Repurchased own shares-asset or reduction in equity?

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Abstract. The main goal of the study is to discuss the different points of view regarding repurchased own shares as a reporting object, emphasizing the author's opinion on this matter. Based on the study of different points of view advocated by the different accounting systems and in the system of European commercial law, the conclusion of ambiguity in their accounting treatment in a historical aspect is reached, and in conclusion, the capital approach is advocated as a modern and consistent one. The study is limited only to the accounting of corporations as stock issuers, as well as to the statutory regulations of only the two main accounting bodies-FASB and IASB. In the course of the research, special attention was also paid to the managerial and financial considerations motivating the act of share buyback, as well as to some limitations and disadvantages of this financial operation. The thesis advocates that the choice of option for reporting and presentation of the repurchased shares is largely based on the specifics of the relevant legal system (a continental or European (Romano-Germanic) legal family based on the continental legal system or a family of common law based on common (Anglo-Saxon) law and precedent and its relationship with the adopted accounting model. The study utilizes methods of observation, investigation, comparison, induction, and deduction, research and analysis of publications from the scientific community, as well as the relevant accounting regulations developed by the FASB and the IASB, and a number of sources of European commercial law. In a practical aspect the research would be useful for business practice, reflecting the importance of share buybacks by corporations both globally and nationally.

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1. Introduction

In general, it is considered that the acquisition of own shares by the company threatens both creditors and shareholders as it reduces the so-called internal property equivalent of one share (*book value*), which leads to a discrepancy between the size of the registered capital and the actual shareholder property. Therefore, the repurchase of own shares, regardless of the purpose pursued, is prohibited or restricted by some modern commercial laws (for example, British commercial law, see *Companies Act*, 2006, section 658). In Bulgaria, the repurchase of own shares is regulated mainly in Art. 187/a/-Art. 187/e/ of the Commercial Law and special provisions regarding the reduction of capital and the purchase of own shares by public companies are contained in the Law on the Public Offering of Securities.

Share buybacks have been a controversial topic in the US for a long time and even banned for half a century. During the severe economic crisis of the early 1930s, regulators banned such programs because they would manipulate the market. It was not until the deregulation of financial markets under US President Ronald Reagan, which in the view of Wall Street "broke the shackles" of the stock markets, that share buybacks were allowed in late 1982.

In 2023, companies are spending more than ever to buy back their own shares - this boosts share prices but increases debt. Markets currently suffer from a problem: there is far more money than opportunities to spend it. Increasingly, public corporations are solving this dilemma by simply buying back their own stock—often on credit. This tightens supply, allows stock prices to rise, and also increases Almost all companies finance their

expensive programs with bonds and thus, with debt. This trend is unlikely to change as long as corporate bond yields are lower than dividend yields. With each share withdrawn, corporations save money for dividends - and consistently - year after year and earnings per share (Investor.bg 2023).

Stock buybacks, once an American oddity, are taking the world by storm. It hit a global record in 2023 of $1.3 trillion, three times the amount 10 years ago (Manager.News 2023). Although US companies remain the biggest buyers, this type of transaction has quickly gained popularity in mainland Europe and the UK since the start of the pandemic. That's why US President Joe Biden included a new 1% tax on buybacks in last year's Inflation Reduction Act (IRA). Now he wants to quadruple it. And redemptions can be abused. When officials at the U.S. Securities and Exchange Commission (SEC) looked at buybacks in 2018, they found that insider selling increased immediately after the announcements, allowing executives to profit from rising stock prices. The SEC finally did something about it by creating a new rule that will require companies to disclose at the end of each quarter their daily share buybacks, why they did them, and whether executives bought or sold stock around the buyback (Investor.bg 2021).

The buyback of own shares is a popular financial operation among public companies in Bulgaria, which in recent years had a number of procedures for the buyback of own shares. Among them are "Neochim" AD, "Bulgarian Stock Exchange" AD, "Alterco" AD ("Shelley Group" AD), "Monbat" AD, "Sopharma" AD, "Industrial Holding Bulgaria" AD, "Albena" AD, “Agria Group Holding” AD, “Gradus” AD, “Trace Group Hold” AD, “Corado-Bulgaria” AD, “Stara Planina” Hold AD, “Sirma Group Holding” AD, “Lomsko Pivo” AD, "Sofia Commerce - Pawn Shops" JSC, and others (Darik Business Review 2023; Banker 2019).

The heightened interest in the repurchased own shares provokes the need to study it as a specific accounting object from the point of view of the issuing companies, including its characteristics, and the presence of different historically and geographically formed approaches for its current reporting and disclosure in the financial statements.

2. Literature review and implementation

2.1. Financial and managerial considerations motivating the buyback of own shares

Without claiming to be exhaustive, we believe that the buyback of own shares is dictated by a number of financial and management considerations, the most important of which are the following:

a) The purchase of shares by the company is the usual way, which is used to reduce the capital as a result of its size being unreasonably large;

b) In developed countries, corporations buy back packages of their shares to bring the value of the financial indicator "Earnings per share" within favorable limits and to increase the current market price of their shares in circulation. The announcement of a decision to buy back own shares is considered to sharply raise the current market price of all shares of the company in circulation. This reaction is traditionally explained by two reasons. On the one hand, it is due to investors' understanding that the company has foreseen future growth in its earnings that the market has not yet felt and will switch to financing from internal low-cost sources of financing (retained earnings and reserves), reducing its excess capital base. On the other hand, it can be judged that the company's shares are artificially undervalued for the purposes of the buyout, i.e., the internal property equivalent of a share does not correspond to the actual financial position, which is better than expressed in the current market prices at the time of redemption.

Regardless of the above, the data from buybacks in Bulgaria, analyzed by some authors (Valkov, P. 2016) leads to the conclusion that no strong dependence can be drawn between the movement of stock prices before the buyback launch period and the subsequent one-year period and that it cannot be said with certainty that the buyback procedures are related to the dividend policy of the individual companies.

c) The company with a favorable net cash position but with currently inadequate investment opportunities may buy back part of its shares, preferring this operation to the payment of dividends in the future. If it distributes the redeemed shares to the remaining old shareholders, the company will save its investors tax payments on cash dividend income, while also preserving a good liquidity position;

d) Small corporations usually resort to buybacks of their own shares to reduce the possibility of takeovers by rival companies through buyouts. The only reasonable way for a threatened company to protect itself from a takeover is to temporarily restrict third parties access to its shares on the free capital market through the buyout;

e) The company can buy back part of its own shares to form a treasury package to use in cases of business combination. In this case, the purchased block of own shares is considered a means of exchange when the payment for the transaction is made by counter-exchange of blocks of shares between the two companies;

f) The company may buy back its own shares to form a package for the purposes of various employee share ownership plans, to reward certain categories of employees. or to distribute it to existing shareholders in lieu of dividends.

2.2. Accounting treatment of the repurchased own shares

From an accounting point of view and according to the company's intention, the term "repurchased own shares" is considered in two aspects:

- as the equivalent of part of the shares in circulation, bought back to reduce the share capital;
- as a package of own shares that the company holds to use for various purposes (*treasury stock*).

The accounting treatment of repurchased own shares depends on the action of three variable factors related to the **choice of price**, **method of repurchase,** and **purpose** pursued with the act of repurchase:

- When the company believes that its shares are momentarily undervalued in the market, the most appropriate way to realize the buyout is by entering the market as an ordinary investor through an investment intermediary. In this case, the acquisition price of the treasury package will consist of two parts: the current market price of the purchased shares at the time of the operation and the expenses incurred in the purchase (the remuneration of the intermediary of the purchase and the like);
- The company can buy back part of its shares directly from the shareholders by offering them a redemption price containing a premium over the nominal value and rule - above the current market price;
- If the company's right to buy back part of its shares at a certain time and a certain price is stipulated in the articles of association, the redemption is carried out at this price, regardless of the current market quotation, but always close to it and never lower than the nominal value.

In connection with the purchase of own shares to reduce the share capital, almost all accounting systems do not provide for the purchased own shares to be reflected in a separate account, since, as a rule, after the purchase, they are almost immediately invalidated. The withdrawal of a certain number of shares from circulation is considered a return of the original equity investment and should be reflected in the nominal value of the shares repurchased and then canceled.

If the company decides to reduce its share capital through the redemption of shares with a redemption clause (*redeemable or callable stock /shares*), the redemption is carried out at the fixed purchase price, and since it is usually higher than the nominal value, the company must reflect this negative difference for it in one of the following ways:

a) The negative difference should be treated as a discount from issues or as a reduction of a previously reflected premium arising from the issue of the same class of shares. This option was advocated in Opinion №6 *Status of Accounting research bulletins*, APB, and earlier it was regulated by the provisions of the effective until 2001 National Chart of Accounts in Bulgaria;

b) To disclose the negative difference as a kind of capital loss (to be treated as a financial expense). The approach is adopted from British accounting theory and practice (*Companies Act 2006)*;

c) The difference to be distributed based on the percentage ratio between the purchased own shares and all shares in circulation at the time of the operation between the discount account and the financial expense account. This option is also perceived in Great Britain as an alternative.

Unlike share buybacks to reduce share capital, the accounting treatment of repurchased shares held as treasury or reserve of securities is significantly more complex. The difficulty comes from the indeterminacy of the concept of "repurchased own shares held as a reserve" and from the existence of two approaches to this concept.

The first approach is based on the understanding that the company cannot treat the repurchased own shares as its own assets. It is logically inconsistent to believe that by holding part of its shares for a long time, the company can announce an investment in itself, when in fact it is exactly the opposite - there is a reduction in net shareholder property. In this sense, the company cannot own a part of itself, much less exercise the rights carried by its own shares. Proceeding from this argument, logically excluding the transformation of the company into its part-shareholder, it should get rid of these shares by selling them or withdrawing them from circulation, reducing its basic capital.

The approach treating repurchased shares not as a real asset, an item of property but as a reduction in the net value of capital is prevalent in American accounting theory. In the spirit of this understanding, the purchased own shares should be disclosed not as an asset, but as a passive item in the balance sheet with a negative sign, regulating the size of the fixed capital. The specified method of disclosure was adopted through the effective 2002-2007 balance sheet scheme in Bulgaria as well. It is also currently advocated in some European countries, for example, Poland (*Commercial Corporate Code*, 2000).

While accepting the logic of the first approach, **a second approach** treats the repurchased treasury stock as a fully real asset. This view was adopted in the 1960s in the USA, in the recommended version of the balance sheet in Article 9 of the Fourth Council Directive 78/660/EEC of 25 July 1978 based on Article 54 (3) (g) of the Treaty on the annual accounts of certain types of companies (in force until 18.07.2013), in a number of European countries (Italy - *Civil Code*, Art. 2424; Luxembourg, Netherlands - Art. 385(5) of *the Civil Code and Manual for annual reporting RJ 240.107*; Ireland-*Companies Act*, 1986; *General Accounting Plan* of 1990 (PGC-90) and

Companies Act (Texto refunded de la layde sociedades anynimas, 1989; Denmark; France, etc.), as well as from the current balance scheme in Bulgaria. In support of this approach is the presence of a special account 512 *Purchased own shares* from group 51 *Short-term financial assets*[1], as according to some authors (Brezoeva, B. 2017), the mark must be used when the moment of the buyback of the shares and their invalidation (or sale) is not in the same accounting period.

It can be considered that, in a historical aspect, the approach is predominant in Bulgaria - it operated during the period 1991-2002, after 01.01.2008 and currently - according to the Bulgarian National Accounting Standard No. 1 *Presentation of financial Statements*, effective from 01.01.2008. Considered in this way, this reporting object should be disclosed in a separate active balance sheet item with the example name "Treasury shares".

If the repurchased shares are disclosed as an asset, the Second EEC Council directive on the formation, maintenance, and change of the capital of public limited liability companies (*Second Council Directive 77/91/ EEC*), 1976, art. 22, paragraph 1/b/ (in force until 03.12.2012) required the mirror creation with the same amount of non-distributable capital source (reserve) in the balance sheet. A similar understanding is advocated by the Fourth Directive of the EEC Council, through the balance scheme recommended in Article 9, and is practically applied through the legislation of individual European countries (Ireland, Luxembourg, Spain, Denmark, France, etc.).

The author believes that the approaches discussed above are not only historically but also geographically grounded. An argument in the opposite direction is a previous study by the author (Zahariev, 1995), in which, although in a more general sense, a close relationship between the various legal systems in the field of commercial law and the accounting regulations based on them is defined. Here we are talking about the two main legal systems: a continental or European (Romano-Germanic) legal family based on the continental legal system, which in turn was founded on Roman law, and a family of common law based on common (Anglo-Saxon) law and precedent. From this point of view, the approach of treating the repurchased shares as an asset, an element of property in the countries of the continental legal circle, is quite understandable, insofar as the spirit of continental commercial law is aimed at maximum protection of creditors by including in it non-real assets that in fact, they represent the exact opposite—a decrease in the net worth of capital. Of course, it is also explainable why the so-called capital approach is adopted in the accounting regulations of countries traditionally associated with legal family based on common (Anglo-Saxon) law and precedent.

In an international aspect, the capital approach is consistently advocated for the treatment of the considered reporting object. For example, according to IAS 32 *Financial instruments: Presentation* at the acquisition or subsequent sale of own capital instruments, any difference between the acquisition price (the book value) and the nominal value, in case of withdrawal from circulation and reduction of the fixed capital (resp. sale price, in case of resale) of the purchased shares is applied to the account of the own capital but not as a reduction of current financial result. For accounting purposes in this case, accounts 106 *Capital-related deductions,* 105 *Capital-related premiums,* or 115 *Premium reserve*, which are credited in the case of a positive difference and debited in the case of a negative one. According to FASB ASC 505-30-30-8 *Retirement of Treasury Shares,* an account *Additional contributed capital* (*Additional paid - in capital*, *Capital surplus, Capital in excess of par value*), allowing in the case of a shortfall in the account balance, the uncovered difference to be charged to retained earnings / resp. uncovered loss (Epstein, Barry J. et al 2022; U.S. GAAP Codification of accounting Standards, FASB-Codification Topic ASC 505-30 *Treasury Stock;* PwC, *Financing transactions* 2022). The amount the company may allocate for additional paid-in capital is determined by dividing the number of shares to be retired by the number of shares issued and shares outstanding on the date of retirement.

Some authors (Mary S. Hill, Richard P., George W. Ruch 2018) describe two methods of accounting for stock repurchases: (1) "treasury stock repurchases", in which the company holds the reacquired shares as treasury stock, and (2) "retirement repurchases", in which the company retires the reacquired shares. Specifically, when accounting for a stock repurchase as a retirement repurchase, the company reports any amount paid in excess of the original issuance price of the reacquired shares as a reduction of retained earnings. In contrast, when accounting for a stock repurchase as a treasury stock repurchase, the company reports the full amount paid as a reduction to total shareholders' equity as "treasury stock," which is a contra-equity account.

From his side, FASB ASC 505-30-30-8 *Retirement of Treasury shares* describes two acceptable methods of accounting for the excess of repurchase price over par or stated value when a corporation's stock is retired: Allocating the excess between additional paid-in capital and retained earnings or charging the excess entirely to retained earnings (Joanne M.Flood, Wiley 2015).

[1] For the purposes of the research, the numbers and names of accounts from the Sample Chart of Accounts, developed by the Department of accounting of Varna University of economics will be used.

When accounting for the costs related to the above transactions with capital instruments, the capital, not the cost approach is applied; these costs are accounted for as part of the transaction and are reflected in a reduction of equity, net of corporate tax (Hristov, V. 2015). Such treatment requires that the redemption costs be reflected in a separate regulatory capital account (for example, in account 106 *Capital- related deductions* or 107 *Expenses on the issue and repurchase of shares*), the balance of which should be indicated in a passive, decreasing item in the equity section of the balance sheet. In the presence of a created premium reserve, it is permissible for the costs of the buyout and the discounts during the buyout to be taken in full as a reduction of the reserve, regardless of its size. As a result of this operation, the premium reserve may also have a negative value, represented by a "minus" sign in the capital section of the balance sheet, although such a possibility is not foreseen according to the applicable national standards in the Republic of Bulgaria (Bulgarian National Accounting Standard No. 1 Presentation of Financial Statements, Item 15.6).

To satisfy the requirement to disclose the impact of the operation on the purchase of own shares on all categories of capital, *two options can be used to present* the costs of acquiring the own shares in the financial statement:

a) on the face of the balance sheet in a separate line, when it comes to the company's own shares, which is not a subsidiary;

b) disclosure in the notes to the financial statement, when it comes to expenses incurred by subsidiaries for the acquisition of the subsidiary's own shares.

In connection with the initial recognition of the repurchased own shares, two main approaches (methods) are known, differing in the methodology for determining the valuation when the repurchased shares are expensed in the relevant accounting account and in the way they are presented in the equity section of the balance sheet (Brezoeva, B. 2017):

- *Par value method*, in which the acquired repurchased shares are reported at nominal (or announced) value. This method is recommended when the repurchase of shares aims at a subsequent reduction of the share capital. In this case, the value of the repurchased shares, which have not been invalidated or sold at the end of the reporting period, is indicated as a negative amount in the adjusting balance sheet item "Treasured own shares" **below** the main balance sheet item "Fixed capital";

- *Cost method*, where treasury shares are accounted for at acquisition cost. This method is considered appropriate when shares are acquired to be sold back in the future. The value of the repurchased share package, not yet sold or canceled at the balance sheet date, is indicated in a separate adjusting balance sheet item **at the end** of the equity section of the balance sheet.

For the purposes of the buyback, a special reserve is created, which the Bulgarian Commercial Law calls "Share buyback reserve" - Art. 187/c/, Item 4, which is analogous to the so-called *Capital Redemption Reserve* from the British Companies Act 2006, Section 733. There are fundamentally different approaches to forming the reserve. For example, Art. 187/c/, Par. 4 of the Bulgarian Commercial law defines it as the sum of the nominal value of all purchased shares, while the British Companies Act 2006 recommends that this reserve be formed only when buying shares with a buyback clause, and its amount is defined as the difference between the proceeds of the new issue, intended to replace the repurchased treasury shares and the par value of the repurchased treasury shares.

Regardless of the adopted technique for determining its amount, the reserve is formed at the expense of retained earnings or other reserves with a general security purpose and can subsequently be used as follows:

- According to Article 187/c/ of the Bulgarian Commercial Law, the reserve can be distributed among the shareholders only in the case of a reduction of the capital with the purchased shares, as well as for the increase of the capital;

- According to the Companies Act 2006 of Great Britain, the reserve can be distributed as new additional shares.

For the first time Bulgarian National Accounting Standard No. 1 *Presentation of Financial Statements*, after its last substantial amendment in October 26,2007 regulates the mandatory indication of the amount of the reserve for repurchased own shares in the liabilities of the balance sheet, Article 2 of Group IV in the Section "A". We believe that such a regulatory arrangement is in full compliance with the changes in Art. 9 and Art. 10 of the Fourth Directive of the Council of the EEC (2006/43/EU) and is entirely in favor of information transparency and usefulness in the disclosure of this specific balance source.

3. Conclusion

The heightened interest in the repurchased own shares provokes the need to study it as a specific accounting object from the point of view of the issuing companies, including its characteristics, and the presence of different historically and geographically formed approaches for its current reporting and disclosure in the financial statements.

The buyback of shares is dictated by a number of financial and management considerations. The accounting treatment of repurchased own shares depends on the action of three variable factors related to the choice of price, method of repurchase, and purpose pursued with the act of repurchase.

From an accounting point of view and according to the company's intention, the term "repurchased own shares" is considered in two aspects: as the equivalent of part of the shares in circulation, bought back to reduce the share capital, and as a package of own shares that the company holds to use for various purposes (treasury stock).

Unlike share buybacks to reduce share capital, the accounting treatment of repurchased shares held as treasury or reserve of securities is more complex. The difficulty comes from the indeterminacy of the concept of "repurchased own shares held as a reserve" and from the existence of two approaches to this concept. The author believes that the approaches are not only historically but also geographically grounded. An argument in the opposite direction is that a close relationship between the various legal systems in the field of commercial law and the accounting regulations based on them is defined-a continental or European (Romano-Germanic) legal family and a family of common law based on common (Anglo-Saxon) law and precedent.

In connection with the initial recognition of the repurchased own shares, two main approaches (methods) are known, differing in the methodology for determining the valuation when the repurchased shares are expensed in the relevant accounting account and in the way they are presented in the equity section of the balance sheet: the "Par value method" and the "Cost method".

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