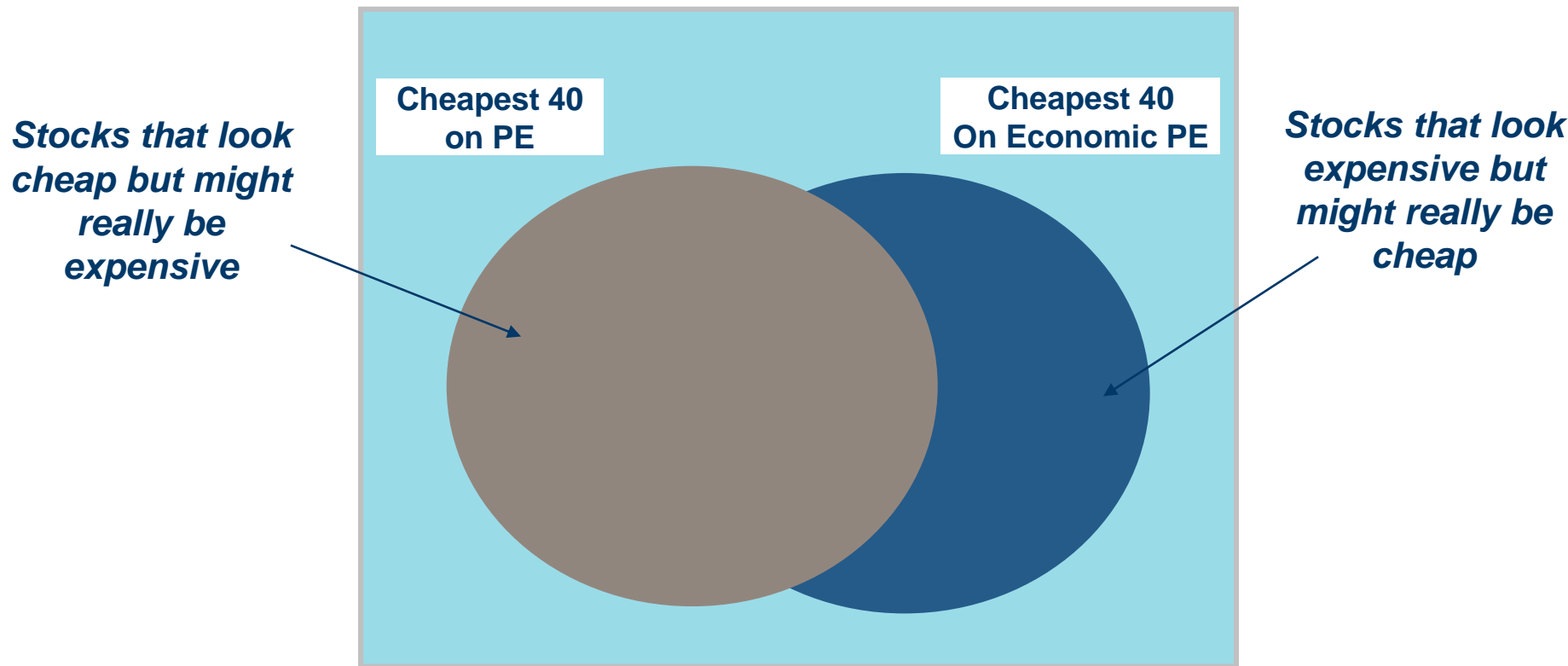
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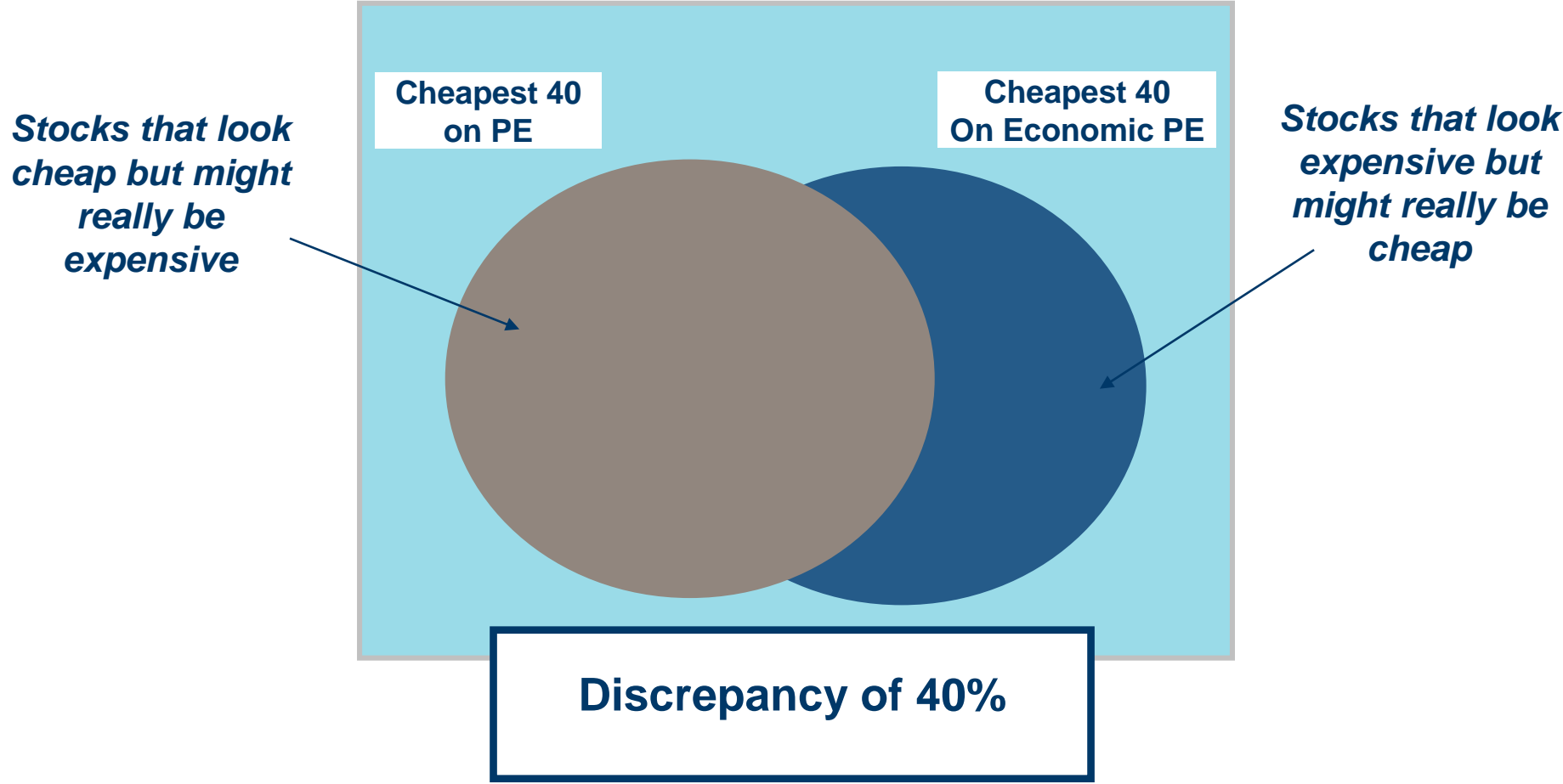
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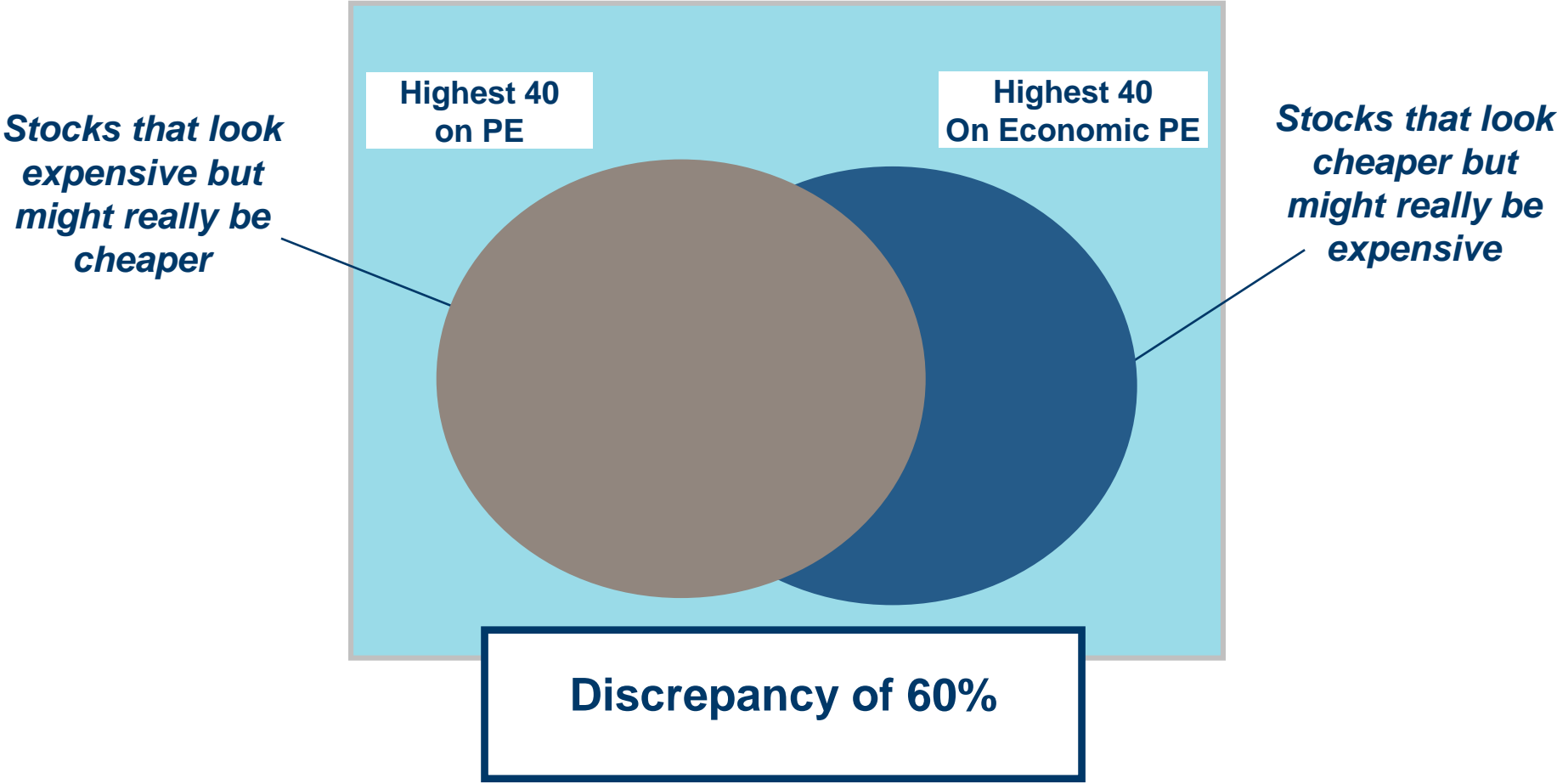
Cheapest PE versus cheapest Adjusted PE

200 Companies in Mainland China



Highest PE versus highest Adjusted PE

200 Companies in Mainland China



Cheapest PE versus cheapest Adjusted PE

200 Companies Across Europe

Stocks that look cheap but might really be expensive

Cheapest 40
on PE

Cheapest 40
On Economic PE

Stocks that look expensive but might really be cheap

Discrepancy of 50%

Cheapest PE versus cheapest Adjusted PE

200 Large Caps Across Asia

Stocks that look cheap but might really be expensive

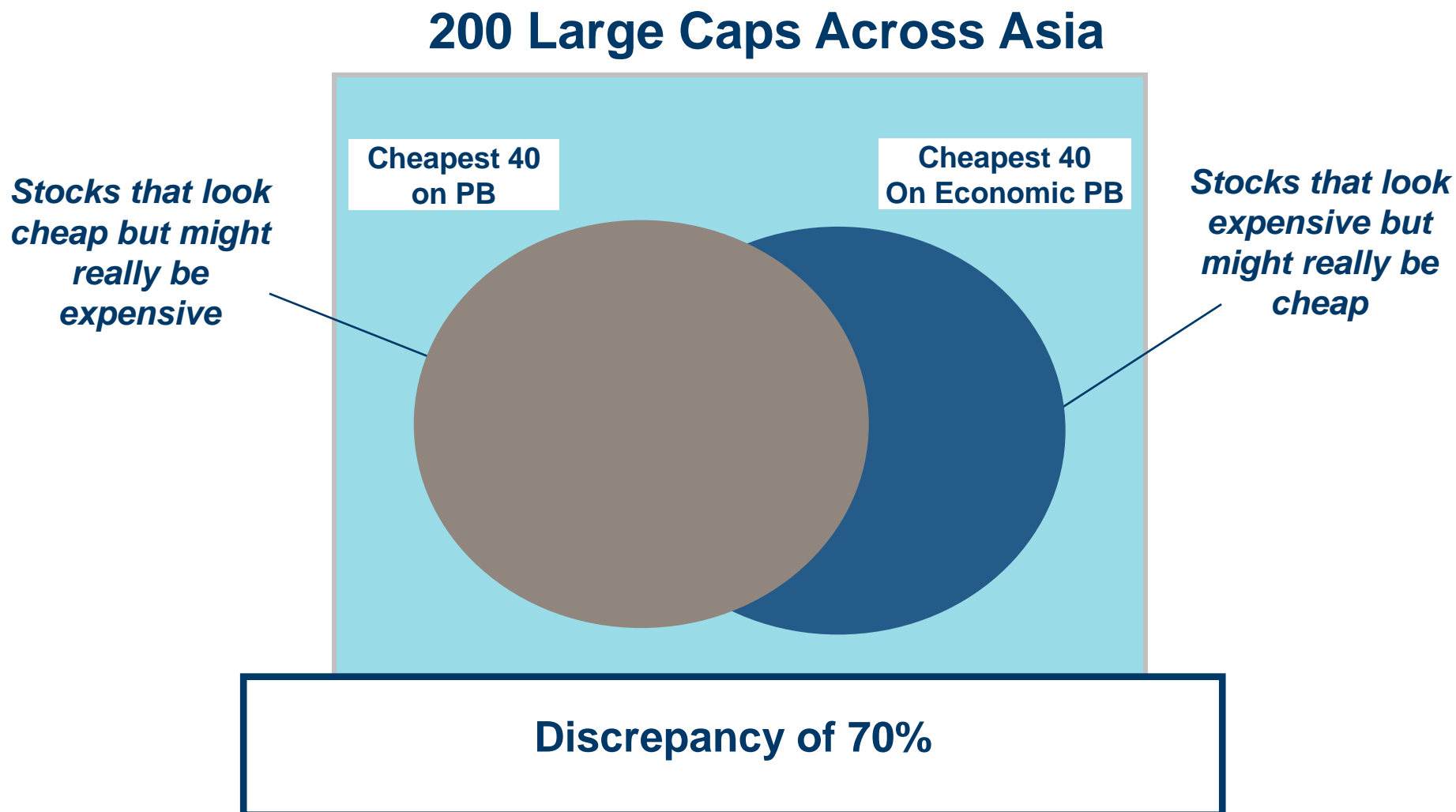
Cheapest 40
on PE

Cheapest 40
On Economic PE

Stocks that look expensive but might really be cheap

Discrepancy of 70%

Cheapest PB versus cheapest Adjusted PB



Directional Differences – S&P 500 Industrials

S&P500 Industrials	Forward P/E vs. V/E'	Price/Book vs. V/A'	ROE vs. ROA'	EPS rev's vs. ROA' Momentum
Discrepancies in screen for highest quintiles	50%	33%	37%	67%
Discrepancies in screen for lowest quintiles	30%	40%	50%	75%

Directional Differences – S&P 500 Industrials

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Directional Differences – Equities Worldwide

Equities worldwide Mkt Cap> \$1BB	Forward P/E vs. V/E'	Price/Book vs. V/A'	ROE vs. ROA'	EPS rev's vs. ROA' Momentum
DISCREPANCY in screens for highest deciles	40%	40%	60%	80%
DISCREPANCY in screens for lowest deciles	39%	44%	52%	76%

Find a Company:

Q Enter a ticker or company name to get started

Manage Metrics

Save State



Ticker	Company Names	Sector	Home Country	As Reported P/E (Current)	V/E' Current	As-Reported ROA (FY0)	ROA' FY0	V/A' Current
AAPL	Apple Inc.	Information Technology	United States	13.5x	9.5x	17.0%	114.4%	8.9x
GOOGL	Alphabet Inc.	Information Technology	United States	21.6x	19.4x	8.7%	26.6%	5x
MSFT	Microsoft Corporation	Information Technology	United States	19.7x	21x	7.2%	23.0%	4.9x
AMZN	Amazon.com, Inc.	Consumer Discretionary	United States	103.8x	63.7x	2.3%	12.2%	15.3x
FB	Facebook, Inc.	Information Technology	United States	28.4x	21x	8.8%	48.3%	11.4x
XOM	Exxon Mobil Corporation	Energy	United States	25.1x	63.2x	2.3%	2.4%	1.2x
BRK.B	Berkshire Hathaway Inc.	Financials	United States	N/A	N/A	N/A	N/A	N/A
JNJ	Johnson & Johnson	Healthcare	United States	17.2x	16.7x	8.7%	16.6%	3.2x
GE	General Electric Company	Industrials	United States	19.9x	21.9x	1.1%	13.8%	2.5x
BABA	Alibaba Group Holding Limited	Information Technology	China	29.4x	22.7x	6.0%	127.4%	28.9x
SEHK:700	Tencent Holdings	Information	China	33.8x	26.1x	9.6%	113.5%	39.5x

Feedback

















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Ticker 	Company Names 	Sector  	Home Country  	As Reported P/E (Current)  	V/E' Current  	As-Reported ROA (FY0)  	ROA' FY0  	V/A' Current  
PSE:TEL	PLDT Inc.	Telecommunication Services	Philippines	12.8x	114.5x	5.5%	1.5%	0.8x
PSE:PCOR	Petron Corporation	Energy	Philippines	14.1x	89x	3.4%	-0.5%	1.1x
PSE:DMC	DMCI Holdings, Inc.	Industrials	Philippines	12.7x	58.7x	7.4%	9.8%	1.8x
PSE:CIC	Concepcion Industrial Corporation	Industrials	Philippines	23.2x	44.2x	13.8%	18.2%	3.7x
PSE:JFC	Jollibee Foods Corp.	Consumer Discretionary	Philippines	32.2x	42.5x	5.6%	6.7%	3.9x
PSE:PIP	Pepsi-Cola Products Philippines, Inc.	Consumer Staples	Philippines	11.2x	41.4x	3.6%	0.6%	0.9x
PSE:GTCAP	GT Capital Holdings, Inc.	Financials	Philippines	15.2x	33.5x	6.6%	15.1%	1.6x
PSE:MEG	Megaworld Corporation	Real Estate	Philippines	11.3x	32.6x	3.9%	4.8%	0.9x
PSE:RLC	Robinsons Land Corp.	Real Estate	Philippines	16.2x	29.6x	5.1%	6.2%	1.5x
PSE:MWIDE	Megawide	Consumer	Philippines	26.8x	28.7x	3.3%	11.3%	2.7x

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PSE:PIP	Pepsi-Cola Products Philippines, Inc.	Consumer Staples	Philippines	11.2x	41.4x	3.6%	0.6%	0.9x
PSE:GTCAP	GT Capital Holdings, Inc.	Financials	Philippines	15.2x	33.5x	6.6%	15.1%	1.6x
PSE:MEG	Megaworld Corporation	Real Estate	Philippines	11.3x	32.6x	3.9%	4.8%	0.9x
PSE:RLC	Robinsons Land Corp.	Real Estate	Philippines	16.2x	29.6x	5.1%	6.2%	1.5x
PSE:MWIDE	Megawide	Consumer	Philippines	26.8x	28.7x	3.3%	11.3%	2.7x

Feedback

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Ticker	Company Names	Sector	Home Country	As Reported P/E (Current)	V/E' Current	As-Reported ROA (FY0)	ROA' FY0	V/A' Current
PSE:TEL	PLDT Inc.	Telecommunication Services	Philippines	12.8x	114.5x	5.5%	1.5%	0.8x
PSE:PCOR	Petron Corporation	Energy	Philippines	14.1x	89x	3.4%	-0.5%	1.1x
PSE:DMC	DMCI Holdings, Inc.	Industrials	Philippines	12.7x	58.7x	7.4%	9.8%	1.8x
PSE:CIC	Concepcion Industrial Corporation	Industrials	Philippines	23.2x	44.2x	13.8%	18.2%	3.7x
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Feedback



PLDT Inc

[+ Watchlist](#)

TEL:PM PHILIPPINES

↓ **1,645.00** PHP **-25.00**
-1.50%

As of 3:28 AM EDT 10/21/2016

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1M

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5Y

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Feedback



DMCI Holdings Inc

+ Watchlist

DMC:PM PHILIPPINES

↓ **13.34** PHP -0.22
-1.62%

As of 3:24 AM EDT 10/21/2016

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OPEN
13.56

DAY RANGE
13.12 - 13.60

VOLUME
6,637,900

PREVIOUS CLOSE
13.56

52WK RANGE
10.42 - 13.83

1 YR RETURN
9.92%

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Feedback



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Pepsi-Cola Products Philippines Inc

PIP:PM PHILIPPINES

↓ **3.08** PHP -0.02
-0.65%

As of 3:20 AM EDT 10/21/2016

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1Y

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PSE:MWIDE	Megawide Construction Corporation	Consumer Discretionary	Philippines	26.8x	28.7x	3.3%	11.3%	2.7x
PSE:URC	Universal Robina Corporation	Consumer Staples	Philippines	25.3x	28.2x	11.4%	11.2%	4.3x
PSE:EEI	EEI Corp.	Industrials	Philippines	25x	8.2x	4.3%	10.6%	1x
PSE:DMC	DMCI Holdings, Inc.	Industrials	Philippines	12.7x	58.7x	7.4%	9.8%	1.8x

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Feedback

International Container Terminal Services Inc. (PSE:ICT)

INDUSTRIALS - MARINE PORTS AND SERVICES

STOCK PRICE: 1.55197

MKT. CAP: 3,155.3

DATE OF ANALYSIS: 10/15/2016 •

COMPANY INDEX

VALENS EQUITIES

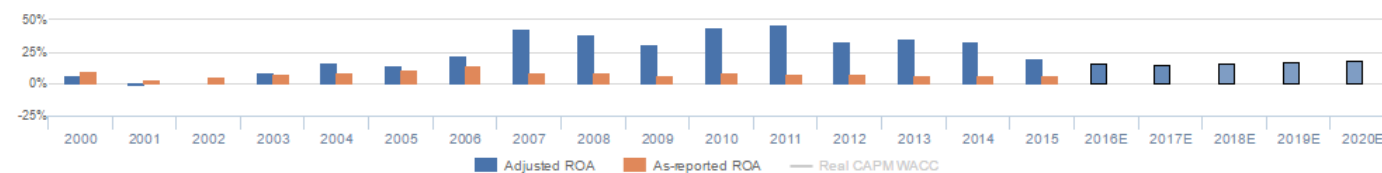
Performance & Valuation Prime

VALENS CREDIT

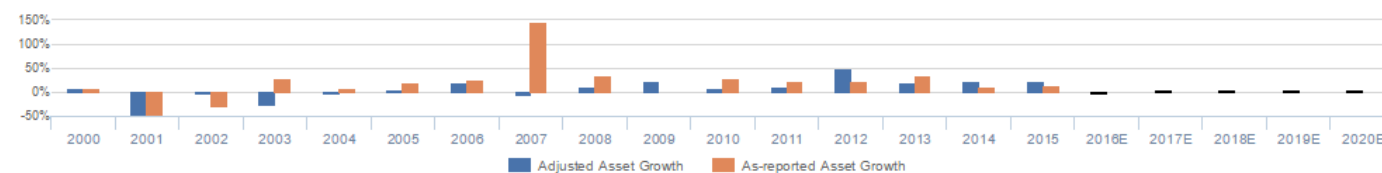
Credit & Capital Structure

☐ Open Embedded Expectations Window

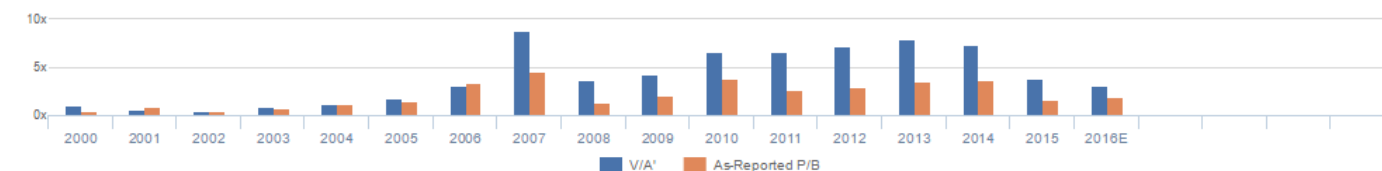
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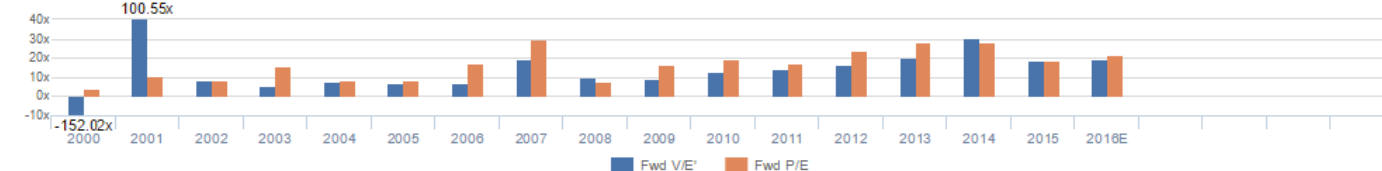
Asset' Growth



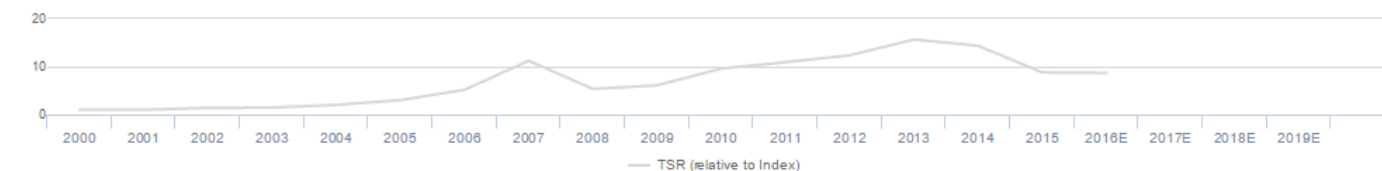
V/A'



Fwd V/E'



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EEI Corp. (PSE:EEI)

INDUSTRIALS - CONSTRUCTION AND ENGINEERING

STOCK PRICE: 7.25

MKT. CAP: 7,513.0

DATE OF ANALYSIS: 10/15/2016 • ⚙️

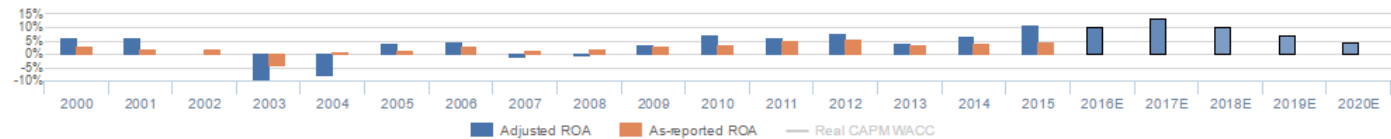
COMPANY INDEX ←

VALENS EQUITIES
Performance & Valuation Prime

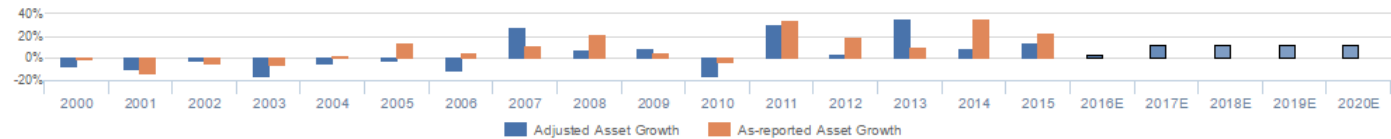
VALENS CREDIT
Credit & Capital Structure

☐ Open Embedded Expectations Window

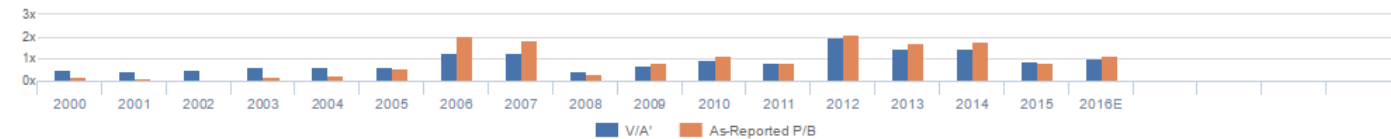
ROA'



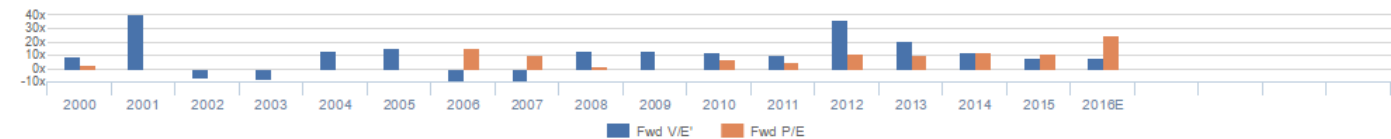
Asset' Growth



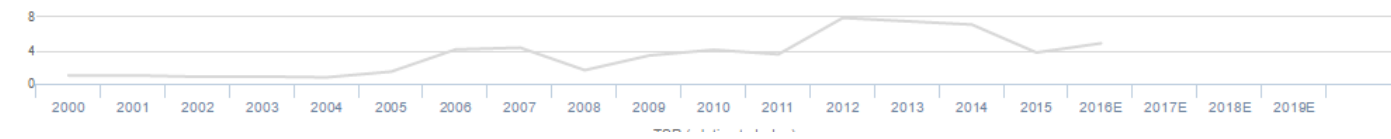
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Ticker 	Company Names 	Sector  	Home Country  	As Reported P/E (Current)  	V/E' Current  	As-Reported ROA (FY0)  	ROA' FY0  	V/A' Current  
PSE:CIC	Concepcion Industrial Corporation	Industrials	Philippines	23.2x	44.2x	13.8%	18.2%	3.7x
PSE:GMA7	GMA Network, Inc.	Consumer Discretionary	Philippines	10.5x	11.3x	13.1%	8.6%	1.3x
PSE:CNPF	Century Pacific Food, Inc.	Consumer Staples	Philippines	21.1x	22.2x	11.8%	13.2%	3.6x
PSE:URC	Universal Robina Corporation	Consumer Staples	Philippines	25.3x	28.2x	11.4%	11.2%	4.3x
PSE:GLO	Globe Telecom Inc.	Telecommunication Services	Philippines	15.1x	28.1x	8.2%	3.4%	1.1x
PSE:LBC	LBC Express Holdings, Inc.	Industrials	Philippines	20.5x	21.9x	8.1%	7.3%	3x
PSE:PGOLD	Puregold Price Club, Inc.	Consumer Staples	Philippines	19.4x	21.9x	7.9%	12.8%	3x
PSE:DMC	DMCI Holdings, Inc.	Industrials	Philippines	12.7x	58.7x	7.4%	9.8%	1.8x
PSE:GTCAP	GT Capital Holdings, Inc.	Financials	Philippines	15.2x	33.5x	6.6%	15.1%	1.6x
PSE:HOUSE	8990 Holdings, Inc.	Real Estate	Philippines	7.8x	14.8x	6.5%	9.0%	1.6x

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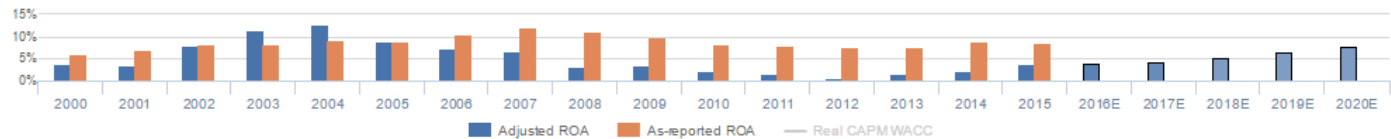
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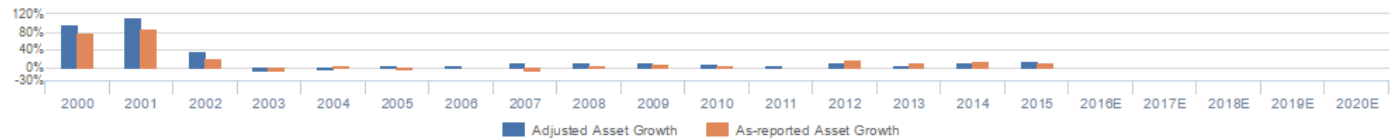
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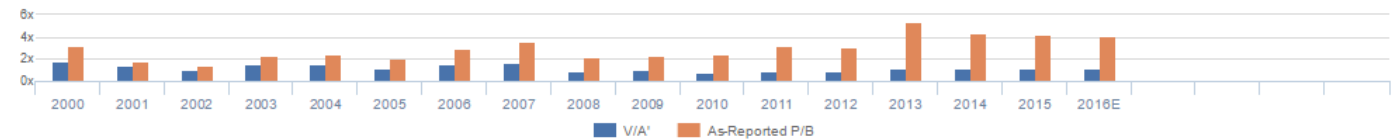
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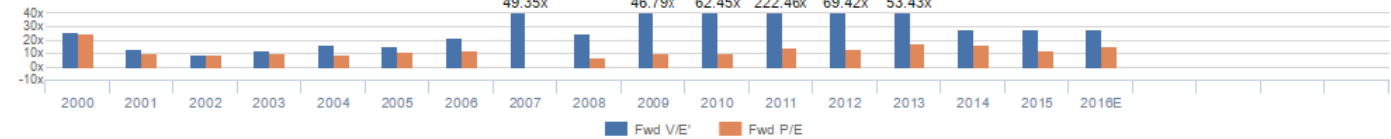
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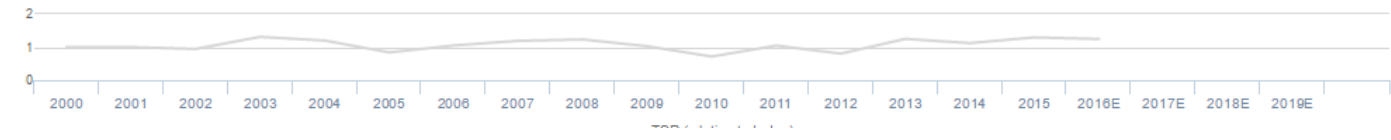
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“Without the firm handle on that flexibility that credit analysis provides,

...we'd argue you can't fully understand the wealth-creation process as an equity investor.”

Mitchell Julis
Canyon Capital



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Ticker	Company Names	Sector	Home Country	V/A' Current	5 Year CDS (current)
X	United States Steel Corp.	Materials	United States	0.5x	958.8
YRCW	YRC Worldwide Inc.	Industrials	United States	0.9x	923.6
CYH	Community Health Systems, Inc.	Healthcare	United States	1.3x	862.6
LSE:VED	Vedanta Resources plc	Materials	United Kingdom	0.7x	825.6
CHK	Chesapeake Energy Corporation	Energy	United States	0.3x	808.4
VRX	Valeant Pharmaceuticals International, Inc.	Healthcare	Canada	8.4x	775.4
DYN	Dynegy Inc.	Utilities	United States	1.7x	656.3
THC	Tenet Healthcare Corp.	Healthcare	United States	1.8x	645.4
FTR	Frontier Communications Corporation	Telecommunication Services	United States	0.9x	636.3

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Ticker ↕	Company Names ↕	Sector ↕ ⚙	Home Country ↕ ⚙	V/A' Current ↕ ⚙	5 Year CDS (current) ↕ ⚙
FTR	Frontier Communications Corporation	Telecommunication Services	United States	0.9x	636.3
WIN	Windstream Holdings, Inc.	Telecommunication Services	United States	1x	634.4
WFT	Weatherford International plc	Energy	Switzerland	1x	619.9
WLL	Whiting Petroleum Corp.	Energy	United States	1.1x	616.7
AVP	Avon Products Inc.	Consumer Staples	United States	2.9x	607.9
SVU	SUPERVALU Inc.	Consumer Staples	United States	1.1x	605.4
UIS	Unisys Corporation	Information Technology	United States	1.9x	595.1
ESV	EnSCO plc	Energy	United Kingdom	0.8x	585.5
NAV	Navistar International Corporation	Industrials	United States	2.6x	570
JCP	J. C. Penney Company, Inc.	Consumer Discretionary	United States	1.1x	557
AMD	Advanced Micro Devices, Inc.	Information Technology	United States	1.7x	523.6
NE	Noble Corporation plc	Energy	United Kingdom	0.6x	507.6
BZH	Beazer Homes USA Inc.	Consumer Discretionary	United States	0.7x	501.7
CLR	Continental Resources, Inc.	Energy	United States	2.2x	486.7

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VALENS RESEARCH

The Dark Side of Financial Statement Analysis And the Impact on Equity and Credit Investing

Professor Joel Litman
October 2016

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