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# Financialized accounts: Share buy-backs, mark to market and holding the financial line in the S&P 500

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**Abstract**

In recent years the US corporate sector has deployed more cash from operations to finance the repurchase of outstanding share capital for treasury stock. Shares repurchased for treasury stock can help flatter earnings per share, fund senior management share option compensation schemes and finance corporate acquisitions. In financialized accounts these are now significant transactions which, it is argued, serve the financial interests of managers and investors.

The US Financial Accounting Standards Board (FASB) is now demanding a "greater use of fair value measurements in financial statements" with the result that share options and corporate acquisitions will be "marked to market". This will force a financialized ratchet because managers in the S&P 500 will need step up cash extraction if they are to hold the financial line.
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## 1. Introduction

In 2006 the US corporate sector will buy-back 3–4 per cent of its outstanding share capital to augment treasury stock. This will cost the corporate sector $450 billion and is a sum that is now roughly equivalent to cash dividends paid by the US corporate sector. Firms listed in the S&P 500 constituent index are distributing a significant amount of their cash resources to underwrite, what is, a relatively new corporate sector/capital market financial circuit.

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Shares repurchased for treasury stock can be: banked helping to flatter reported earnings per share (EPS); issued as share options to senior executives and employees; or used as a currency to finance acquisitions. The constellation of double-entry booking manoeuvres associated with share buy-backs and use of treasury stock can be employed to construct financialized accounts because these transactions serve to reconcile the financial interests of investors and managers. For investors share buy-backs increase liquidity and boost corporate EPS which, in turn, may also help to support inflated share prices and market value (MV). For managers share buy-backs and the allocation of treasury stock can help boost shareholder value metrics such as EPS, MV or total shareholder returns (TSR). In the FTSE 100 senior executive long-term incentive bonus plans employ EPS as a primary performance metric (PWC, 2005, p. 13).

Jensen and Meckling (1976) argue that the gap between managerial and investor interests can be reconciled through a combination of decision making rules, financing and incentive mechanisms. Jensen (1986) introduces the concept of free cash flow to argue that managers should be forced to "disgorge" cash; that is, return to shareholders cash which, if invested, would deliver a negative net present value (NPV). In a more recent paper on managerial incentives Jensen and Murphy (1990) observe that the majority of CEO performance incentives come from "ownership of their firm's stock" (p. 38).

Throughout the 1990s the value of share capital repurchased for use as treasury stock by the US corporate sector averaged $200 billion per annum throughout the period 1995–2005. Hall and Murphy (2003) suggest that tax benefits, increased transparency of corporate governance, and the link to shareholder value metrics help to explain the growth of share repurchases and the issue of share option grants to senior executives and employees. During the 1990s the value of stock options granted in the average S&P 500 firm increased from $22 million to $238 million a year by 2000 before falling off to $140 million in 2002. Roughly 10 per cent of these options grants have been allocated to senior executives effectively coupling managerial remuneration to stock market appreciation (Hall & Murphy, 2003, p. 49).

In an earlier period the US corporate sector could avoid expensing share options against earnings but still claim tax credits, for example, Microsoft's comprehensive income for the period 1994–2005 amounted to $72 billion and stock option income tax benefits $16 billion (Microsoft Annual Reports, various years). It was also possible to use treasury stock to finance a corporate acquisition and avoid absorbing the market value of the deal into the acquiring firm's balance sheet.

Although it has been possible to avoid expensing share options and accounting for corporate purchases at their "fair value" or "market value" this position has recently changed with the Finance Accounting Standard Board (FASB) recommendations on accounting for share options (FASB 123R) and business combinations (FASB 141). FASB 123R and 141 will, we argue, force a financialized ratchet because senior executives will need to extract even more cash from operations if they are to hold the financial line (see Andersson, Haslam, & Lee, 2006).

This paper is organised into three sections. The first of these reviews the accounting treatments surrounding the repurchase of issued share capital and the use of treasury stock to finance share option compensation schemes and corporate acquisitions. In the following section we reveal the growth in share buy-backs using information taken from "S&P 500 survivors", that is, those firms remaining in the S&P 500 constituent list over the period 1993–2003. In the final section of this paper we review the implications of a shift in policy towards "fair value" accounting.

We start with how the US corporate sector accounts for the repurchase of and the subsequent allocation of treasury stock to finance compensation schemes and corporate acquisitions.

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