QV UPDATE
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The Past Isn't What It Used to Be

At a recent client meeting, a question was posed: "Does book value remain a useful metric for evaluating QV Global Equity Strategy holding Berkshire Hathaway?" It's a good question that reveals a broader theme.

Since 1965, book value – an accounting convention measured as a company's assets net of its liabilities, has been the primary yardstick used to approximate the growth in Berkshire's underlying value. However, in Berkshire's 2018 annual letter to investors, CEO Warren Buffett stated that after 54 years, Berkshire will abandon its focus on communicating annual changes in book value because the metric has become less relevant. Its usefulness has declined over time as Berkshire's operating businesses (which are stated at cost in the company's financial statements) have grown to comprise a much larger proportion of the company's underlying value than its securities (which are stated at current prices.) Although book value still retains some explanatory power, it increasingly understates Berkshire's true economic value.

On a related note, the analytical value of Berkshire's reported earnings has also recently decreased due to a 2017 change in US accounting rules. This new rule requires businesses to include unrealized security gains and losses within their income statements. For companies with a large equity portfolio like Berkshire, this rule introduces volatile swings in reported net income, which reduces clarity on the trajectory of earnings per share in the business. While investors can easily remove these gains or losses to arrive at underlying operating earnings, both of these examples offer a broader reminder that very few constructs in investing remain monolithic over time. Market structures shift, business models evolve or go extinct, and external changes can and do relegate long held conventions to the dustbin. Accordingly, changing landscapes require evolving analytical frameworks.

In 2019, investors will have to adapt to another accounting change. This new rule mandates that most operating leases, previously accounted for as off-balance sheet liabilities, must now be reported as on-balance sheet items. For companies with large operating lease portfolios, the effect on financial statements is meaningful. As an example, UK-based grocer and QV Global Equity Strategy holding Tesco PLC recently outlined how the new rule will impact its financial results. Capitalizing operating leases will create a right-of-use asset on its balance sheet as well as a new lease liability. As a result of this accounting change, Tesco's book value will decrease by ~10% and debt levels will appear to rise considerably. Operating lease rental expenses will be removed from the income statement and replaced with new depreciation and interest expenses. As a result, operating income will rise ~20%, but profit before tax will fall ~15%. This accounting change introduces a permanent shift in stated profit, valuation and debt metrics. Depending on the size and relative maturity of an operating lease portfolio, and how companies elect to adopt the accounting change, other companies' financial metrics will be more, or less, affected than Tesco's. While this may sound complicated (it is), it's important to keep in mind that although these changes will affect the comparability of financial metrics relative to the past, there is no economic impact. Revenues and cash flows will not change, but investors will have to adjust their analytical lens.

Adventures in accounting aside, the tectonic plates of capital markets rarely cease to shift either. Today's stock market is not the same as it was 20 or 30 years ago. Sustained low interest rates and the change in the US corporate tax rate have impacted corporate profit margins relative to the past. Long-term trends like the offshoring and outsourcing of manufacturing and shifting index sector representation have affected aggregate capital intensity and cash flow characteristics. Such shifts affect the interaction of financial ratios and valuation, potentially altering comparability over time.

Good conclusions are more often drawn with the benefit of historical context rather than information attained in isolation. An adaptive framework that incorporates shifts in comparability over time is a critical component in this process.