



Why Debt & Equity Investors Look at Financial Statements Differently – And Why You Should Care

**Adjusting Financial Statement Information to
Achieve Relevancy to the Users of Financials**

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*If you are interested in analysis similar to this working paper, please consider attending luncheon & workshop on March 29, 2017, in Hong Kong entitled: **The Dark Side of Financial Statement Analysis***

Accurately adjust for gross distortions in financial statements, and significantly improve both your equity and credit research.

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As a firm thesis, we contend that information contained in corporate financial statements needs to be reclassified into relevant groupings and adjusted in various ways in order to yield calculations that are most valuable to the users of the financial statements. This common-sense observation is fraught with complications that are almost always left unaddressed by major financial data providers and sell-side research purveyors.

This specifically acknowledges that there is no one-size-that-fits-all in financial statement ratios and analysis. Different elements of the financial statements, and analyticals derived therefrom, will be more or less important to different users depending on their stake in the company's outcomes.

For example, a debt holder may simply be concerned about the company's ability to ensure that a particular tranche of debt be serviced until its maturity date, and have little or no interest in the debtor's longer-term liquidity or ultimate survival abilities. On the other hand, for an investor in the common equity of the same company, the concern is primarily with the long-term prospects of the firm, although near-term liquidity is relevant if it could impinge on solvency and thus on long-term survival.

Indeed, based on a survey of thousands of valuation models using the discounted cash flow method, in the majority of the cases an overwhelming portion of the value of the firm is dependent specifically on what happens to the company AFTER year four, and not on the first four years. The importance of cash flow generation over the first four years is only indirectly relevant, and for many early stage companies, even that is seemingly irrelevant, because meaningful cash flows will not take place during the first years of operations.

Accordingly, it may be that the relevance of information in the reported financial statements, and the financial analytical and valuation calculations based thereon, and thus the appropriate grouping of data, can differ markedly depending on which users of the financial statements are to be served. The primary distinction will be between debt holders and equity holders, but even this may vary among the classes of creditors and other claimants (lessors, etc.) to the cash flows of the firm. This set of distinctions is probably fairly well understood, and addressed, by many analysts.

However, what is not so obvious to major database providers and sell-side analysts is that the very calculation of the commonly known ratios may need to vary as well. Whether the ratios of interest pertain to return on assets, capital



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expenditures, margins, or other statistical computations, these may each require a dissection and rebuilding (i.e., analysis and synthesis) of the financial statement items in the way that is most relevant to the particular class of user.

For one example, consider the case of pension expenses. First, it is not fully appreciated by the general analyst community and by users of popular databases that pension expense is an integral part of the costs that reduce reported cash flows from operations, as reported in the statement of cash flows.

Furthermore, it is even less commonly understood that the calculation of pension expense includes the impact of actuarial adjustments recognized in the current reporting period, which in general will not be predictive of the entity's future cash flows from operations. Indeed, such adjustments have only a limited relationship with the entity's actual operations of the current reporting period, even though under generally accepted accounting principles, they are to be reported currently.

Third, it seems also virtually unrecognized by most users of financial statements that, particularly for many large industrial companies having unionized work forces, the pension expense number can be super-material to the level of cash flow from operations, net income, EBITDA, and other measures of the firm's annual performance commonly employed.

In response to such possibly distorting anomalies in the financial statements, some academics and practitioners have called for recalculating cash flow from operations and adjusting earnings to remove from reported pension expense those aspects of accounting that can cause material, even year-to-year directional changes from pension expenses that are either non-cash in nature or that are not from the current year, or both.

One such adjustment advocated by some equity researchers is to simply "count" only the pension service cost for the year, and remove all other effects from the total reported pension expense number. It would appear that such adjustments would "smooth" or eliminate the effects of many pension expense adjustments included in the current measurement year that stem from changing forecasts or from booking "catch-up" charges from prior years.

The notion underlying such adjustments is that pension service cost is to provide the best estimate of the cost associated with the ultimate retirement of employees resulting from their provision of service in a particular measurement year.



Why Debt & Equity Investors Look at Financial Statements Differently – And Why You Should Care

Therefore, it provides a better estimate for forecasting a longer-term calculation of performance, and is more suitable for judging changes in the operating performance of a firm, so that it is not distorted by the aforementioned non-recurring components of pension expenses that can exhibit a “lumpy” pattern from year to year.

The equity investor may want to ascertain that what is incorporated in the pension cost going into the “terminal period” of a valuation, beyond the explicit forecast period, provides the best estimate applicable to the long-run forecast period. They would not want to have used a pension expense number from a particularly high or low “lumpy” year of pension expenses. The use of the pension service cost (possibly also inclusive of the interest accrued on the projected benefit obligation) is therefore compelling for measuring the operating performance of the firm. The real, legitimate effects of actuarial adjustments – i.e., those that imply that too much or too little pension expense had been recognized in past periods – can be handled at the balance sheet level, adjusting the total pension obligation without distorting the current year’s operating performance. Note that such a departure from generally accepted accounting principles would be undertaken for specific financial analytical purposes, and is not meant to imply that GAAP-basis financial statements are not correct, per se.

This wouldn’t be a bad solution at all, given the focus of those users of financial statements. However, would one apply this same adjustment for debt analysis? Probably not.

The debt-holder users of the financial statements have concerns that are not well served by estimating the longer-term forecasts of the firm. Instead the focus is the near term, specifically over the period to maturity of the debt. Of paramount importance are the actual cash flows available to avoid default, up to the point of maturity, permitting the firm to pay its debt obligations as they become due.

For this reason, the focus of the debt-holder might more usefully be on the actual pension cash contributions to be made. The interest coverage ratios, debt to cash flow ratios, and other performance measures might therefore only incorporate cash flow costs related to pension payments over time to maturity.

Certainly, when a firm fails to make adequate cash contributions to support its long-term pension obligations, it might impose severe limitations on its ability to offer retirement benefits, attract new employees, and keep existing employees satisfied and secure. These can occur when the firm’s pension assets fall below certain levels relative to its pension obligations.



Why Debt & Equity Investors Look at Financial Statements Differently – And Why You Should Care

However, should a firm actually default on repayment of a loan, these hardships would pale in comparison to the issues that could impact the firm's employee-related activities. Simply stated, there is no firm that would rationally make a cash contribution to its pension at the risk of defaulting on its debt obligations. The company would choose to not contribute to the pension and would instead conserve its cash for debt service payments. It would make no sense, from the perspectives of any of the stakeholders of a company, from owners to employees, for a firm to risk default and bankruptcy in exchange for maintaining a healthier pension position. ("What firm would strive to provide additional coverage for future retirees, while terminating all the current employees because of bankruptcy?")

For this reason, the notions of "adjusting earnings" and "adjusted cash flow from operations" can require wildly different calculations of analytical ratios or comparisons derived from financial statement information, in order to make them relevant to different users of the financial statements. Equity holders have a different claim on, and thus interest in, the cash flows of the business than do the debt holders. Those differences arguably will require complexities in financial statement analysis that goes beyond simply "adjusting the financials," as commonly observed. The analyses to be prepared for different holders require different adjustments.

Interest coverage ratios calculated for the holders of debt tranches having near-term maturities, say, in the next 2-5 years, might completely remove any cost of pension cash contribution. This would be done with the understanding that management would not make such payments as long as interest and debt service might require those cash flows. This would represent an additional cushion for debt holders, one that could be in the billions of dollars, protecting against default risk.

On the other hand, with equity holders assuming that the firm is a long-term going concern, their place in the capital structure requires that they expect to receive cash flows from the firm AFTER all other obligations are paid, to include servicing its pension obligations.

The calculation of financial ratios for a particular firm can require very different "adjustments" in order to make those calculations meaningful to a particular class of users of the financials.

Another obvious example involves leases.

For comparability purposes, some more-advanced database providers have begun



Why Debt & Equity Investors Look at Financial Statements Differently – And Why You Should Care

capitalizing all operating leases, thus explicitly recognizing the associated assets and debt obligations, in order to facilitate comparability among firms that capitalize some leases and do not capitalize others.

However, for debt analysis purposes, a user might avoid capitalizing the previously non-capitalized operating leases, relying on financial reporting as dictated by current GAAP rules (which, however, will likely change in the next few years, such that all leases will receive capital treatment). This further complicates the need for debt analysts to understand the real default risk. Clearly, “book debt” that appears in the financial statements from unsecured lending has an entirely different character of default risk than “book debt” from asset-backed leases. Default on a lease might result in the creditor repossessing the asset, but it is less likely that default on a lease would result in a lessor obtaining control over all the assets of the firm.

Furthermore, not only would the debt analysts not capitalize the operating leases in the financial statements, they might appropriately seek to DE-capitalize the leases that had been previously capitalized. For firms with any significant leasing activity, the decision to capitalize or de-capitalize leases can have extremely material effects on many or most of the key financial ratios, and can easily result in the appearance of direction-changing implications from year to year, and across firms even in the same sub-industry. (These issues are distinctly NOT inherent across industries, and are distinctly intra-industry complications.)

The importance of adjusting a given entity’s financial statement ratios and the resultant analyses has been heralded by some leading database providers and academics. What is not as often discussed is how markedly different those adjustments need to be in order to service the particular user, and debt versus equity analysis highlights this issue.

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