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Featured Articles

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Spike in Corporate Stock Buybacks Raises Speculation about Adequacy of Accounting Rules

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by Denise Lugo

Summary: *Some accountants fear the billions of dollars spent by corporations this past year to buy back their own stock comes with little accountability from today's financial reporting requirements to*

force public companies to reveal whether this profits shareholders or not. CPAs have been lobbying the FASB to take another look at Topic 505, Equity, which contains the rules relevant to stock buybacks. Other accounting professionals said the answer lies in more GAAP disclosures, as opposed to tinkering with current rules.

Some accountants fear the billions of dollars spent by corporations this past year to buy back their own stock comes with little accountability from today's financial reporting requirements to force public companies to reveal whether this profits shareholders or not.

Current accounting guidance for stock buybacks does not reflect the movement of the stock price and whether the buyback is a good investment for shareholders. Furthermore, shareholders have no way of evaluating management's use of corporate cash or borrowed funds to effectuate the buyback, some CPAs said.

"If there is a recession, a lot of businesses would have difficulty servicing their debt if the debt was incurred to fund stock buybacks," Richard Hecht, a CPA consultant, and a retired founding partner of accounting firm Marks Paneth LLP, said. "And the public and politicians are going to come back at the accounting profession and say 'why didn't you tell us that there were significant losses in companies' investments in their own stock,'" he said.

Hecht, also a former vice president of the New York State Society of CPAs, wants the FASB to take another look at stock buyback rules under Topic 505, *Equity*, fearing "a political, rather than a GAAP financial measurement will result, which will not be good for the accounting profession and the investment public." [In July, S. 2391, the Stock Buyback Reform and Worker Dividend Act of 2019, was introduced in Congress by Sen. Sherrod Brown, an Ohio Democrat, to require a host of new disclosure requirements about corporate stock buybacks.]

The topic is not cut and dry. Other accounting professionals have a different view from Hecht, believing the answer lies in either the FASB or the SEC providing more disclosures, as opposed to tinkering with current accounting rules.

"If you're going after measurement, the odds of getting it done are probably slim to none in my estimation," Peter Bible, chief risk officer at EisnerAmper, said.

The simple answer would be to revise management discussion and analysis (MD&A), the portion of a company's annual or quarterly SEC filings in which management addresses its performance, Bible said. "There's a section on stock buyback programs and there is something now about when you come into one and how much is done and how much remains to be done, but it doesn't really go into the purpose of why you're doing it. And I think including that disclosure about why you're doing the stock buyback and the benefits you expect to receive from that, would be a very meaningful disclosure," he said.

FASB a year ago voted against adding a project to its agenda related to share repurchase disclosures (price and earnings per share effects), believing current SEC disclosure rules provide investors with enough information.

Biggest Argument for Buybacks is it Signals Management's Optimism

Buybacks are at an all-time high. Companies in 2018 spent $806.4 billion in buybacks, up 55.3 percent from 2017, and up 36.9 percent from the prior annual record set in 2007, according to Standard & Poor's Dow Jones Indices March 2019 report.

Already for this year's first quarter, Apple Inc. led buyback spending with $23.8 billion, up from $10.1 billion it spent for the fourth quarter 2018, S&P reported in June 2019. Apple holds eight of the 10 records for quarterly buybacks, spending $75.1 billion on buybacks over the past year, $234.7 billion over the last five-year period, and $284.3 billion over the last 10-year period.

Oracle Corp. at $10 billion, Pfizer Inc. at $8.9 billion, Bank of America Corp. at $6.3 billion and Cisco Systems, Inc. at $6.1 billion, round up the top five for buybacks for Q1 2019, S&P said.

It is not unusual for companies to buy back their own common shares, and they do so for a variety of reasons, including to provide tax efficient distributions of excess cash to shareholders; to increase future earnings per share (EPS) and return on equity; to provide stock for employee stock compensation contracts or to meet potential merger needs; and, to discourage takeover attempts or to reduce the number of stockholders.

"The biggest argument for buybacks is that they signal and reflect managerial optimism," Takis Makridis, president and CEO of Equity Methods, said. "Those against buybacks point to the fear that a company is buying back its stock to juice earnings per share so that it can look better and inflate its incentive payment," he said.

Makridis said some executives believe there needs to be a shift away from a short-term mind-set in running companies to long term gains. "Some observers say buybacks are too short term a move because companies should be focused on how to invest in the long run for the business," he said.

Companies' Outcomes Differ When Buying Own Stock

Companies achieve different outcomes when they buy back their own stock. In some cases, EPS increased and the value of the company's stock went up after a buy back. In other cases, it did not and the value of the company's stock went down and shareholders lost money on the investment. Hecht points to Walgreens Boots Alliance Inc. and Microsoft as two prime examples of this.

"I looked recently at Walgreens Boots Alliance (WBA), which is a company I had invested in and they bought 1,400 stores from Rite Aid. In 2017 and 2018, they've spent over $5 million each year in buying back their stock," said Hecht. "And the stock has gone from over $80 a share in '16-'17 down to $50 a share. So the shareholders weren't serviced well by spending $10 million on stock buybacks, which could have been used to invest in growing the business in refurbishing the Rite Aid stores that they acquired," said Hecht. "To me it's a significant misuse of corporate funds." [In June 2017, WBA agreed to purchase 2,186 Rite Aid stores and related assets.]

Microsoft is the other side where stock buyback has benefited the shareholders, because the company's income is continuing to go up-its price-to-earnings (P/E) ratio is going up, Hecht said. "All of these things made the stock buyback beneficial to the company," he said. "So I'm not only looking at making this something to record where companies have not benefited the shareholders. In some cases, it has benefited the shareholders. There are two sides to this."

In response to Hecht's remarks, a WBA spokesperson said "WBA generates significant operating cash flow and our key priority is to reinvest back into the business. We're continuing to invest in areas that can help make progress against our long-term strategic priorities."

WBA generated $23.4 billion of operating cash flow over the past three years and reinvested over $4 billion in capital expenditures and $5 billion in acquisitions, principally to build out its store network. The company anticipates an overall investment of approximately $850 million for the integration of Walgreens-owned Rite Aid stores and related assets into its network, as well as a $500 million investment for the ongoing conversion of these stores.

Buybacks are Accounted for Under Rules for Treasury Stock

Topic 505 comprises the following five subtopics: 505-10, *Overall*; 505-20, *Stock Dividends and Stock Splits*; 505-30, *Treasury Stock*; 505-50, *Equity-Based Payments to Non-Employees*; and 505-60, *Spinoffs and Reverse Spinoffs*.

Subtopic 505-30 contains the guidance relevant to the repurchase of common stock is generally referred to as the acquisition of treasury shares or as a retirement (or constructive retirement).

Simply put, under the accounting guidance the journal entry companies record is a debit to treasury stock and a credit to cash.

On the balance sheet, the company will report the buyback as treasury stock, which is shown as a reduction of shareholders' equity, and an outlay of cash. On the cash flow statement, it shows up as a cash outflow in the financing section of that statement.

But on the income statement it is not obvious, because there is no line showing cost of share buyback. When companies report their EPS the number of shares that are outstanding decreases because of the buyback and so it has the effect of increasing EPS versus what would be reflected had the company not done the buyback. The only place on the income statement that shows there is an effect is in the EPS line.

Most accountants said they are fine with the accounting rules as they stand. Others, like Hecht, said they view stock buybacks as an expenditure of shareholder funds that should be evaluated like any other investment of corporate funds and want to see accounting changes. "For example, if corporate funds are used to buy publicly traded stock in a third corporation, it is valued at current market value. Why is stock in your own corporation treated differently?" Hecht said.

The guidance on the valuation of buying the stock of a third-party public company requires it to be valued as a level one investment, which means at fair market value, Hecht said. But the accounting rules for treasury stock require it to be valued only at cost without reflecting any changes in the fair market value of that stock. This "does not reflect the gain or the loss to the shareholder on the use of these corporate funds," he said.

CPAs Signal Appetite for More Detailed Disclosures

Companies view buyback programs as positives and they almost want to advertise the fact that they are undertaking buybacks, Scott Ehrlich, president of Mind the GAAP, LLC, in West Chester, Pennsylvania, said.

And most accounting professionals said they want more detailed information. "Readers of financial statements should be able to better evaluate the effects of a buyback on EPS as well as if, with the benefit of hindsight, management has made good resource decisions in repurchasing its own stock," Ehrlich said. "U.S. GAAP, interestingly, doesn't require very much disclosure at all around share buybacks," Ehrlich said. "If material, the statement of cash flows would typically include a line item indicating the cash paid for stock repurchases. But apart from that one disclosure, there's not much else required in [Topic] 505 or other Codification sections around repurchase programs," he said.

SEC disclosure rules focus on how many shares a company bought and what it paid for them, but there is a lack of disclosure rules about the performance evaluation of whether using capital to purchase shares is in the best interest of shareholders, Ashley Carpenter, senior consultation partner in Deloitte & Touche LLP's national office, said. "I think that is a disclosure that's lacking."

A lot of companies that enter into share repurchase plans enter into fairly complex transactions through investment banks - such as accelerated share repurchase plans, Carpenter said. "And so there are some disclosures around the outstanding forward contracts," he said.

The way those work is "you get a number of shares upfront typically, which the investment bank has borrowed, and then as the investment bank buys the shares there is this kind of true up process before the end of the transaction where they either issue more shares to the company or the company issues shares to them based on the actual prices that they incurred to purchase the shares, less their profit," said Carpenter. "So there are some disclosures required about that remaining lag piece, but in terms of a performance evaluation measure of the use of capital for repurchasing shares, that does not exist," he said.

Given the proliferation of share buybacks, which have increased with the Tax Cuts and Jobs Act, said Carpenter, "then that could be useful for investors."