

ACCOUNTING FOR VALUE



DAVID CREED LOOKS AT WHETHER CURRENT ACCOUNTING APPROACHES, INCLUDING THOSE FOR SHARE-BASED PAYMENT, ADEQUATELY REFLECT MOVEMENTS IN SHAREHOLDER VALUE.

This article argues that there is a need to change the perspective taken by the International Accounting Standards Board (IASB). Our present accounting standards, and indeed company reports themselves, cover only management's stewardship of the company's assets and liabilities. Companies are accounted from the perspective of the entity itself. Only when this is seen as a subset of a wider accounting that is needed to explore the quality of the management of the assets attributable to the holders of ordinary equity will equity investors be able to appreciate if value attributable to them has been created or destroyed. This assessment, I contend, should be the primary objective of our accounting system.

What is required is an equity management performance statement that would show value created or destroyed through the issue of shares, or options over shares, to persons other than the equity holders, for example by way of treasury shares, employee share options, share buybacks or employee share trust activities where the company is the trust guarantor. It seems to me that a firm starting point in the intellectual journey through this difficult terrain is a statement that, if any two companies have identical economic positions at the start of a year (including an identical equity base) but follow a different path through the year to achieve, by year-end, identical economic positions, then their performances should be accounted, and judged by equity investors, as equivalent. If by the year end they are not identical, the relative gain or loss must be evident between the two companies' performance statements. This concept can be explored using examples from three aspects of financial reporting, namely:

- convertible debt accounting;
- accounting for treasury shares; and
- accounting for share based payment.

CONVERTIBLE DEBT ACCOUNTING

Take, for example, two identical companies that simultaneously issue identical nominal amounts of fixed rate debt at the beginning of the year; one in convertible form (that is, containing an embedded equity option), the other straight. The debts have identical tenors and mature at the year end. Present UK accounting will show a greater gain in the P&L account for the company issuing convertible debt because of its lower coupon relative to straight debt, but no account will be taken of the equity conversion element. Arguably, and ignoring tax, if the convertible debt matures without conversion, it is correct that the company issuing convertible debt has outperformed the other.

However, if conversion occurs, say on the last day of the year, there is at present no easy way of comparing the two companies' performance. This comparison becomes essential if the company issuing straight debt funds its repayment at maturity with an issue of equity to third parties at the market price.

Now we have two companies, in identical economic positions at both the start and end of the year, that will show different performance outcomes in their P&L accounts, and that will have raised the same amount of equity from third parties but, in all likelihood, at different share prices. Only by finding a way of comparing the trade-off between the lower coupon on the convertible debt with the differential in the share prices at which the two companies raised equity will it be evident if value has been created or destroyed for the original shareholders. The IASB is developing an accounting standard that will propose split accounting – that is, ascribe values to the debt and equity elements of convertible debt – but that approach will still not move away from entity accounting to shareholder value accounting.

TREASURY SHARES ACCOUNTING

Some commentators on the implications of the forthcoming treasury stock legislation have argued that companies may be tempted to trade in their own stock – and so they may. How do we account a company's performance in this respect? It is easy to imagine, as in the previous example, two identical companies. One neither buys-in nor issues treasury stock in the year, while the second does so. Assuming that the second company issues all its bought-in stock by the end of the year, and that all its transactions are for cash with third parties at market prices, this firm clearly has a net cash inflow or outflow from its treasury stock dealings and their financing. The first company does not. From the perspective of those shareholders who held stock for the whole of the year, this has to be a performance gain or loss, every bit as valid as that achieved by buying and selling assets within the company. However, at present, it will not be reported as such anywhere in the financial statements.

SHARE-BASED PAYMENT ACCOUNTING

The third example is more complicated but I believe the most convincing and addresses the accounting of share-based payments, currently the subject of FRED 31.

Any share option, given to an employee, is a cost, although it has been rightly argued that it is not a cost to the company from the

perspective of the entity. It is, of course, a potential cost to the company's shareholders, who may be diluted on exercise of the options. They stand to lose the difference in value between issuing shares at market price and at the employee option exercise price. If an employee share option plan (ESOP) is set up, the cost is the total cash cost of setting up, servicing and closing the trust. Note that this last approach can give a gain (or loss) if none of the options is exercised, similar to the gain or loss from an equivalent treasury share buy, hold and sell operation.

PROPOSED ACCOUNTING APPROACH. One way of accounting these activities could be as follows. The options are valued at grant date, as proposed by FRED 31. The P&L labour cost line is charged with the option premium. A new performance statement is set up, within what I will call the equity stewardship account (ESA), with an equivalent income being shown in that performance statement. The ESA also needs a new companion balance sheet to show the funds raised on share issues, so the existing company balance sheet format would change to show equity as a liability, and the ESA's balance sheet would show that liability as an asset.

Since the outcome of the share option grant is unknown, the ESA performance statement needs a provision equal to the option premium income to ensure no initial gain or loss occurs at grant date. In a sense, the operating division of the company has bought the options at market price from the equity management division of the same company, each division having its own accounts. If the options lapse, the premium provision is reversed and the premium appears as a gain in the ESA.

APPLYING THIS APPROACH. Imagine three identical companies:

- *Company One:* does not pay its labour force with share options.
- *Company Two:* pays employees with share options and issues new shares when employees exercise these options.
- *Company Three:* sets up an employee share trust which, on its foundation, buys with company cash sufficient shares from the market so as to satisfy the full exercise of all options granted.

USING SHARE OPTION INCENTIVES. If the above method is applied, Company Two's economic position is identical with that of Company One, where the options are abandoned unexercised. The aggregate of the company P&L and ESA performance accounts for each company will be identical. Of course, this disregards the impact that the issue of options may have had on employees. When in the money, share options can spark employees' enthusiasm (although not necessarily so as to generate greater or more effective output) and when out of the money they can induce employee depression. But, for Company Two, no net cost was incurred, so that any impact on performance from issuing the options is fairly shown in its P&L account.

However, if the options are exercised and shares issued, the ESA performance statement would reflect a loss equal to the difference between the market price at issue and the exercise price, and the provision set up in the ESA performance statement on option grant would be reversed. As a result the ESA performance statement would show a net loss or gain, depending on whether the market price of the shares at exercise was sufficiently above the option exercise price to negate the gain from the reversion of the provision. The issue of new shares at market price is accounted in the ESA as equity capital. (Any issue at below market price would be accounted so as to put the value of the discount as a cost to the ESA's performance statement.)

Suppose that Company One, which did not issue options, decides to

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issue shares at market price on the date Company Two's options are exercised. Economically, both firms will now be in identical positions, save that Company Two's aggregate performance statements (P&L plus ESA) show the correct gain or loss relative to Company One. The relative cash surplus or deficit in Company Two over Company One will equal the reported difference between their aggregate gains or losses. This comforting factor – the cash difference you end up with after completing all steps of a financing operation (which this essentially is) being equal to the reported gain or loss – is a condition whose satisfaction is close to all treasurers' hearts.

USING AN EMPLOYEE SHARE-OWNERSHIP TRUST. In Company Three, the ESOP should be accounted as part of the company's total assets and liabilities, like a defined benefit pension plan fund. However, the activities of the ESOP can best all be reported in the ESA. When all employee options are exercised or abandoned, and all the ESOP's shares allocated to employees or sold in the market, the ESOP will show a gain or loss to be accounted in the ESA performance statement to accompany the release of the option income provision, as in Company Two's case. This gain or loss is just as valid as the gain or loss experienced by Company Two, it is just that the treasurer may have had more fun buying and selling shares in and out of the ESOP.

It is immaterial in the accounted performance outcome in this example whether the company buys or issues shares, or redeems the options for cash at their market value at exercise, or the employees or the company have an option to choose which of these settlement outcomes is desired. FRED 31 differentiates between some of these outcomes in its proposed accounting, but I find there is a fundamental flaw in the concept that a share issue obligation given to employees for a future improved performance is accounted in a performance statement differently according to whether it can be, or is, cash settled. At the end of the day, the employee's gain has to be matched by someone else's loss, whether or not that someone enjoys the value arising from an improved employee performance.

NATURAL PROGRESSION

Accounting for equity management is key to the architecture of our accounting principles. For many years there have been managers, particularly in the US, abusing their equity shareholders and failing to account comprehensively and rigorously for their stewardship of the company's equity. The confluence of the IASB's and ASB's examinations of financial instruments and share-based payments makes the study of the management of the equity base a natural next step.

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