Lembas Capital

ALPHA-GENERATING ACCOUNTING

How Alpha Hides in GAAP Accounting

The market may be a weighing machine in the long run, but it sure helps to know when someone is putting a thumb on the scale.

You can generate significant alpha by understanding the mechanics that drive GAAP accounting.

Both investors and entrepreneurs can benefit. Investors can buy companies with temporarily ugly numbers and can short stocks with superficially good reports. Entrepreneurs can better market their equity to potential investors and win the fundraising contest over their competition.

This alpha exists because our metrics based on the Generally Accepted Accounting Principles (GAAP) are a victim of their own success. The framework we built to analyze nineteenth-century railroads is largely the same one we use today to evaluate digital networks, raise capital for pharmaceutical candidates, and finance modern industrial projects. The Financial Accounting Standards Board (FASB) has, overall, done an excellent job at keeping this framework relevant. But sometimes GAAP lags business reality, and some of our fundamental metrics are in need of an update.

The main problems with GAAP are twofold. First, GAAP doesn't show you sample journal entries that lead from a transaction to a company's books. Second, it's not easy to see who is involved in each transaction. A business only has so many types of key relationships – customers, employees, suppliers, investors, competitors, the government, and the public at large. Companies track these relationships; GAAP does not.

The solution is simple. Walk through the major GAAP drivers from journal entries to publi reporting and parse out those relationships to reframe our existing metrics. I'll spare you a long weekend with the ***Accountants' Handbook*** and start with my conclusions:

1. "Revenue" Isn't Revenue (It's Contract Timing)
2. The Cash Conversion Cycle Should Be Measured in % and Include Deferred Revenue
3. "Free Cash Flow" Isn't Free Cash Flow (It's an Accrual Metric)
4. WACC Should Include All Liabilities
5. Equity and Share-Based Compensation Should Be Marked to Market

You can generate alpha by recognizing how reported GAAP numbers will attract or rebuff capital from the investment community at large. It's not enough to find an accounting flaw that will later resolve itself. You need to understand how other investors will trade on that information in order to capture the mispricing.

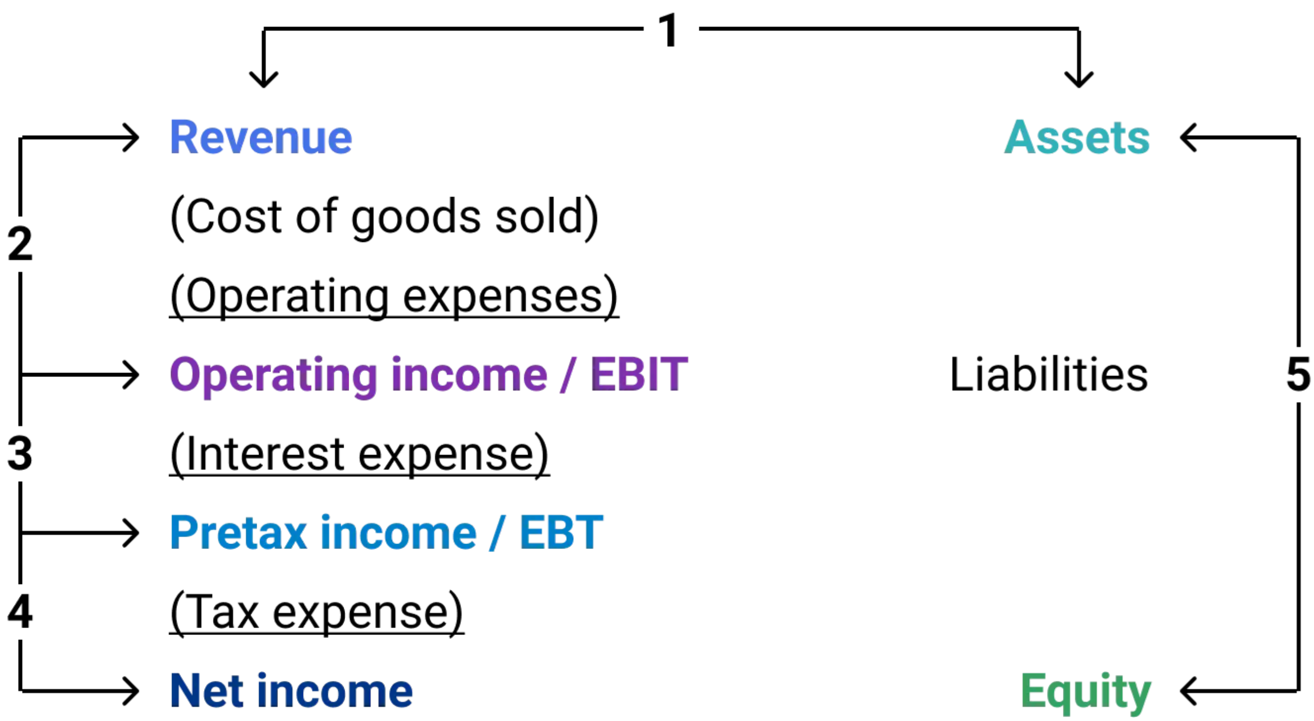
Return on equity is the glue that holds GAAP together, so that's where we'll start.

Why Can't We Just Use Return on Equity?

The idea of long-term risk-adjusted return on capital **existed long before economists invented the term for it**. The old merchants of Venice may not have known the modern rules for what should be booked as revenue this year vs. next year, but they surely thought hard about their return on investment. What gets measured gets managed, so double-entry accounting was developed in the Middle Ages to track businesses and reduce bookkeeping mistakes.

In 1914, **Donaldson Brown** at the DuPont Company invented a way to use double-entry accounting for business analysis. He broke down the inputs to after-tax earnings per each invested dollar, making it easier to isolate which drivers matter most for a company's return on investment. Everyone today calls this **return on equity** (ROE) analysis.

Fig 1. The DuPont Return on Equity Formula



$$\text{Return on Equity} = \frac{\text{Net income}}{\text{Equity}}$$

$$= \underset{1}{\frac{\text{Revenue}}{\text{Assets}}} \quad \underset{2}{\frac{\text{EBIT}}{\text{Revenue}}} \quad \underset{3}{\frac{\text{EBT}}{\text{EBIT}}} \quad \underset{4}{\frac{\text{Net income}}{\text{EBT}}} \quad \underset{5}{\frac{\text{Assets}}{\text{Equity}}}$$

Source: Lembas Capital

So long as revenue, expenses, assets, and liabilities are accurately booked, executives can use the DuPont ROE formula to assess where each of their business units is outperforming or underperforming. One might need to work on increasing sales turnover (#1 in Fig 1); another might be better served by improving operating efficiency (#2).

The problem, as we all know, is that accounting reports often do not map closely to business reality.

Mapping GAAP to Relationships

Businesses don't run on accounting outcomes. They run on relationships.

No entrepreneur worth her salt needs a consultant to tell her to build a competitive moat or to earn a high return on equity. She would, however, be interested to hear of a cost-effective customer acquisition channel or of an untapped pool of talented employees or of a new supplier that could reduce her cost of goods sold. Her business's GAAP accounting outputs are tied to the relationships that she builds and maintains.

Just like Donaldson Brown broke down return on equity into its constituent parts, we should categorize each line item in GAAP accounting by the type of business relationship involved.

Fig 2. Categorizing GAAP by Relationships

Relationship	Income Statement	Δ on Balance Sheet	Cash Flow Statement
Customers	Sales	Δ Accounts/Receivable (A)	
		Δ Deferred Revenue (L)	Cash collected from customers
Employees	(COGS expense, portion)	Δ Capitalized R&D/S&M (A)	
	(R&D expense, portion)	Δ Cash Wages Payable (L)	
	(S&M expense, portion)	Δ Share Comp Payable (L)	
	(G&A expense, portion)		(Cash paid to employees)
Suppliers	(COGS expense, portion)	Δ Inventory (A)	
	(R&D expense, portion)	Δ Accounts/Payable (L)	
	(S&M expense, portion)		
	(G&A expense, portion)		(Cash paid to suppliers)
Capex	(Depreciation expense)	Δ Net Fixed Assets (A)	(Tangible capex paid in cash)
	(Amortization expense)	Δ Net Intangible Assets (A)	(Intangible capex paid in cash)
Investors	(Interest expense)		
	Interest revenue		(Net cash interest expense)
		Δ Debt (L)	
		Δ Equity issued (L)	Cash from (to) financiers
Government	(Tax expense)	Δ Deferred Tax Asset (A)	
		Δ Deferred Tax Liability (L)	(Cash taxes paid)
Equity Owners	Net income to equity owners	Δ Accruals	Cash flow to equity owners

Source: Lembas Capital

This framework would help you identify which relationships are overperforming or underperforming. You could follow how each line item is connected across the financial statements and then dig into anything you find particularly interesting. Excel-related questions on each quarterly analyst call would be all but eliminated (perhaps I'm dreaming here).

But companies today don't report their statements from the journal entries on up, and their business relationships are underappreciated in our current methods of analysis.

Every mismatch between GAAP metrics and business reality is a potential alpha opportunity for you.

To start, we'll look at revenue recognition, the cash conversion cycle, and free cash flow.

Not all of a company's key relationships result in a financial contract. That's why some are not mentioned in the example GAAP statements in Fig 2. You might consider Capex as a form of payment to suppliers, but I've kept those relationships separate to make it easier to follow. You could also create more categories, but I stopped at 7 to keep things relatively simple (customers, employees, suppliers, investors, competitors, the government, and the public at large).

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