Why accounting rules shouldn't drive strategy
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When changes in accounting rules provide no new information, they don't register with investors. Nor should they lead managers to shift focus.

The US Financial Accounting Standards Board (FASB) recently adopted new rules to require that companies reflect the value of their pension funds on the balance sheet. Critics almost immediately began complaining that the change would cause investors to rethink the value estimates of a wide swath of companies. Those with significant pension liabilities, the critics argued, would face lower valuations as they moved off-balance-sheet assets and liabilities onto the balance sheet.

Yet we are certain that knowledgeable investors won't pay much mind. After all, they've seen such rule changes before. Remember the rules that govern accounting for M&A and for expensing stock options? In both of those high-profile cases, none of the changes made the slightest bit of difference to the valuation that knowledgeable investors placed on stocks.

The greater risk, however, is that the new accounting rules could lead managers to make strategic mistakes that might actually destroy value. The new accounting rules merely move data from one page of an annual report to another. Yet we've already heard executives pondering plans to change capital structure policies, dividend payouts, or buyback programs to accommodate greater volatility in shareholder equity as expenses and liabilities appear on balance sheets.

With few exceptions,1 these managers would be ill advised to use financial-accounting changes to guide strategic decisions. Investors already know the level of pension liabilities from the ample disclosures in the footnotes to financial statements. With no new information, they will value businesses just as they did before. In short, managers should not change their behavior merely because accounting rules have changed—and they must learn to ignore the pundits and to focus on investing in projects with a positive net present value (NPV), even if next quarter's accounting earnings drop.

Remembrances of things past
Before managers make strategic mistakes, they would do well to recall some earlier episodes of controversy over changed accounting rules. In 2001 intense lobbying, news coverage, legislative reviews, and general bluster accompanied proposed new accounting rules for mergers and acquisitions. Before then, companies could, in certain well-defined circumstances, carry over the book value of an acquired company with no goodwill,2 using an accounting approach known as pooling of interest. After the rule changed, all transactions automatically generated goodwill, which is recorded as an asset and must be tested periodically for a loss in value. If the test indicates such a loss, the company must write down the difference and charge it against earnings. Either method results in identical cash flows, and therefore value, since any writedown of goodwill is a noncash charge.3

Back in 2001, though, managers, lobbyists, and banks alike feared that the elimination of pooling accounting would make acquisitions more difficult, thus stifling activity. Yet four years later, such fears have proved unfounded; M&A volumes and values are back to their peaks before September 11, 2001. This makes sense. The value created by an acquisition is driven by the fundamental value of the acquired company, the price paid, and cash flow synergies, not from the way the company accounts for them on the balance sheet.

The real value destruction came from managers, who prior to the rule change jumped through hoops—and spent substantial sums on accountants—in an effort to make the pooling of interest possible for deals that were straightforward takeovers. Take, for example, AT&T's acquisition of NCR, in 1991.

To get NCR to agree to pooling accounting, AT&T incurred costs on the order of $500 million, according to outside-in estimates.4 That money was wasted because investors don't care about the accounting treatment of a deal. Similarly, executives still often use accounting rationales such as earnings per share (EPS) accretion to drive M&A decisions. Finance theory and practice make it crystal clear that using changes in EPS as a proxy for value creation is misleading at best and completely wrong at worst.5

Another accounting tempest erupted in 2004, when FASB began requiring companies to account for employee stock option expenses on their income statements—more than ten years after the first attempt to change the rules. Coalitions of companies, politicians, and business publications joined hands to argue that the change would ruin businesses, especially in the high-tech industry, by limiting their freedom to issue employee stock options.

Of course, all the information necessary to put a value on issued and outstanding stock options had long been available in the footnotes to the financial statements of US listed companies. Investors, predictably, were nonplussed by the furor. Market participants had for years been able to estimate the dollar value of claims for employee stock options from the disclosures, and nothing in the rules change would affect the market's view of what companies are worth.6 One sell-side analyst we talked with summarized his feelings succinctly: "I don't care as long as the information is there."

Rationally, the expensing of stock options should have been a nonevent. But managers, partially driven by politics and punditry, started to base their compensation policies on accounting rules rather than the value employees added. Many well-known companies changed the way they compensate employees, moving away from options and toward other means, such as restricted stock options and straightforward cash bonuses. In itself, this could be a neutral move. It's the accounting-based rationale that indicates the wrong priorities of executives. Worse, about 900 companies from many industries decided to vest their options early,7 most likely to avoid option expenses in the first year that the new rule went into effect. This move had a negative NPV: employees who previously had to work for several years to gain access to options suddenly had the immediate right (though not the obligation) to exercise them. Since any increase in flexibility increases the value of options to employees, this early vesting inevitably drained value away from shareholders. Again, in some of these cases, the decisions may well have been based on a business rationale. Still, we doubt that it was a good one if the force behind the decisions was accounting rather than the creation of shareholder value.

Pension accounting rules: More of the same

FASB Statement 158,8 which went into effect on December 15, 2006, changes how corporations account for the funding status of their pension and other postemployment benefit plans. Beyond the headlines, this change once again provides investors with no new information: the rule simply means that financial information about the fair value of the under- or overfunding and about the annual financial performance of all postemployment plans must move from the footnotes to the balance sheet and the statement of comprehensive income. The data from the footnotes will replace the current amounts on the balance sheet, which were in essence obsolete estimates and often not even close to the market value of the funded status.

This new standard, which is similar (but not equal) to the requirements of international accounting rules,9 could result in a drop in shareholder equity on the order of $200 billion, or 5 percent, for the S&P 500.10 Yet absent some new information that investors previously didn't have, they probably won't care. Nor will they care about the increased equity volatility that might come with the implementation of the new rule. The changes might require amendments to some tightly written debt covenants, but we doubt they will force renegotiations. Savvy lenders understand the difference between accounting and cash flow: for example, credit-rating agencies have long incorporated in their ratings the debt from pension liabilities and other off-balance-sheet items (for example, leases).

Pension regulations in general are of course important. The US Pension Protection Act of 2006 aims to improve the funding of corporate pension plans by imposing tighter funding requirements, which influence cash flows to equity and therefore equity value. Similarly, scholars and practitioners alike rightfully debate whether the discount rates used in estimating pension liabilities are correct, given macroeconomic developments. But this is a good debate about the NPV of liabilities—and very different from moving data from one page to another.

Watch out for what's important

Given these changes in accounting rules—and the certainty that more will come—value-minded managers, boards, and advisers must be disciplined about keeping their focus on fundamentals. Too much time is wasted debating the impact of accounting rules that simply do not matter.

In our experience, when managers plan to change capital funding or payout regimes, pensions, compensation, or other financial plans solely as a result of revised accounting rules, value is typically destroyed. Shareholder value depends on cash flows and the cost of capital, not on the method of accounting for them.

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