FASB

Cash Flows Rules Causing Misleading Valuations of Tech Firms? Some Want FASB to Study

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The FASB should add another project to its agenda on the statement of cash flows because current rules cause analysts to overvalue technology companies that aggressively use stock-based compensation to pay employees, some say.

"Just like shell games, investors are investing in something that is not there," Niall O'Malley, managing director, portfolio manager at Blue Point Investment Management, said on January 12, 2024. "Emerging and high-growth software companies often generate minimal returns on their income statement as they seek to gain market share. Investors rely on their cash flow from operations and free cash flow to value the company," he said. "Under current FASB accounting rules, investors and analysts are overvaluing companies that aggressively use stock-based compensation, since an ongoing operating expense is being added to operating cash flows and free cash flows."

In general, the topic generates a lot of attention because it involves billions of dollars — up to 8 % of total compensation for public companies in the US. Under current US GAAP, stock-based compensation is recorded as a non-cash expense on the income statement. When creating the statement of cash flows, the stock-based compensation gets added back because it is not viewed to be an actual cash outflow.

The method of compensation particularly for software companies and technology companies have migrated over five times since 2006, and so needs to be broken out clearly and not added back because it's an ongoing expense, according to O'Malley, who authored, Overstated Cash Flows and Ownership Shrinkage: Accounting Treatment of Stock-Based Compensation Needs to Change, in the Baltimore Business Review. "The models on Wall Street are treating the free cash flow as something that compounds and contributes to the terminal value which is creating a situation where the technology stocks are seriously overvalued," he said.

Others agree, stating that a better accounting approach would be to add back the stock-based compensation in the financing section of the statement, or do an offsetting entry.

"Today stock comp has been accounted for when you calculate diluted shares outstanding but future stock comp is not accounted for. That's a big number for some of these companies — it's all of their free cash flows and more," Cornell University business school professor Sanjeev Bhojraj said on January 16. "For some of them it could reduce the valuation by significant numbers."

Bhojraj explained that two transactions are effectively happening at the same time: one is that the employee is working for the firm and therefore is getting compensated; the other is that the employee is essentially a provider of capital. "In other words, you're adding back a non-cash cash and inflating your future cash flows, while not adequately accounting for the potential increase in future stock issuances," he said.

FASB has Narrow Project for Financial Institutions

The statement of cash flows is one of several that companies must file with the SEC. Some have stressed that since issuance in 1987, ASC 230, Statement of Cash Flows has not been substantially revised by the FASB although much has changed since then.

The board took note and last year **added a project** to its technical agenda to revise the standard in a targeted way to focus on enabling financial institutions to do a better job of telling their story about cash interest received. A research project was also kept to consider further improvements to the statement of cash flows but it is not yet clear what path that will take.

"The technical agenda project (Statement of Cash Flows—Targeted Improvements) does not take up the issue of stock comp," a FASB spokesperson told Thomson Reuters on January 12 via email in response to a query. "However, there is still a research project on the agenda to consider further improvements to the statement of cash flows," she said. "We are currently assessing all feedback in that project."

So far the FASB has gotten mixed responses from investors, according to the board's discussions last year. Two years ago, the board heard that it was an important topic, ranking high on the list among those it should address. But a subsequent survey the board submitted to 9,000 investors in 2023 to gauge the appetite for revisions received lackluster response. Only 44 investors responded to the survey and staff had to do further outreach to get feedback from about two dozen more.

"What should I take from a survey on a topic to an investor that doesn't respond?" FASB Chair Richard Jones observed during the meeting. " Even those who responded said that they 'get what they need today' which I thought was an interesting response."

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