Discussion of “Operational Restructuring Charges and Post-Restructuring Performance”*

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1. Introduction

“Operational Restructuring Charges and Post-restructuring Performance” examines an important and interesting issue. Atiase, Platt, and Tse (2004) investigate whether firms that report restructuring charges exhibit improved future performance. This question is relevant because one of the motivations usually cited by management for restructuring is to improve performance and create shareholder value. Therefore, determining whether restructurings are beneficial is important for evaluating management and making investment decisions.

2. Research design issues

The key problem that Atiase, Platt, and Tse face when investigating the relation between restructurings and future performance is determining how restructuring firms would have performed had they not done the restructuring. This information is, of course, not available, so the authors provide two other comparisons:

1. the firm with itself before and after the restructuring, and
2. the firm with a control matched by industry and performance prior to the restructuring.

Each of these benchmarks can be criticized. Comparison (1) is problematic because the restructuring may have improved or hurt performance relative to the firm’s performance had it done nothing. Comparison (2) is problematic because the decision to restructure is not exogenous. Restructuring is an endogenous decision based on many factors, such as the firm’s investment opportunity set, the state of the economy, and prior accounting decisions made by management. The fact that the control group chose not to restructure (even assuming that they had similar prior performance) suggests that they are fundamentally different from the restructuring firms. The authors point out that the control firms are smaller than the

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restructuring firms. The problem, however, is more general; any differences we observe post-restructuring between the two groups may be driven by factors other than the restructuring. These problems make interpretation of the results difficult.

A more fruitful path for the authors could have been to reduce the scope of the paper and consider a specific situation when it is important to know whether restructurings improve performance. For example, are managers held accountable for restructurings, and does compensation differ when restructurings are successful versus unsuccessful? Alternatively, we may be interested in predicting the type of restructurings that are most likely to be successful from an investor's perspective. Another perspective would be to examine whether performance improvement varies with the type of restructurings undertaken or the type of charges included in the restructuring. The broad objective set by the authors led to a research design that made it difficult to know how to practically apply the results in the paper.

A second issue is the measures of performance used and the mechanical implications of a restructuring charge on these measures. The authors examine future performance in terms of changes in return on equity (ROE), operating income before depreciation (OPIN), and cash flow from operations (CFLO) relative to a base year (where the base year is either the year of restructuring or the year before the restructuring). A comparison with the year of restructuring is problematic because when the firm decides to take a restructuring, it may also decide to take an "earnings bath". Management may decide that, given that performance is going to be poor, they may as well clean up the books of all overstated accruals. Thus, the base year may understate true performance.

If restructuring charges consist mainly of accrual write-offs, then even when no action is taken by management to improve underlying performance, one would expect to see (mechanically) an improvement in ROE, and to a lesser extent OPIN, purely because the firm has fewer expenses to record. Cash flows suffer less from this problem. Generally, the results are strongest for ROE and weakest for cash flows. This is unfortunate because the mechanical effect works in exactly this direction and makes interpretation difficult. The comparison using the year before the restructuring partially addresses this concern.

A third issue that raises interpretation concerns is the sample selection. The authors acknowledge that they have a survival bias in the sample because of the requirement that the firm have information on future performance. They provide information on delistings and mergers, which helps alleviate survival concerns. However, if the most poorly performing restructuring firms go into bankruptcy or merge and consequently are excluded from the sample, then it is difficult to say that, on average, restructurings lead to future improved performance. One must also add the qualification that the firm must remain in business for at least another three years following the restructuring (a fact that is not known ex ante).

A final issue of concern is the time period examined. The authors used a short window: restructurings occurring from 1991 to 1993. These years are chosen because the authors want some history (that is, at least three years of future performance). However, this makes extrapolating the results to more recent time periods difficult. What types of firms restructured in the early 1990s? Are they the same types of
firms restructuring in the late 1990s? Why are firms in computer services, financial services, health care, and consulting excluded? Are the restructurings clustered in particular industries?

3. Details on types of restructurings

Although firms usually provide very poor disclosures on the costs included in the restructuring, I think that the authors should have attempted to collect this information. The types of costs included could be an important determinant of future performance. For example, if the restructuring charge consists mainly of write-offs of property, plant, and equipment (PP&E) and goodwill, then the timing and amount are likely to be highly discretionary (e.g., Francis, Hanna, and Vincent 1996). These are accounting entries and do not require any action to be taken by management to improve performance. However, writing off PP&E and goodwill will mechanically improve future ROE, because the firm will no longer have depreciation and goodwill expenses and will have a lower book value of equity. In contrast, the timing of write-offs of inventory is less discretionary and the write-offs are likely to have less mechanical implications for future ROE. Recording a liability for future employee severance pay will mechanically reduce future cash flows as the future payments are made, but it does not affect future earnings. It would have been useful if the authors had examined these components and provided insights into the effects of each on their future performance metrics.

4. Other performance metrics

I found it curious that the authors did not investigate stock price performance for restructuring and nonrestructuring firms. Burgstahler, Jiambalvo, and Shevlin (2002) suggest that investors are fairly sophisticated in pricing special items but they do not fully understand the implications of special items. Do restructuring firms end up underperforming or overperforming relative to the market over the time period examined? This would provide insights into whether the firms were in declining industries, whether the sample time period was unusual, and a host of other issues.

Prior research suggests that the market generally has a small positive reaction to announcements of restructurings (e.g., Francis, Hanna, and Vincent 1996). A related question is whether firms with positive stock price reactions end up having better future performance.

Another way of investigating future performance would have been to investigate analyst following. Did restructuring firms retain the same number of analysts? Did they meet expectations in the future? Was there less dispersion of analyst forecasts? I would be curious to understand whether restructuring firms were able to maintain interest in their stock. Analysts often drop poorly performing firms, which can reduce liquidity and increase the cost of raising capital. Thus, understanding how analyst following was affected is an indirect way of investigating performance.

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5. Determinants of future improved performance

An interesting issue is whether we can predict which restructuring firms will perform better in the future. This question is relevant for both management compensation as well as investment decision making. Prior research has examined various factors that influence write-offs and restructurings in a variety of contexts (e.g., Pourciau 1993; Elliott and Hanna 1996; Francis, Hanna, and Vincent 1996; Myers 2001; Moehrle 2002). Some potential determinants are

- whether a new management team takes the write-off (more likely to be an earnings bath blamed on old management),
- when the firm has poor prior performance (the charge potentially reflects a serious recurring performance problem),
- the type of charges included in the restructuring (whether they consist mainly of write-offs),
- the level of earnings in the restructuring year (whether the charge is being used to smooth income or take a bath), and
- the firm has taken a charge before (more likely to indicate ongoing problems).

The last point is not supported in the present study. Surprisingly, the authors suggest that repeat restructurers have better future performance (ROE) than the control group (for example, Figure 2, panel B). However, the problem with this result is the authors find that repeat restructures also had better prior performance than the control group. This result suggests that the matching technique is not working too well. It could also suggest that repeat restructurers could be delaying write-offs in earlier periods. It is not clear whether the multiple restructurers are reporting reversals of prior accruals or undertaking new restructurings. As mentioned above, more detail on the nature of the charges would have helped.

I think the paper would have been improved if the authors had provided ancillary tests ranking restructuring firms on their post-restructuring performance. They could have split firms into quartiles based on future performance. It would be interesting to see whether firms that performed well (for example, top quartile) had different characteristics from firms that performed poorly (for example, bottom quartile). Perhaps good performers were less likely to have had a prior restructuring charge, had better prior performance, were clustered in particular industries, had different turnover in their management teams, were less leveraged, had different levels of prior accruals, and had different accrual components in their restructuring charges than firms that did poorly. Such an investigation could have helped the reader better identify the characteristics of firms that are successful in undertaking a restructuring.
6. Conclusion

The paper addresses an important and interesting question. However, the issues surrounding restructuring charges are complex. When interpreting the results of this paper, one must rely heavily on the ceteris paribus assumption. The results generally suggest that performance improves after restructuring. However, this result does not hold for all metrics and in all tables. The results suggest that sometimes restructurings seem to benefit firms, sometimes they do not. Perhaps this is all one can hope for, because if it was in all firms' interest to restructure, then we should see all firms restructuring all the time. When interpreting the results, one must question the appropriateness of benchmarks used, the mechanical effects of writing off accruals, the effects of recording liabilities that relate to future cash outflows, and the generalizability of the results due to the short time period examined.

References


