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Accounting for Own Shares
- An analysis of a new equity instrument in Sweden-

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Preface

This thesis is the end of an era. To be precise, it is the final episode of the masters program where we are using the collected knowledge of this three semesters. This journey began in March 2000 when we became aware of the '7th seal'. Even though this brings to mind a depressing story by Bergman, this has been a quite interesting, instructive and enjoyable journey. This thesis would not have been possible to fulfil without participation of our respondents, which we like to thank. These are, in alphabetical order:

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Abstract

The possibility for companies to repurchase and hold own shares has been forbidden in Sweden for more than a century. On March 10th, 2000, the Swedish government abolished this prohibition and companies now have the possibility of using the equity instrument of own shares.

This demanded for a revision of the 7th Chapter of the Companies Act and, to some extent, also the Annual Accounts Act, which we have explored. We have also been studying international accounting methods for own shares. Furthermore, , international norms and recommendations that have impacted the design of the Swedish regulation on how to account for own shares have also been explored.

In the empirical part, we discovered how this new equity instrument influences companies. Advantages and disadvantages have been discussed, as well as if own shares is profitable for all parties. Standard setters and auditors have also been interviewed about this issue.

Through an analysis of the theoretical and empirical findings we presented how own shares shall be accounted for in Sweden. We further discovered that the Swedish regulation is somewhat too detailed within certain areas, which makes transactions with own shares somewhat more complicated than necessary. Even though the legislator did not consider protection for the minority, we have found a connection between own shares and this protection. We have analysed the cost-, par value- and EC-method and studied positive and negative features compared to the Swedish regulation of accounting. Our contribution with this thesis is an improved method of how the accounting for own shares could be conducted in Sweden.

Key words: Own shares, Treasury shares, Accounting, Repurchase, Equity Instrument, Companies Act, Annual Accounts Act, New Share Issue, Listed Limited Liability Companies, Stock market.

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1. Introduction

This Chapter deals with the background, problem discussion and the purpose of our thesis. Furthermore, we will state the limitations of this thesis.

1.1 Background

The possibility for companies to repurchase and hold* their own shares has been forbidden in Sweden for more than a century. To purchase own shares means, in this context, the transaction when a company buys back shares that already have been issued, for which the company has been fully paid. In this case, the company uses its assets in order to purchase company shares. The repurchase transaction reduces the assets and the equity in the company, that is, it has a reducing effect on the balance sheet total. Own shares in this context is a technical term that will be used in this thesis.

The reason for the prohibition has been that the company's creditors should be protected and the company should not be able to influence or manipulate the share's market value, if the share is listed on a stock exchange. Further reasons have been the fear that only some of the shareholders could benefit and that it is in conflict with the principle of equal treatment of shareholders. The prohibition has also made it impossible for companies to perform illegal dividends in accordance with the 12th Chapter[†] of the Companies Act (Aktiebolagslagen).

In the Swedish Companies Act, there have been three exceptions from this prohibition when the company is allowed to purchase their own shares. The first case has been when the company acquires another company and where this company held shares in the acquiring company. It has also been allowed in a situation of redemption,[‡] where

* With *hold* in this context is the concept of possession and not a holding based on for example, pawn.

[†] In the 12th Chapter the issue of dividend and the use of the company's assets is regulated.

[‡] When the company purchase shares in order to reduce the share capital.

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company control has been abused. Finally,, it has been allowed when a company has acquired shares on an auction for unpaid receivables. Shares held by the company through one of this three methods must, if they are not used in order to reduce the share capital, as soon as possible be sold without the company making a loss. The company had a time limit of three years to sell these shares. (SOU 1997:22)

Since the first Swedish Companies Act of 1895, it has been forbidden for companies to purchase, hold and endorse own shares. This prohibition was then included in the Companies Act of 1944 and then transferred into the 7th Chapter of the Companies Act of 1975, which is presently valid. During the last decade, a committee appointed by the Swedish Department of Justice has been reviewing the Companies Act. The results, so far, have been some changes in the Companies Act, and in the spring of 1997, the committee proposed changes concerning equity. The committee's argument was that the possibility for companies to transfer surplus of capital to the shareholders would be improved if companies were allowed to repurchase and hold their own shares. Hence, Swedish companies would thereby have the same options as international companies in this matter. In the autumn of 1999, the government proposed to the Swedish parliament that companies should be allowed to purchase, hold and endorse their own shares. On the 23rd of February 2000, the Swedish parliament decided to modify the set of laws concerning own shares. This allows Swedish listed companies to repurchase a maximum of 10 % of all outstanding shares*. A transaction to repurchase is not allowed to exceed the amount that is available in the non-restricted reserves. There is no limitation on the time they can keep these shares. (SOU 1997:22)

Our interest in this subject results from the fact that the revision of the law is implemented from the 10th of March 2000, which puts this subject in a development stage at the moment. The first contact with the subject was during a course in Swedish Company Law, where we became aware of the fact that the whole of the 7th Chapter of the Companies Act would be rewritten. When we started discussing the

* The term of outstanding shares means the number of issued shares held by the shareholders.

subject, a number of problems occurred, which made this topic interesting for us to investigate.

1.2 Problem analysis

We will now declare why we want to carry out this study. In order to do that, we have to describe the problem we aim to investigate.

As described above it has been forbidden for a long time for Swedish companies to purchase, hold and endorse own shares. Why has it taken more than a century for Swedish government to abolish this prohibition and why has it been modified at this point? The 7th Chapter of the Companies Act has been revised, but what is the content of the altered law and the statutory work?

As mentioned in the background, there is a limit on 10% of how much the company can hold of its own shares. At the same time, a protective limit for the minority at 10% is regulated in the Companies Act. The reason why the minority must be protected is that it would be too risky for a potential shareholder to invest capital in the company and become a minority and, thus, be dependent on the view of the majority. The levels are the same in both cases. This could imply that there is a relation between the two limitations, since the protection of minorities has been an important issue for Swedish company regulation for some time. The European Community, EC has in the directives that regulates own shares, stated that a company is not allowed to hold more than 10% of the outstanding shares. Aktiebolagskommittén finds that, in difference with the EC directives, the USA company regulation has no limit on how much shares a company is allowed to hold (SOU, 1997:22). Why have the Swedish government restricted the allowance to 10 %?

During the Winter and Spring of 2000, a number of Swedish companies declared that they want to repurchase their own shares. What are the purposes for companies to making these repurchase programs? A repurchase of own shares represents a change in the relation both to internal and external parties. For the internal parties, it is primarily the relation to the company's shareholders that is effected by the allowance, but also management and employees would be

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effected. For external parties, the possibility to repurchase, hold and endorse own shares makes it more risky for a creditor that has invested capital in the company if the company can change the relation between the internal and the external capital. If a company decides to repurchase their own shares, will it then be profitable for *all* parties? What are the advantages and disadvantages for repurchasing own shares?

When repurchasing shares, the company effects the books of account by the fact that the company uses assets to repurchase a part of its equity. The change of the law causes a need for a different treatment in the accounting. Own shares have been allowed in USA company law, as well as, in the European Union, EU. This implies that accounting methods have been developed. Which accounting methods exist and which would be preferable, considering Swedish preferences, and how should accounting for own shares be conducted in Sweden? We will describe how own shares shall be treated in the book of account. Since own shares been forbidden in Swedish law, there are no norms or recommendations established by Swedish accounting standard setting bodies. Sweden, as a member of EU, is obliged to follow the regulation of the union, but at the same time the government has chosen to follow the recommendations from International Accounting Standards Committee, IASC. Those regulations, norms and recommendations will impact Swedish accounting. What norms and recommendations will be established?

1.3 Purpose

The main purpose of this thesis is to explore how accounting is influenced by the allowance to purchase, hold and endorse own shares.

The main purpose could be divided into three parts, in order to illustrate and to facilitate the aims of the examination.

- To interpret the contents of the new statutes in the Swedish law.
- To examine the influence that the statute has in the accounting area.
- To explore how companies will account for these shares and how this new equity instrument effects them.

1.4 Scope and Limitations

Purchase of own shares causes a number of questions within many areas, such as the financial area, stock market area, and from the accounting perspective. The law is new and knowledge is limited on what the effects will be within each area. Every part of the problem is interesting to investigate but, due to the lack of time and the scope of the problems, we have to make some limitations. Our interest is primary within the accounting area and the focus of the thesis is to explore the effects within this field.

Sweden is one of the last countries in the industrialised hemisphere that has abolished a prohibition approach for holding and purchasing own shares. How other countries' legislation has been formed is outside the scope of this thesis. There are different accounting theories used internationally, and it is important for the result of this thesis to state the contents of the different theories. In order to analyse the Swedish accounting for own shares, a comparison is made between the Swedish and the international methods.

The revision of the 7th Chapter of the Companies Act has caused changes in several other Swedish laws. We are only going to explore how the revised 7th Chapter effects the Annual Accounts Act (Årsredovisningslagen, ÅRL). In Sweden, banks, as well as insurance companies, have their own Annual Accounts Act. We are only going to study companies that are comprised by the general Annual Accounts Act, which is the reason why we do not include any banks or insurance companies that have repurchased their own shares in our thesis.

A violation against the company law, as well as any other law, will cause effects for those who perform this act under the Criminal legal framework. At the same time, there is strong connection between Company law and taxation law in Sweden. Both of these areas would have been interesting to investigate from a repurchasing perspective, but these areas are thesis subjects in themselves. The scope of the thesis would be too extensive. Thus, in order to make a high-quality analysis, we will not study the aspects of crime and taxation.

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Since the Swedish law became valid, a number of companies have announced their desire to repurchase own shares. A number of Boards of Directors have, from the Annual General Meeting, received a permission to repurchase their own shares. Some of the companies have actually gone through with a repurchase, but some boards have not used their permission from the Annual General Meeting. Considering the purpose in this thesis, we are only interested in those companies that have gone through with their plans. Exploring the reasons why a company does not fulfil their plans to repurchase own shares is outside the scope of this thesis.

This thesis is written for anyone who wants to know more about the change of the 7th Chapter in the Swedish Companies Act and its effects on companies and accounting. Due to this fact, the thesis is primarily designated for business administration students and students within commercial law with an interest in accounting.

2. Methodology

In this part, various methodological approaches that can be used when conducting research activities will be discussed. The chosen research approach will be presented, as well as the scientific approach and the research design. Furthermore, , we will present the data collection process and, finally,, we will discuss the quality of this research.

In order to conduct proper research activities, it is of outermost importance to acknowledge certain methodological issues. Therefore, it is important that the methodology is combined with the main problem of the thesis. This should be of assistance to the reader, in order to judge the result of the thesis.

2.1 Research approach

To study a problem various approaches can be used. The choice of approach depends on the degree of precision with which the original research question can be formulated, and how much knowledge already exists in the area of research. Patel & Davidsson (1994) state that research approaches can be of exploratory, descriptive or hypotheses testing characteristics.

When the information about the subject is insufficient, the study becomes automatically *exploratory*. The main purpose with explorative studies is to collect as much knowledge about a certain problem area as possible. This designates that the problem is analysed from a number of different points of view. This type of study can serve as basis for further research. When conducting an explorative study a number of different methods are used in order to obtain the information desired.

If a problem area already contains so much information that developed theory about the problem exists, it may be advantageous to use a describing study, this is called the *descriptive* method. In a descriptive study only the essential aspects of the phenomenon are investigated. The descriptions of these aspects are detailed and fundamental.

The last approach that can be used is the *hypotheses testing* approach. This testing could be used in an area where the knowledge is so extensive that new theories can be developed. The researcher collects data and makes hypotheses that will be tested in the empirical world and either rejected or accepted.

To increase our understanding of the purchase and accounting of a company's own shares, we conducted an *exploratory* study of the new Swedish law. The problem area is relatively new and the available literature is inadequate. The information and knowledge within this area is limited. The issue of accounting for own shares needs to be treated from a number of points of view and therefore, , the exploratory approach is suitable for accomplishing our purpose in this thesis.

We have been dealing with our problem from four different angles. We have used **preparatory work** as well as interviewing people that have been involved in this. We have also studied how **standard setting bodies** works with norms and recommendations for own shares. The **companies**, which are the users, have also been including in the research to widening the perspective. The final group is the **auditors**, who are the primarily practical users of the accounting for own shares. There are other angles to explore, such as a shareholder perspective or a creditor perspective. We have chosen not to include these two because the focus of the thesis is to explore the accounting issues.

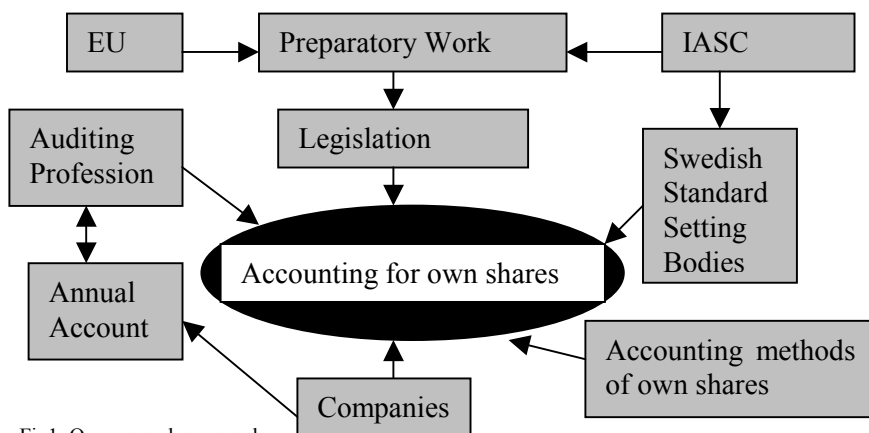


Fig1. Our research approach

Source: Our own

2.2 Positivistic and hermeneutic perspective

Two different perspectives of science in modern research are the *positivistic* approach and the *hermeneutic* approach, according to Patel & Davidsson (1994). These perspectives are extremes concerning how a problem should be approached. In the positivistic approach there is a strong connection between science and items that are not science, and it is often used within natural science. The main purpose of the research in this method is to explain a phenomenon with help of cause and effect. Objectivity and facts are the two basic features in positivism. Personal valuation and societal norms shall not be included within the scientific work. The truth is the desirable effect – how things really are - is of importance and not what they seem to be. The empirical research is the most important part; the scientific value has to be verified with empirical data.

The hermeneutic approach has developed in contradiction to the positivist approach or could, alternatively, be seen as a complement to the positivistic. The hermeneutic is the approach that has a strong emphasis on the overall view; no single phenomenon can be comprehensive unless it is not seen as a part of the overall picture. The approach assumes that all actions, social norms and values have a human foundation. The starting point is the pre-knowledge that increases as more investigations are done on the subject and as the researcher is able to reach a higher level of knowledge.

Our problem is about the contents of the revised 7th Chapter of the Swedish Companies Act, and how companies should account for own shares. Our thesis is based on a hermeneutic research view, which means that we have performed interviews with different parties to try to accomplish an overall view of our subject. Our interest is limited to only some parts of the subject, and due to this we are not able to achieve objective reflections and conclusions. The pre-knowledge, as well as background and personal values, both our own and from the respondents, will affect the result of the study. We have started at a point where we had some pre-knowledge in the subject that has increased as more investigations were conducted. Although our research has many hermeneutic features, we cannot exclude the positivistic elements of our thesis. The aim to accomplish an over-all

view cannot be fulfilled since in some aspects individual phenomenon will be studied more closely. We consider ourselves as subjective, but we have the ambition to remain objective and to collect as much facts as possible before making an analysis of the problem. The final reason for closing with the positivistic approach is that the empirical part is of great importance since it should be seen as a base for further research. We cannot argue that we are completely hermeneutic or completely positivistic, but we have influences from both approaches.

2.3 Quantitative or qualitative method

Concerning investigations there are two approaches to choose between. These are, the quantitative and qualitative method. A major difference between the methods is that the quantitative method reverses the information received to figures, and from these results a statistical analysis is performed. In a report with a qualitative approach, it is the researcher's conception or interpretation of the information that is vital. In a qualitative examination, the researcher collects the information that will be analysed and interpreted. (Holme I.M, Solvang B.K, 1997)

This thesis is to be considered as a qualitative investigation as we are not going to present the result of the investigation in figures. A qualitative analysis is advantageous in this thesis in order to increase the perception of the complex problem of own shares. The information received is not reversed into figures. The figures are only used to further illustrate the result of the research. Nor is a statistical analysis performed. A quantitative analysis does not benefit the thesis since we would not be able to establish the underlying factors within the subject. Another disadvantage is that the quantitative approach does not facilitate the possibility of establishing a confident relationship between respondent and the interviewer (Andersson B-E, 1994).

2.4 Research design

There are three main ways to form a theory. Kam (1990) discusses two of these, the deductive and the inductive approach. The *deductive* approach is characterised by the fact that a theory about the conditions

of the reality exists. A hypothesis is formed from the already existing theory. The researcher examines whether the existing theories are combined with the reality by making observations in the reality and comparing those observations to the existing theories. The opposite of the deductive approach is the *inductive* approach where the researcher follows the path of exploration. The researcher is primarily conducting observations in the reality. Secondly measurement and interpretation of the data collected is carried out. From the results the researcher formulates a theory. Alvesson & Sköldbberg (1994) discuss a third dimension to the research design, the approach of *abduction*. In this approach, the researcher uses a combination of both the inductive and the deductive approaches and, thereby, creates an analysis of the empirical findings, together with previous theories.

We have no theories about how a repurchase of own shares will effect companies and accounting. At the same time, there is no developed practice within the area, due to the fact that the legislation is completely new. We have chosen not to formulate a theory, since we want to accomplish an overall view of our problem. When using the deductive approach, and to some extent the abductive approach, a risk exists that the researcher only tries to test whether the theory is correct or not correct in the empirical world. Due to this, no consideration is taken of factors outside the research area when the researcher tries to confirm or reject the theory. We also think that it would be too difficult to create a good theory to work with in an area where earlier research is limited. The connection between the inductive approach and the exploratory research approach, which we are using, is strong, since both approaches have their base in the overall perspective. These factors illustrate that an inductive approach is desirable in this thesis. Our contribution to the theoretical framework is presented in the conclusions and reflections.

2.5 Data Collection

Eriksson and Widersheim-Paul (1994) present different techniques on how to collect data. The chosen alternative depends on which method best answers the questions of the investigation. In this thesis, both *primary* and *secondary* data are used together. The primary data is the

facts we have collected ourselves through interviews. Secondary data is literature, material of law and electronic sources which all contribute to a wider perspective in the thesis. We started gathering the information by using the GUNDA-system. We have also used LIBRIS, Mediearkivet, FAR CD online and AffärsData Tidningsdatabasen. The words used to obtain information were: *own share, own stock, own shares, redemption, cost method, par value, equity method, repurchase, egna aktier, förvärv, återköp*.

The empirical part of the thesis consists of interviews with persons dealing with these matters in the selected companies. These companies were selected during the spring of 2000 from a list of companies that proclaimed that they had the intention to repurchase their own shares when this became allowed on the 10th of March. The list was published in Göteborgs-Posten on 19th of February, 2000. After this selection, we read the major economic professional newspapers in order to keep ourselves informed about the companies' actions. A narrower selection of companies was made in the beginning of August 2000, aided by an article in Affärsvärlden (number 32/2000). In this article, it was published which companies actually went through with a purchase program between March and August 1st, 2000. Companies from different sectors were selected with the primary focus on the two areas of manufacturing companies, and construction and real estate. In order to accomplish the overall view that we desire, we have chosen companies with different business activities. Six companies remained and were then chosen. Electrolux, Swedish Match and Volvo were selected as manufacturing companies, and NCC, Skanska and Wallenstam were selected in the construction and real estate area. We are aware of the fact that we cannot make any general conclusions about all Swedish companies from the selection that we have made. We can only contribute with the aspects based on this selection.

We have also conducted interviews with a member of the committee that was working with the preparatory work. Standard setting bodies and auditors have also been interviewed in order to fulfil our purpose. By using interviews with both companies and members of standard setting bodies and auditors, we have tried to achieve the overall view that we desire. The companies have a micro perspective from the

perspective for each individual company, while the other respondents have more of a macro perspective of the entire industry and commerce.

The most common mistake during an interview is that the purpose is not clearly stated for the respondent, which causes an uncertainty on what the interviewer wants to accomplish with the questions (Andersson B-E, 1994). When agreeing upon a date of interview we clarified the purpose of the thesis and asked if the respondent desired the questionnaire in advance by e-mail. This was appreciated since the respondents could more easily prepare themselves for the interview. In the cases where it was not possible for us to visit the respondent, we have made interviews by telephone. The risk when using interviews by telephone is that the restriction on how long the interview is allowed to be is more limited than when using personal interviews. This is because it could be difficult to maintain the interest of the respondent compared to when interviewing by person. Therefore, it is important to interview a person with insight within the subject. (Lekvall P, Wahlbin C, 1993) We have tried to minimise these errors when using telephone interviews, by interviewing persons with high levels of insight and interest within this subject. When interviewing by phone we have used a speaker telephone, which made it possible for us to have a discussion with each respondent, and these interviews were as thorough as the personal interviews. There was no major difference in the time consumed by the personal and telephone interviews. After conducting all interviews, we made the conclusion that in the respect of time and scope, there were no differences between the two used forms. All interviews were recorded and, after the interviews were conducted, the content was transformed into text word by word. This was done in order to facilitate the process of determining the results, reflections and conclusions. None of the interviews is represented word by word as the empirical chapter is based on a summary of all interviews.

2.6 Quality of research

To judge a report's scientific value, the concepts of validity and reliability are used. These concepts are especially interesting if the researcher is using a quantitative method or inductive approach. *Validity* is defined as the absence of systematic errors of

measurement. There are two different types of validity, internal and external. *Internal validity* refers to whether or not the research is measuring what it is supposed to measure. There should be an existing connection between theory and empirical findings. *External validity* regulates the relationship between the result of the measured object and the reality. *Reliability* defines as the absence of random errors of measurement. A thesis with high reliability is not affected by who conducted the measuring. The individual researcher does not affect the conditions during the research either. (Widersheim-Paul F, Eriksson L, 1994)

To ensure the validity in our thesis we have carefully studied the preparatory work, the literature within the subject, and articles in the accounting doctrine. Based on this information, we have developed the questions for our interviews. The persons we have interviewed for this thesis have a high level of knowledge about the issue of own shares and how to account for it. We have also, in order to accomplish a high validity, sent the issues that were to be treated to each respondent before the interviews, so that they would be able to prepare themselves. We did not send the questionnaire since this increases the risk to influence the respondent to answer what they thought we wished to accomplish. When using interviews as a source of information, the reliability is dependent on the respondents knowledge in the area. During an interview, both respondent and interviewer make judgements that could make the reliability decline. We have also used a dictaphone, which made the process of putting the material together easier, as well as to make sure that we both have understood the respondent in the same way. We have also contacted the respondents on a further occasion in those cases where obscurities occurred when processing the interviews. The lack of reliability identified could be attributed to limited time at our disposal. We were obliged to conduct interviews with a few respondents, which could result in a narrower perspective. We have tried to reduce this by interviewing people from different areas in industry and commerce.

Thurén (1997) claims that there are four criterions that have to be considered when discussing critics of sources:

- Authenticity– the source shall be authentic, that is not false or a forgery.
- Relation of time – there should not be too long of a time between the event and the declaration of the source, otherwise the source can be questioned.
- Independence – the source shall not be referred to in another source.
- Objectivity – the source shall not make a false presentation of the reality depending on political, economic or other interest.

We have considered these criteria when collecting and analysing the material and to the outermost extent use material that fulfil these criteria.

2.7 Layout

In **Chapter 3**, we define own shares. Furthermore, , in this chapter we state the contents of the preparatory work which is the basis for the new law.

In **Chapter 4**, we describe the existing accounting method used within this area. There are primarily three different approaches used: the cost method, the par value method, and the “EC-method”. We will illustrate how transactions of repurchase, endorse and retirement will be recorded in the book of accounts in each method. We will also present the EC directives, international norms and recommendations on own shares, which could be a base for issuance of recommendations from Swedish accounting standard setting bodies. The Chapter ends with the government’s discussion on how the accounting for own shares shall be done.

In **Chapter 5**, the interview results are presented. More than 30 companies have proclaimed that they are interested in repurchasing their own shares. We have interviewed companies from different sectors, in order to find how the accounting of own shares is treated. The interviews aims to answer the question about how the accounting for own shares should be dealt with. Accounting standard setting bodies and auditors have also been interviewed for the accounting aspects.

In **Chapter 6**, the analysis of the theoretical and empirical findings will be discussed in order to make a basis for our conclusion.

In **Chapter 7**, we present how own shares in Sweden shall be recorded in the book of account after we have analysed the material collected.

In **Chapter 8**, we present the result of the study and the reflections that we have made from this study. We will also present an improved method to account for own shares. Furthermore, , we will present subjects that are interesting to investigate in future research.

3. The legislation and regulation

In this chapter, we define own shares. Furthermore, we will state the contents of the preparatory work which is the basis for the new law.

3.1 Definition of own shares

A repurchased own share is a share that the company has issued and received full payment for and, in another occasion, has chosen to repurchase. The own share can be seen as a non-issued share and there is no possibility to trade it at the stock market. What happens at a repurchase transaction is that the number of available shares declines on the stock market, but the nominal number of shares of issued shares remains the same. A repurchase of shares reduces a company's assets and its shareholders' equity. (Horngren C T, et al. 1999) The size of the company literally decreases on the balance sheet. The own share account has a debit balance, which is the opposite of the other owners' equity accounts. Therefore, "Own shares" is a contra stockholders equity account. (Hartman B P, et al. 1997) The company could, if they would like to, sell the shares back into the market on another occasion. In the USA, own shares is named treasury stock because the company often holds the shares in its treasury for safe keeping (Kieso D E, Weygandt J J, 1995). IASC uses the term treasury shares while Aktibolagskommitten (SOU 1997:22) use the term own shares and therefore, we will use this as well.

Reasons why companies want to purchase their own shares could be, according to Kieso & Weygandt (1995):

- The company wants to reissue the shares to management or employees as a part of bonus or share compensation plans.
- The company wishes that the repurchase would increase trading of the remaining company shares on the market, as well as achieving a higher valuation of the share. At the same time, they want to reduce the number of shares on the market and, thereby, enhance the profit on the remaining outstanding shares.

Hartman et al. (1997) contribute with two other reasons:

- The company is trying to increase net asset by buying its shares low and hoping to sell them for a higher price later.

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- To use own shares as payment in a merger or an acquisition with another company, or that the management wants to avoid a take-over by an outside party.

When a company has purchased own shares and they have no wish for keeping them, they have three options for how to use these own shares:

- Own shares are used in order to reduce the share capital* with an associated amount of the shares nominal amount, or
- endorse the shares to somebody else, or
- use the own shares as dividend to the shareholders. (FAR INFO, 2000)

3.2 Swedish legislation

3.2.1 Background

Since the first Swedish Companies Act of 1895 it has been forbidden for limited liability companies to purchase own shares. Later on, it also became forbidden for subsidiaries to purchase and hold shares in the parent company. Acquisitions, including payments as well as excluding payments, were integrated in the prohibition. Any agreement that was entered and that was in conflict with this prohibition was not valid. (7 Chapter 2§ 1st para. Companies Act (1975:1385))

In the Companies Act there have been three exceptions from this prohibition and the company has been allowed to purchase their own shares. The first case is when the company acquires another company and this other company already holds shares in the acquiring company. It is also allowed in a situation of redemption where company control has been abused. The final situation is when a company has acquired shares on an auction for unpaid receivables. Shares held by the company through one of these three methods had to, if they were not used in order to reduce the share capital, as soon as possible be sold, but without that the company made a loss. The company had a time limit of three years to sell these shares. If the shares were not sold

* A reduction is done for principle two different reasons. One is to cover losses and the other is to make a repayment to the shareholders.

within this time period they became non-valid. The company then had to make a reduction of the share capital with the non-valid shares nominal amount. These three exceptions are still valid for those limited liability companies that are excluded* from the revision in the Company Act. (SOU 1997:22) A fourth exception has been included in the Companies Act, which is for repurchasing shares without payment; for example,, by a gift (FAR INFO, 2000).

In June 1990 the Department of Justice received an assignment from the government to create a committee which was named Aktiebolagskommittén. The result, so far, has been some changes in the Companies Act, but it was not until the spring of 1997 that the committee proposed changes concerning the equity of the companies (SOU 1997:22). In the autumn of 1999, the government proposed to the Swedish Parliament that Swedish companies should be allowed to purchase and hold their own shares. On the 23rd of February 2000, the Swedish Parliament decided to modify the set of laws concerning therepurchase of own shares.

3.2.2 Change of legislation

There are several arguments from the government as to why it should allow Swedish companies to repurchase own shares. During the last years, the industry and commerce have had strong development, following the Swedish economy. This development has caused great profits to be accumulated in these companies. At the same time, mergers have led to an excess liquidity in these companies. (Proposition 1999/2000:34) One of the reasons why this excess liquidity exists could be that it has not existed any suitable methods to transfer profits to the shareholders. Excess capitalised companies are valued lower than optimal capitalised companies on the market, and, therefore, , companies should have two alternatives, either repurchase shares or pay dividend. Dividend, in accordance with the 12th Chapter of the Companies Act, is not always the optimal way. The companies want to have a stable dividend policy without great variations from one

* Explained further in 3.2.4 “Which companies are allowed to purchase their own shares?”

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year to another. With excess liquidity the dividend for one year could be abnormal, while it in the next year returns to a normal level and this is unappreciated by the stock market. To avoid this effect, the company could repurchase some of its shares and then give the shareholders a possibility to choose. The shareholders that want a high yield accept the offer, while the shareholders that desires a long-term investment keep their shares. The company, when it has repurchased the shares, has resources (shares) that could be turned into capital when needed. (Skog R, 1996)

On the international market today, the competition is strong and the financing is of great importance for companies that want to be successful on the market. To be able to optimise its financing on a short-term basis, the company must have the possibility to hold its own shares and then either cancel them or sell them on another occasion. The government finds that a transfer by repurchase would be profitable from a societal economic point of view, since the transferred capital most often is reinvested in other businesses. Previously, a reduction of the share capital had to be made if a company wanted to change their financial structure, but a reduction of share capital is a slow and difficult procedure. Another argument often used in the discussion of allowing own shares is that the repurchased share is a useful instrument when acquiring other companies. A new share issue* is the method that is most comparable to a sale of a repurchased share, but it is slow and costly. The internationalisation of industry and commerce along with the financial markets caused a greater demand for a change of the Swedish legislation. At the same time, a prohibition of own shares, when it is allowed in most other European countries, could lead to that foreign investments in Sweden would decrease since a prohibition could be seen as an obstacle. (Proposition 1999/2000:34)

If a company should be allowed to purchase, but not sell own shares, the government fears that each repurchase would lead to the restricted equity decreasing. This, from a creditor point of view, would be unfortunate. By repurchase, a company could keep the working capital

* When the share capital increases by a subscription of shares, which is paid for.

at a low level when suitable and at a later time when a contribution of capital is needed resell the shares. A right to sell could also give better conditions to implement changes in the company's structure. Own shares could be used as an asset in mergers and acquisitions where it could be used as a form of payment. The only existing form of contributing capital to a company before has been a new share issue, which is both a costly, as well as, time consuming process. Aspects of time and the costs of prospects are two reasons that make buying and selling own share more suitable. Another reason for a change of legislation is that it raises the possibility for companies to protect themselves from a hostile take-over. Repurchases of own shares mostly leads to a higher stock market value of the share when the number of shares decreases, which gives a higher profit on each remaining share and hence the market value will increase (Proposition 1999/2000:34).

3.2.3 Limitations in the law

The government also had some suggestions about limitations in the new law. These limitations were included in the Companies Act in order to maintain a certain level of protection for the creditors. One limitation, in accordance with article 19.1c in the second directive of the EC concerning corporate and stock exchange issues, is that a purchase of own shares is not allowed with a larger amount than the capital cover in restricted equity is sufficient after the transaction. The purchase should not amount to more than the consolidated need for the company or the group, liquidity or be in conflict with good business practice. This, according to the prudence concept of dividend stated in the 12th Chapter of the Companies Act, is a decision made concerning purchase on an Annual General Meeting of shareholders. The acquisition shall be based on the financial position in the most recently made balance sheet total. If the decision is made at an Extraordinary General Meeting where the balance sheet is not established, then the Board of Directors shall enclose a copy of the latest annual report, and a copy of a report of the auditor with the proposal of repurchasing shares. The board should also include a declaration of events that are of significance for the company's development, and that have occurred after that the annual report was written, and a statement from the company's auditor about this declaration. There is no change in

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legislation concerning ownership in a group; a subsidiary is not allowed to repurchase shares in the parent company. If a subsidiary purchases parent company shares, the agreement is not valid. If a subsidiary should possess own shares then these should be considered as the parent companies in the matter of the 10% limit. (Proposition 1999/2000:34)

Another limitation is that a company should only be able to purchase shares that are fully paid for according to article 19.1d in the second directive. A company is not allowed to hold more than 10% of the total number of shares after the acquisition. If a company purchased own shares in violation of the law, the shares must be sold within six months. If this is not done then the shares shall be declared non-valid and a reduction should be made with the nominal amount of these shares. If this reduction of the share capital has the effect that the share capital decreases below the limitations of how low the share capital is allowed to be before the company shall go into liquidation, then this regulations becomes active. (FAR INFO, 2000) The regulations only focus on those shares exceeding the 10% limit; that is, those shares that the company should not be able to acquire. The Companies Act does not take consideration of the number of votes on each share*. If a company possesses 10% of the total number of outstanding shares, but the number of votes are exceeding 10%, is of no importance. The company still does not have the right to use any of the votes. If the company acquires shares to a greater amount than what is available in the non-restricted equity, they only get to keep those shares that contributes to this equity and is obliged to sell the others. (Proposition 1999/2000:34)

The primary reason why the government denies companies' request to purchase or sell own shares outside of a stock exchange or authorised marketplace is that, if companies are allowed to make agreements with a single shareholder, this could have negative effects. It could, for

* In Sweden there are different voting rights for shares and a difference is made between A-shares and B-shares. The difference in voting rights between the two categories can be as much as 10 times.

example,, cause blackmail situations where a company more or less is forced to purchase shares from one shareholder that threatens to take control over the company, so called *greenmail*. Another risk with agreements with single shareholders is that this shareholder could benefit in an inappropriate manner. Public limited companies should not have any reasons to make agreements about own shares with a single shareholder. This risk does not occur if the company makes the purchase offer to all shareholders or to all shareholders with a certain kind of shares. (Proposition 1999/2000:34)

3.2.4 Which companies are allowed to purchase their own shares?

In the proposed law, the Swedish government suggested that public limited liability companies listed on a stock exchange should be included in the law. A public limited liability company is recognised in the fact that it has a share capital of at least SEK 500.000, and it also has the opportunity to turn to the public to receive capital. The basic idea with a limited liability company is that the shareholders only have a responsibility for the company's action with the paid in capital. If the company without any restriction could give away assets or increase the liabilities it would mean an increased risk for the company's creditors. Therefore, the legislation tries to protect these creditors by laws that limit the action that the company is allowed to perform with its capital. The idea of this is that the company always should have assets matching its liabilities and, exceeding this, there should always exist a marginal of capital. This margin consists of the restricted reserves that are share capital, share premium reserve, revaluation reserve, statutory reserve and funds that in order with the articles of association* are not allowed to be used as dividend. The book value of the assets should, at least, be equal to the book value of the liabilities plus equity. If a company purchases own shares, then capital is distributed from the company to its shareholders. Therefore, the creditors should be as protected as in a situation of dividend. The purchase is not allowed to exceed the amount in the restricted reserves, neither should the amount

* In the articles of association the company can decide, within the legal framework, anything that is valid for the individual company.

exceed the non-restricted reserves if these are necessary for other financial purposes in the company. (Proposition 1999/2000:34)

Own shares could mean that company control is transferred from the shareholders to the management, which has been one argument against allowing own shares in Sweden. The government finds that it is the shareholders that control a company by the Annual General Meeting. Therefore, this should be the authority in the company that decides on own shares issues in order to make sure that shareholders remain in control of this issue. (Proposition 1999/2000:34) The reasons why the government restricted the proposal to only include certain public limited liability companies is that there are some public, as well as private, companies that are considered to be closed companies* in the respect of taxation (32§ para. 14 Municipal Tax Act). In order to prevent such limited companies that are closed companies to repurchase their own shares, the government decided that only listed companies are allowed to go through with such transactions. This is done for tax reasons. After the government has solved the taxation problems for these closed companies at a later time, they could be allowed to purchase their own shares as well. (Skog R, 1999)

3.3 The purchase and selling of own shares

3.3.1 Regulation of purchase and sale of own shares

There are certain criterions that have to be fulfilled for a public limited liability company to *purchase* its own shares. Firstly, the purchase must be made on a stock exchange market or on another authorised market place in Sweden or in another country within the European Economic Area, EEA. For a purchase on a share market outside the EEA, the company needs permission from the Financial Supervisory Authority (Finansinspektionen). The purpose of allowing purchase outside of the EEA, is that Swedish companies listed on established stock exchanges, primarily in North America, should be able to purchase own shares in these markets as well. In Sweden, at the

* Companies where one single shareholder or a limited numbers of maximum 10 shareholders have voting majority in the company.

moment, the Stockholm Stock Exchange is the only stock exchange in the country where this is allowed. There are two authorised marketplaces that have been granted in Sweden for share repurchase transactions. These two are IM Marknadsplats AB and Aktietorget AB. Secondly, an offer from the company to the shareholders must be directed to *all* shareholders or to all owners of a certain kind of shares. (Proposition 1999/2000:34)

An offer to the shareholders to purchase shares could be designed in two ways. In the first alternative, the company declares that they want to repurchase a certain number of shares at a specified price within a limited period of time. The second alternative is that the company announces how many shares they want to repurchase in a specified spread*. The shareholders that want to sell inform the company of the number of shares and the price. The company then repurchases all shares at the same price - that is the lowest price that is necessary, in pre-advance, to acquire the declared number of shares. (FAR INFO, 2000) If the supplied number of shares from the shareholders exceed the 10% limit, a proportional reduction shall be conducted. This regulation does not exclude the possibility for the company to declare a spread, what the company offers to acquire shares. The shareholders could at the same time proclaim the lowest price at which they wish to sell. The company could then exclude the exceeding acceptances with these given conditions, as long as it is done in a predictable, fair and equivalent way. (Proposition 1999/2000:34)

A *sale* of own shares shall be conducted in accordance with the regulations on new share issues. That is, through an endorsement that resembles a new share issue, with the difference being that the issued shares already exist. The sale should be made on a stock exchange or another authorised marketplace, in Sweden or another country within the EEA. If a sale is conducted outside the EEA, the same rule about permission from the Financial Supervisory Authority must be fulfilled, as when repurchasing. (Proposition 1999/2000:34)

* The difference between bid and ask price on the market.

3.3.2 Making the decision

The decision about *purchasing* own shares is made by the Annual General Meeting or the board after permission of the Annual General Meeting. The decision or the permission to the board must be entered in the Register of Companies (Aktiebolagsregistret). This registration is, on the other hand, necessary both when the company makes a new share issue or a reduction of the share capital (4th Chapter 12§ & 6th Chapter 4§., Companies Act (1975:1385)). The permission to the board must include suggestions on how the shares shall be purchased, for example, by an agent or on the market. The permission must also contain a timetable on how long the board may use the permission. The timetable shall not exceed that time until the next Annual General Meeting. The highest amount of shares that shall be repurchased and the division between the different kinds of shares, and the lowest and the highest price that could be paid for these shares, shall also be included in the permission. Finally,, the permission shall include a statement of the property; for example, securities that are to be used as payment if the shares are not to be bought with cash. The decision by the Annual General Meeting is valid if 2/3 of the votes, as well as 2/3 of the represented shares at the meeting, are in favour. The number of votes is the same as when the company wants to reduce the share capital or if new shares are issued. (Proposition 1999/2000:34)

The decision to *sell* the own shares shall be made by the Annual General Meeting or, after permission of the Annual General Meeting, by the board. If the share is going to be sold to the shareholders with priority, simple majority can make the decision if the articles of association do not state anything else. Simple majority means, in this case, that the suggestion gets more than half of the represented shares. If the selling is going to be made on the stock exchange, or if own shares is going to be used as payment in an acquisition of another company, this transaction should be compared to an issue, with exception from shareholders priority. Therefore, the decision has to be made by 2/3 of the represented shareholders as well as 2/3 of the given votes. This majority demand follows the rules in the 4th Chapter of the Companies Act about new share issue. (NBK, 2000)

In Sweden there is a law concerning directed share issues to the management of the stock market company called LEO-law^{*}. The law consists of rules about cash issues offered to, for example,, members of the company management. The government has decided that the law is also applicable on own shares. This indicates that in those companies that are obliged to follow the law, it is the Annual General Meeting that has the controlling influence in the matter of directed share issue to the management. The decision about a direct share issue cannot be made by the board, but only by the Annual General Meeting. If the board still makes such a decision, it is always the Annual General Meeting that has the final word in the matter. The decision of the Annual General Meeting is valid only if 9/10 of both the represented shareholders, as well as the given votes on the meeting, are in favour of the decision. (Proposition 1999/2000:34)

3.3.3 The status of own shares in a new share issue

The company has no priority to buy new shares in a new share issue. This implies that the companies cannot subscribe to own shares or hold subscription rights. At the same time, it is not allowed to hold own shares as a security. (FAR INFO, 2000) These subscription rights should, therefore, be handed out to the shareholders, or in accordance with the decision from the Annual General Meeting. The law does not deal with any special rule concerning the case of bonus issue[†]. There is no obstacle to the company getting new shares associated with a bonus issue. This could be important if the company hold different kind of shares. (Skog R, 1999) Own shares held by the company give no preferential right[‡] in a new share issue to subscribe for new shares. The company is prohibited, through a sale or another action, to possess any

^{*} The official name of this law is: Lag (1987:464) om vissa riktade emissioner i aktiemarknadsbolag

[†] When capital is transferred from restricted or non-restricted reserves to the share capital, so that the nominal share capital increases, no external capital is provided.

[‡] The right to acquire new shares in proportion to the number of shares that the shareholder already owns.

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of the subscription rights that occurs in a new share issue. (Proposition 1999/2000:34)

In a new share issue, the shareholders are considered to have the priority to purchase the shares. The rules concerning an endorsement of own shares shall follow the rules of new share issue (Skog R, 1999). The offer should, therefore, be directed to all shareholders, but there is a possibility to make exceptions from the preferential right and direct the offer to another group of interested parties; for example, if the company wants to give the employees the possibility of subscribing for new shares. The company could also give the possibility to acquire own shares to the public. The decision about leaving the shareholders out of the preferential right should always be made by the Annual General Meeting, with a majority of 2/3. Own shares owned by the company itself should not be included in matters of the voting majority. If the company has 10% of the shares, and these shares represent 10% of the votes in the company, the right to compulsory purchase* is fulfilled if a shareholder owns more than 81% of the shares and votes in accordance with the 14th Chapter 31§ Companies Act (1975:1385). 81% represent 90% of the shares and the votes in the company, after the repurchased 10% have been reduced. (Proposition 1999/2000:34)

3.3.4 Information and publication

It is important that the circumstances that are significant for the value of the shares are made public when the companies are repurchasing or selling own shares. This is necessary to counteract attempts to try to rig the market and abuse the law. Companies that are listed must report the purchase or sell to the Swedish Stock Exchange Market or an authorised marketplace where the shares are listed. Information about the purchase or the selling shall be public. The Industry and Commerce Stock Exchange Committee (Näringslivets Börskommite, NBK) has

* The right to make redemption of remaining outstanding shares without the permission of the shareholders. This could be done if a single shareholder owns more than 90% of the shares.

issued a recommendation on how the information should be made public. (Proposition 1999/2000:34)

The Industry and Commerce Stock Exchange Committee finds that it is of great importance that information related to repurchasing and selling own shares is given to the stock market. When the company has taken the decision about purchasing or selling own shares, the company must immediately make the decision public. Besides the information that is going to be reported to the stock exchange market, the information also has to be made public in at least three national newspapers. The press release should contain information on:

- A timetable that shows the time that the board is allowed to purchase or sell, or the decision on when purchases or selling of own shares will, at the latest, be done.
- Information on the company's existing holdings of own shares and the highest amount of shares that the company has the intention to buy or sell.
- The shares' highest and lowest price.
- In brief, the motives behind the purchase or the selling. NBK also wants the company to report the financial effects on the company result as detailed, if possible. (NBK, 2000)

When the company has conducted trade, they must report about the actual acquisition or sell of own shares to the stock exchange or the authorised marketplace. This must be conducted as soon as possible and, at the latest, before the beginning of the next coming business day. This information should also be published in a press release of unaudited annual earnings figures and in the interim reports. (FAR INFO, 2000)

3.4 Trade regulation

The Industry and Commerce Stock Exchange Committee have, in the recommendation about purchasing and selling own shares, given some information on how the trade shall be done in order to avoid the confidence for the stock exchange market decreasing. The recommendation only comprises offers of own shares and not convertible securities, warrants or any other financial instruments. The

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company is not allowed, on the same day, to give the assignment to more than one broker on the stock exchange market. One assignment has to be drawn to a close before a new assignment can be given to another stockbroker. This rule has made it easier for the stock exchange market to ensure that the company follows the trade limitations. A company's purchase or selling of own shares during a day is not allowed to exceed 25 % of the average day turnover (including own trade), during the four calendar weeks immediately preceding the week during the company made the trade on the actual stock exchange market. If the share is traded on several stock exchange markets, the company's trades are not allowed to exceed the 25 % of the average day turnover per day, for that share, on each and everyone of these stock exchange markets. The company can only place order on own share between the lowest and highest share price - the spread. This information can be found in the stock exchange market trade system. An exception from the 25% limitation is allowed concerning trades of a group of shares (blockaffärer). Such a trade occurs when trade is conducted of at least 500 round lots (börsposter) in the shares with the highest sales at the stock exchange or at another authorised market place. For all other shares, the limit of such a trade is set at 250 round lots. (NBK, 2000)

Assume that the company chooses to make a repurchase on Wednesday in the 40th Week. The maximum number of shares is 25% of the average day turn over during the weeks of 36-39. The total number of shares during these weeks has been 1.000.000 shares. Each week has five business days adding up to a total of 20 business days. The average day turn over will in this example then be 50.000 shares. The total number of shares that the company can repurchase on Wednesday in week 40 is 25% out of 50.000, that is 12.500 shares. If the company is assumed to have shares that are not traded with, to a larger extent, then the limit is set to 250 round lots. If one round lot in the company is 100 shares, then a trade of 250 round lots with a total number of 25.000 shares is allowed for this company in accordance with the regulation when trading with a whole group of shares.

Chapter 3 – The legislation and regulation

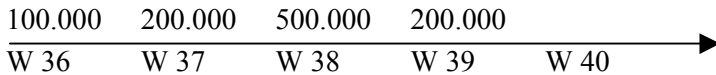


Figure 2: Illustration of trading with own shares. The day turn over of the company's shares is above the line while the weeks are shown below.

Source: Our own

A consequence of this rule is that the trade with own shares cannot be done until a spread is established. Furthermore, the Industry and Commerce Stock Exchange Committee has made a recommendation that a company is not allowed to purchase or sell own shares during the last 30 minutes before the close of the business day. The company is not allowed to buy or sell own shares during a period of 30 days before the publication of the company's annual report. This is done in order to avoid any discussion concerning insider information. There is also a possibility for the company to direct an offer to all shareholders or all owners of a certain kind of shares in the company. The recommendation from the Industry and Commerce Stock Exchange Committee only deals with the matter when a sale of own shares is included by the rules of the Companies Act concerning new share issues and prospectus. When a company has made the decision about making a public offer, the company should immediately make this public by a press release. This press release shall contain information about the conditions for the offer, the company's current possession of own shares and the number of shares that the offer comprises. The company should also submit information regarding the size of the payment and what the payment consists of; for example, cash or another form of property. The time for acceptance of the offer should be at least three weeks and is not allowed to begin before the prospectus becomes public. The prospectus shall be reviewed of the company's auditor and a report of the review shall be included in the prospectus. (NBK, 2000)

The prospectus shall, as a general rule, be directed to all shareholders in the company. The company is allowed, under certain circumstances, to make an exemption from this rule. This means that it is possible for a company to make the offer include only one kind of share. One reason for this exemption could be, for example, that the offer is including a kind of share with a few outstanding shares and that the

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company wants with this offer to exclude the share from the market.
(Skog R, 1997)

In order to prevent trading with the assistance of inside information, the government decided that stock market companies that purchase their own shares shall report this possession of own shares and changes in the possession. This should be done in writing to the Financial Supervisory Authority for registration in the register of insider trade. It is prohibited for companies that have purchased own shares to sell any own shares until three months after the latest purchase transaction. This rule is created in order to prevent speculation on short-time basis.
(Skog R, 1999)

4. The accounting for own shares

In this Chapter we describe the existing accounting methods used within this area. There are primary three different approaches used: the cost method, the par value method, and the “EC-method”. We illustrate how transactions of repurchase, endorse and retirement will be recorded in the book of accounts in each method. There will be a presentation of these three methods as a base for illustrating how to account for own shares in Sweden. This is also made in order to explain why Sweden has not chosen any of the methods used internationally. We will also declare the existing EC directives and international norms and recommendations on own shares, which could be a base for issuance of recommendations from Swedish accounting bodies. The Chapter ends with the government’s discussion on how the accounting for own shares shall be done.

4.1 Introduction to international methods

Before declaring the different methods, some definitions have to be clarified since American accounting uses another form of terminology than the Swedish. The purpose is to declare how accounting for own shares shall be presented in Sweden. Therefore, in order to facilitate for the reader, the American account terms have been translated into terms used in Sweden. Paid in capital is presented as “Share capital”, additional paid in capital is placed as “Restricted reserves” and the retained earnings are “Non-restricted reserves”. Treasury stock is named “Own shares”, since this is the term used in Sweden.

To illustrate the accounting for own shares in each method a fictive company will be used with a balance sheet total December 31st year X1 as shown below. The company has 1.000.000 shares of SEK 10 par value of outstanding shares. This gives a share capital of SEK 10.000.000. The company has also SEK 2.000.000 of restricted reserves and SEK 5.000.000 of unrestricted reserves. The company’s total equity is SEK 17.000.000. Assets and liabilities are as presented below.

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Fixed Assets	25.000.000	Share Capital	10.000.000
Current Assets	10.000.000	Restricted Reserves	2.000.000
Cash	5.000.000	Non-Restricted Reserves	5.000.000
		Long-Term Liabilities	15.000.000
		Current Liabilities	8.000.000
	<u>40.000.000</u>		<u>40.000.000</u>

Balance Sheet 1: Balance sheet total December 31st year X1

Source: Our own

4.2 The cost method

One method to treat own shares is to see the possession of the shares as a temporary reduction of the equity. The purpose with the possession is, thereby, to put the shares back to the market after a short time. In American accounting, this method is called the cost method and is the most common method used when accounting for own shares, mostly because of the simple account technique. (Nilsson S, 1996) This method is based on the value of the shares being debited "Own shares" at the price paid to repurchase the shares, and the same amount is credited to "Own shares" when the shares are sold. The difference between the sales price and the cost is entered in "Restricted reserves" and not in the income statement accounts. The reason why the method is called cost method is because the shares' value is booked at the same price that the shares are purchased for; that is the acquisition cost. In the cost method, a repurchase and the following endorsement are considered to be one transaction. The valuation to acquisition means that the company must keep a record of how many shares that have been purchased in each occasion and the price paid. (Kieso D E, Weygandt J J, 1995)

4.2.1 Purchase of own shares

Examples illustrating how the cost method is used for own shares with the conditions given in 4.1 follow. Assume that the company on January 31st purchases 100.000 shares to the par value of SEK 10 for a price of SEK 15 for each share. The repurchase implies that the

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company's "Cash" or similar is credited with SEK 1.500.000 and "Own shares" is debited with the same amount. "Own shares" can be seen as a storage account of shares within equity. The account of "Own shares" is placed at the end of "Equity", which is under "Share capital", "Restricted reserves" and "Non-restricted reserves". When this account is debited at a repurchase, it indicates that equity and the assets decrease to the same extent as the company repurchases shares (Hartman B P, et al., 1997).

	<u>Debit</u>	<u>Credit</u>
Cash		1.500.000
Own Shares	1.500.000	

Transaction: Accounts effected by the repurchase transaction.

Fixed Assets	25.000.000	Share Capital	10.000.000
Current Assets	10.000.000	Restricted Reserves	2.000.000
Cash	3.500.000	Non-Restricted Reserves	5.000.000
		Own Shares	(1.500.000)
		Long-Term Liabilities	15.000.000
		Current Liabilities	8.000.000
	<u>38.500.000</u>		<u>38.500.000</u>

Balance Sheet 2: Balance sheet total February 1st X2 (after purchase, under the conditions that no other transactions has occurred)

Source: Our own

Both the numbers of shares issued (1.000.000) and the number of own shares (100.000) shall be disclosed. The difference (900.000) is the number of outstanding shares. Note that "Own shares" is debited for the cost of the shares repurchased. The share capital is not affected by the repurchase, since the number of issued shares has not changed, but the number of outstanding shares has decreased with the same number as the company has repurchased. The cost method does not recognise that own shares should be accounted for as an asset and could be sold for cash. Own shares should be seen as reduction of the shareholders

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claims. This effect is correctly shown as a deduction from share capital and retained earnings. (Kieso D E, Weygandt J J, 1995)

4.2.2 Sale of own shares

The company may sell its own shares at a variety of prices. The accounting for the sale is different when own shares are sold above cost, than when they are sold below cost. If the selling price of the own shares is equal to the cost the sale of the shares, it is debited “Cash” and credited to “Own shares”. When the selling price of the shares is greater than the cost, the difference is credited to “Restricted reserves ” from “Own shares”. (Kieso D E, Weygandt J J, 1995) A sale to a higher price could assemble a new share issue, which in Sweden would have the effect that the profit should be credited to the “Share premium reserve” (Överkursfond) as a part of the company’s restricted reserves. (Nilsson S, 1996)

4.2.2.1 Sale of own shares over acquisition cost

To illustrate this, assume that 50.000 own shares, previously acquired for SEK 15, are sold at a price of SEK 20 per share is sold on June 30th X2. “Cash” is debited with SEK 1.000.000 while “Own shares” are credited with SEK 750.000, which is the number of shares sold multiplied with the acquisition cost for these shares. The difference of SEK 250.000 is credited to the account of “Restricted reserves”. The entry is as follows:

	Debit	Credit
Cash	1.000.000	
Own Shares		750.000
Restricted Reserves		250.000

Transaction: Accounts effected by the endorsement transaction.

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Fixed Assets	25.000.000	Share Capital	10.000.000
Current Assets	10.000.000	Restricted Reserves	2.250.000
Cash	4.500.000	Non-Restricted Reserves	5.000.000
		Own Shares	(750.000)
		Long-Term Liabilities	15.000.000
		Current Liabilities	8.000.000
	39.500.000		39.500.000

Balance sheet 3: Balance sheet total July 1st X2 (after sale, under the conditions that no other transactions has occurred)

Source: Our own

The company's equity increases with 1.000.000, which is the same amount for which the company sold the repurchased shares. The 250.000 in difference is not to be seen as a profit, that is to have any impact on the profit of the year in the income statement. This represents that any surplus or deficit when selling own shares should be accounted separately from the company's profit of the year. There are two reasons for this. The first is that gains on sale occurs when assets are sold and own shares are not to be seen as an asset. Secondly, a company does not realise a gain, or a loss, from share transactions with its own shareholders. As a result of this, share capital from a sale of own shares should not be included when measure profit of the year. (Kieso D E, Weygandt J J, 1995)

4.2.2.2 Sale of own shares below acquisition cost

If assuming that one month later, July 31st X2, a new sale is conducted at a price below the acquisition cost then Cash is debited with the amount that the own shares are sold for. "Own shares" is credited with the acquisition cost for the shares that have been sold. The excess of cost over selling price is debited "Restricted reserves". If the cost difference is greater than what is available in "Restricted reserves", the remaining amount is credited to "Non-restricted reserves". The assumption of the sale is that the company sells 20.000 own shares at a price of SEK 12 for each share. This means that the company's cash is debited with SEK 240.000, at the same time as "Own shares" is credited with SEK 300.000, which is the acquisition cost for these

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20.000 shares at a cost of SEK 15 for each share. The difference, of SEK 60.000 is debited “Restricted reserves”. (Kieso D E, Weygandt J J, 1995) After posting these entries, as shown below, the balance sheet will show the following balance on August 1st X2:

	Debit	Credit
Cash	240.000	
Own Shares		300.000
Restricted Reserves	60.000	

Transaction: Accounts effected by the endorsement transaction.

Non-Current Assets	25.000.000	Share Capital	10.000.000
Current Assets	10.000.000	Restricted Reserves	2.190.000
Cash	4.740.000	Non-Restricted Reserves	5.000.000
		Own Shares	(450.000)
		Long-Term Liabilities	15.000.000
		Short-Term Liabilities	8.000.000
	<u>39.740.000</u>		<u>39.740.000</u>

Balance sheet 4: Balance sheet total August 1st X2 (after sale, under the conditions that no other transactions have occurred)

Source: Our own

Note that the own shares are credited at cost for each entry. “Restricted reserves” is used for the difference between the cost and the resale price and the share capital is not effected. A sale of own shares will increase both assets as well as equity. (Kieso D E, Weygandt J J, 1995)

4.2.3 Retirement of own shares

The company may choose to use the own shares to reduce the share capital. The effect of a reduction is that the company’s share capital decreases with the same nominal amount that the number of reduced shares are. The transaction has similarities with a sale of own shares, except that the debits are made to share capital accounts instead of cash. (Kieso D E, Weygandt J J, 1995)

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Assume that the company chooses to use the shares to make a reduction of the share capital on June the 30th instead of selling them. That is, they use all the 100.000 own shares for a reduction. In order to illustrate the effects at a reduction, the average issue price per share must be known. In this example, it is assumed to be SEK 11 per share. The par value for each share is reduced from the “Share capital” in this case, with SEK 1.000.000*, while the difference between share issue price and par value is reduced from “Restricted reserves”. The difference is SEK 1 per share, which equals to a total of SEK 100.000, reducing “Restricted reserves”. The difference between the share issue price and the acquisition cost must be debited to “Non-restricted reserves” since own shares must be reduced with all the costs of acquisition. (Hartman B P et al., 1997) The difference of SEK 4 on each share†, equal to SEK 400.000, is reduced from “Non-restricted reserves”. At the same time, own shares are used to reduce the share capital. Therefore, the account of “Own share” is credited with the amount of the acquisition cost, SEK 1.500.000.

	Debit	Credit
Share Capital	1.000.000	
Restricted Reserves	100.000	
Non-restricted Reserves	400.000	
Own Shares		1.500.000

Transaction: Accounts effected by the retirement transaction.

* 100.000* 10 SEK/share equal to 1.000.000 SEK

† Acquisition cost of 15 minus share issue price of 11

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Non-Current Assets	25.000.000	Share Capital	9.000.000
Current Assets	10.000.000	Restricted Reserves	1.900.000
Cash	3.500.000	Non-Restricted Reserves	4.600.000
		Own Shares	0
		Long-Term Liabilities	15.000.000
		Short-Term Liabilities	8.000.000
	38.500.000		38.500.000

Balance sheet 5: Balance sheet total on July 1st X2 (after reduction, under the conditions that no other transactions have occurred)

Source: Our own

The figure illustrates that the share capital has decreased with SEK 1.000.000, which is the nominal value of the repurchased shares. The balance sheet total has decreased with a total of SEK 1.500.000, compared to before the purchase and the reduction.

4.3 The par value method

The par value method is an alternative method used in USA where the repurchase is considered as a definitive reduction of the share capital (Nilsson S, 1996). When using the par value method, the price paid to repurchase the share is compared to the original issue price; that is, the initial price that the share has been issued at. In the par value method, where own shares are accounted for at the par value, a repurchase will debit the account of “Own shares”. The account of own shares represents only the par value of the shares compared to the cost method where the account represents total cost of the repurchase. The method is not as clear as the cost method to illustrate that the shares are *not* reduced. In the par value method the repurchased share is seen as a sort of reduction of the share capital; thus the share capital cannot be reduced before the actual retirement is done. (Hartman B P et al., 1997) Note that the amount of equity and the total balance sheet are the same in the two methods, but, in the par value method, the purchase cannot be seen directly in the balance sheet without comparing with previously years. (Nilsson S, 1996)

4.3.1 Purchase of own shares

4.3.1.1 Purchase of own shares over par value

When repurchasing shares to a price *over* par value the nominal amount is debited to “Own shares”. If the acquisition cost, when repurchasing, exceed the original issue price the difference between the shares par value and the original premium is debited to “Restricted reserves”. Furthermore, the difference in the original issue price and the acquisition cost for the own shares is debited to “Non-restricted reserves”. (Hartman B P et al., 1997)

Examples which illustrate how the par value is used for own shares with the conditions given in 4.1 are as follows. Assume that the company repurchases 100.000 shares, the par value is SEK 10 and the share issue price was SEK 11. The premium with the issue was SEK 1 per share that already has been entered under the account of “Restricted reserves”. The company repurchases the shares at a market value of SEK 15. When repurchasing “Cash” is credited with SEK 1.500.000, which is the market value multiplied with the numbers of shares. “Own shares” is debited with SEK 1.000.000, which is the par value of the repurchased shares*. “Restricted reserves” is debited with SEK 100.000, which is the premium of SEK 1 per share multiplied with the 100.000 repurchased shares, which the company received at the issue. Since the market value of the own shares excess the share issue price including the premium “Non-restricted reserve” will be debited with SEK 400.000, which is the difference between the market value and the share issue price multiplied of repurchased shares†. After posting these entries, the balance sheet will show the following balance on January 1st X2.

* 100.000 shares multiplied with 10 SEK

† 15 SEK minus 11 SEK multiplied with 100.000 shares

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	Debit	Credit
Cash		1.500.000
Own Shares	1.000.000	
Restricted Reserves	100.000	
Non-restricted reserves	400.000	

Transaction: Accounts effected by the repurchase transaction.

Non-Current Assets	25.000.000	Share Capital	10.000.000
Current Assets	10.000.000	Own Shares	(1.000.000)
Cash	3.500.000	Restricted Reserves	1.900.000
		Non-Restricted Reserves	4.600.000
		Long-Term Liabilities	15.000.000
		Short-Term Liabilities	8.000.000
	<u>38.500.000</u>		<u>38.500.000</u>

Balance Sheet 6: Balance sheet total January 1st X2 (after repurchase over par value, under the conditions that no other transactions have occurred)

Source: Our own

This illustrates that the balance sheet total has decreased by SEK 1.500.000, which is the amount that the company paid for the own shares.

4.3.1.2 Purchase of own shares under par value

When purchasing own shares at a price *below* par value, the nominal amount is debited “Own shares”, since the share capital cannot be reduced with a value less than the nominal value. The difference between the shares’ par value and the acquisition cost will be credited to “Restricted reserve”. (Hartman B P et al., 1997)

Assume that the company repurchases 100.000 shares at the price of SEK 5 each. “Cash” is credited with SEK 500.000*. “Own shares” is debited with SEK 1.000.000, which corresponds to the nominal value

* Repurchased price multiplied by the number of shares

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of SEK 5 per share. Finally, “Restricted reserves” is credited with SEK 500.000, which is the difference between the par value and the acquisition cost.

	Debit	Credit
Cash		500.000
Own Shares	1.000.000	
Restricted Reserves		500.000

Transaction: Accounts effected by the repurchase transaction.

Non-Current Assets	25.000.000	Share Capital	10.000.000
Current Assets	10.000.000	Own Shares	(1.000.000)
Cash	4.500.000	Restricted Reserves	2.500.000
		Non-Restricted Reserves	5.000.000
		Long-Term Liabilities	15.000.000
		Short-Term Liabilities	8.000.000
	<u>39.500.000</u>		<u>39.500.000</u>

Balance sheet 7: Balance sheet total January 1st X2 (after repurchase under par value, under the conditions that no other transactions have occurred)

Source: Our own

4.3.2 Sale of own shares

A sale of own shares, using the par value method, resembles a new share issue with the difference that “Own shares” is adjusted and not the “Share capital”. At a sale to a higher price or lower price, “Cash” is debited with the sales price and “Own shares” is credited with the par value of the shares. The account of “Restricted reserves” is credited with the difference between par value and sales price. The account of “Non-restricted reserves” is never affected by a sale using the par value method. (Hartman B P et al., 1997)

4.3.2.1 Sale of own shares over acquisition cost

Assume that the company resells the 50.000 shares that were acquired for SEK 15, at a price of SEK 20 per share. In this case, “Cash” is

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debited with SEK 1.000.000 and “Own shares” is credited with SEK 500.000, which is the par value of the shares. The rest, SEK 500.000*, which is the difference between the sales price and the par value of the share, is credited in “Restricted reserves”. The entry is as follows:

	Debit	Credit
Cash	1.000.000	
Own Shares		500.000
Restricted Reserves		500.000

Transaction: Accounts effected by the endorsement transaction.

Non-Current Assets	25.000.000	Share Capital	10.000.000
Current Assets	10.000.000	Own Shares	(500.000)
Cash	4.500.000	Restricted Reserves	2.400.000
		Non-Restricted Reserves	4.600.000
		Long-Term Liabilities	15.000.000
		Short-Term Liabilities	8.000.000
	39.500.000		39.500.000

Balance sheet 8: Balance sheet total January 1st X2 (after sale over par value, under the conditions that no other transactions have occurred)

Source: Our own

4.3.2.2 Sale of own shares under acquisition cost

If the company sell the 50.000 shares, purchased at SEK 15, at a price of SEK 12 per share, the “Cash” is debited with SEK 600.000[†], which is the number of shares multiplied with the sales price. “Own shares” is credited with SEK 500.000[‡], which is the par value of the 50.000 sold shares. When selling at a price of SEK 12, SEK 100.000[§] will be credited to “Restricted reserves”. This is the difference between the

* 20 SEK minus 10 SEK multiplied with 50.000

† 50.000 multiplied with 12 SEK

‡ 50.000 multiplied with 10 SEK

§ 12 SEK minus 10 SEK multiplied with 50.000

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sales price of SEK 12 and the par value of SEK 10. The entry is as follows:

	Debit	Credit
Cash	600.000	
Own Shares		500.000
Restricted Reserves		100.000

Transaction: Accounts effected by the endorsement transaction.

Non-Current Assets	25.000.000	Share Capital	10.000.000
Current Assets	10.000.000	Own Shares	(500.000)
Cash	4.100.000	Restricted Reserves	2.000.000
		Non-Restricted Reserves	4.600.000
		Long-Term Liabilities	15.000.000
		Short-Term Liabilities	8.000.000
	<u>39.100.000</u>		<u>39.100.000</u>

Balance sheet 9: Balance sheet total January 1st X2 (after sale below acquisition cost, under the conditions that no other transactions have occurred)

Source: own

4.3.3 Retirement of own shares

When own shares are retired, the company's share capital decreases with the nominal value of the number of reduced shares. When using the par value method, "Own shares" is credited with the nominal value of the shares and the companies "Share capital" is debited with the same amount. (Hartman B P et al., 1997)

Assume that the company on June 30th X2 chooses to retire the 100.000 shares that the company purchased at a price of SEK 15 per share. The company's "Share capital" is then debited with SEK 1.000.000, which is the share's nominal value. "Own shares" is credited with the associated amount of SEK 1.000.000. After posting these entries, the balance sheet will show the following balance on July 1st X2.

	Debit	Credit
Share Capital	1.000.000	
Own Shares		1.000.000

Transaction: Accounts effected by the retirement transaction.

Non-Current Assets	25.000.000	Share Capital	9.000.000
Current Assets	10.000.000	Own Shares	0
Cash	3.500.000	Restricted Reserves	1.900.000
		Non-Restricted Reserves	4.600.000
		Long-Term Liabilities	15.000.000
		Short-Term Liabilities	8.000.000
	<u>38.500.000</u>		<u>38.500.000</u>

Balance sheet 10: Balance sheet total on July 1st X2 (after reduction, under the conditions that no other transactions have occurred)

Source: Own

The balance sheet above illustrates that it is only the company's share capital that is effected by the reduction.

4.4 "EC-method" of accounting for own shares as an asset

The EU allows a type of accounting for own shares that recognises these shares as an asset and considers them to have a value for the company that should be presented. EU accepts this, in contrary to the USA, where this method is not allowed anymore, since the USA accounting does not consider own shares as an asset. According to the fourth directive, own shares could be accounted for as an asset on the asset side in the balance sheet. This signifies that an amount associated with the shares value is accounted for as a reserve on the passive side on the balance sheet. This amount is then not allowed to be used by the company. (Thorell P, 1993)

Kam (1990) has some established theoretical definitions concerning what an assets is. Certain criterions must be fulfilled in order to classify an item as an asset:

- The asset is *expected to contribute to economic benefits* for the company in the future. There has to be some kind of certainty that it will contribute benefits in the future, based on available facts.
- The company must *control* the asset. By controlling an asset, it means that the company can benefit from it and at the same time no other company can benefit from the asset.
- The asset must be a *result of transactions or events in the past*. That is, the assets that are expected to enter into the company in the future are not an asset until they are actually transferred.

4.4.1 Purchase of own shares

Examples to illustrate how this method (from now on called the “EC-method”) is used for own shares with the conditions given in 4.1 follows. Assume that the company repurchases 100.000 own shares to a price of SEK 15 per share. The repurchase gives that the company’s “Cash” will be credited with SEK 1.500.000. The same amount is debited as a financial asset in the account “Own shares”. At the same time, the company transfers SEK 1.500.000 to the passive side as a reserve. The transaction goes from “Non-restricted reserves” to “Restricted reserves”. The company’s “Share capital” is not affected by the repurchase since the number of issued shares has not changed. However, the number of outstanding shares does decrease with the number of shares that the company bought. The company’s total equity is not effected at all, but the SEK 1.500.000 of the restricted reserve makes an equity reserve that the company is not allowed to use until the own shares is sold.(Thorell P, 1993) The entry is as follows:

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	Debit	Credit
Cash		1.500.000
Own Shares	1.500.000	
Non-restricted reserves	1.500.000	
Restricted reserves		1.500.000

Transaction: Accounts effected by the repurchase transaction.

Non-Current Assets	25.000.000	Share Capital	10.000.000
Current Assets	10.000.000	Restricted Reserves	3.500.000
Own shares	1.500.000	Non-Restricted Reserves	3.500.000
Cash	3.500.000	Long-Term Liabilities	15.000.000
		Short-Term Liabilities	8.000.000
	40.000.000		40.000.000

Balance sheet 11: Balance sheet total January 1st X2 (after repurchase, under the conditions that no other transactions have occurred)

Source: Our own

Note that the company's balance sheet total is not effected by the repurchase.

4.4.2 Sale and retirement of own shares

When the company sells these shares, an adjustment of the effected account as described above is done. Does a surplus or a deficit occur within the sale, the "Restricted reserves" or the "Non-restricted reserves" is debited alternative credited. Another alternative is that the deficit respective the surplus is recorded as income. Exactly which account that shall be adjusted is not regulated in any of the EC directives. This is regulated in each member states own laws and recommendations.

The issue of retirement is not regulated in the EC directive. Each member state has separate regulations within this issue. The directive only focuses on the own share transaction itself. In Sweden, for

example, the issues of reduction of the share capital are regulated in the 6th Chapter of the Companies Act. (Thorell P, 1993)

4.5 Summary of accounting for own shares

The different methods are used depending on the purpose of the repurchase. If the purpose is to reduce the share capital, the par value method is preferable. On the other hand, if the purpose of the purchase is to later sell the own shares, then the cost method is preferable. The “EC-method” that considers own shares as an asset are allowed in just a few countries and the purpose behind the repurchase is not conclusive. The three methods differ on how to treat the repurchase in the balance sheet. The cost method and the “EC-method” mergers from the acquisition cost and both methods account the total acquisition cost. The par value method initiates from the acquisition cost and divides this on different accounts, with starting point from the shares par value and the original issue price.

When using the cost method, adjustments from the restricted reserves are done on the selling date. When using the par value method and the “EC-method”, the adjustments of the restricted reserves are done on the acquisition date. The difference between the two later methods is that the par value method divides the acquisition cost on three accounts within the equity: own shares, share capital and non-restricted reserves. The “EC-method” arranges a reserve that associates the acquisition cost of the shares in the account of restricted reserves. In the cost method, own shares are presented below the entry of non-restricted reserves and could be seen as a credit post to this. In the par value method, own shares are placed directly below share capital. While in the “EC-method”, own shares are placed on the asset side. When using the par value method, the non-restricted reserves decrease at the purchasing moment. When using the “EC-method”, the same accounts are adjusted when purchasing own shares or selling these shares. Each member state has its own laws and recommendations that regulate how a deficit or surplus shall be treated when selling the shares.

4.6 International norms and recommendations

The norms treating purchase and endorsement of own shares includes recommendations released by international and national standards setting bodies. The standard setting bodies can be divided in internationally bodies and bodies that have a narrower geographic range. The most influential international body from a Swedish perspective is IASC. The Swedish standard setting body: the Swedish Financial Accounting Standards Council (Redovisningsrådet) works with the IASC's material. On the other hand, Sweden, as a member of the EU, has to follow the EC directives.

The directives that EU issues have the same function as the accounting laws and are valid in each member state. EU uses the directives to achieve harmonisation in the accounting laws among the member states. The directives turn to the governments in each member state who are obliged to include the directives in the country's own laws. According to Article 189 in the Treaty of Rome, it is up to every single member state to choose how the country shall implement the directives in the country's own laws. (Flower J, Lefevre C, 1997) The Swedish government refers to the IASC and EC directives when analysing the accounting issues of own shares. (Proposition, 1999/2000:34)

4.6.1 IASC

IASC (2000-08-22) has a great influence on the development of international accounting. It was founded 1973 and is an expert committee that works for harmonising accounting internationally. IASC publish continual recommendations that are called, International Accounting Standards, IAS. The recommendation from IASC that has the biggest impact, when deciding on how own shares shall be treated in the company, is IAS 32. The Standard Interpretations Committee, SIC is working with interpretations of IASC recommendations. SIC have issued an interpretation of IAS 32, on how to present the own shares in the accounting called Draft interpretation, *D16: presentation of own shares*. This draft recently became valid, beginning July 1st 1999. This interpretation concerns the issues of how own shares should be presented and how an occurring difference between the acquisition

cost and the sales price should be accounted for. The conclusion of D16 is that own shares should be presented as a deduction from equity in the balance sheet. If own shares are sold, the differences are to be presented in the financial statement as a change of equity – not as a profit or a loss.

SIC 16 does not take any position concerning which accounts within the equity should be adjusted when holding own shares. Although, SIC 16 gives three options:

- the total cost of acquisition for own shares can be presented as a single adjusted entry, or
- the par value of the shares is entered as a deduction from share capital. Any premiums or discounts are adjusted to restricted or non-restricted reserves, or
- adjustments to each kind of equity.

The adjustments should be specified concerning each entry, either directly on the balance sheet or in the notes.

SIC has also issued a draft interpretation concerning transactions cost of share capital, SIC 17, which also is based on IAS 32. This interpretation deals with the costs when acquiring or endorsing equity instruments, classified in IAS 32. The cost of the repurchase or the endorsement shall result in a decrease, respectively a net increase of equity. The transaction cost of a repurchase or an endorsement should be accounted for as a part of that transaction. This will result in a deduction from equity.

4.6.2 The EC Directives

The directives concerning the issue of own shares are the second and the fourth directives. The second directive regulates the issue of own shares, while the fourth handles the transaction of accounting. The main question, if companies should be allowed to purchase own shares are not regulated in either of the directives, thus every single member state can decide itself if this should be allowed within that country. The status in the EU before the Swedish law became valid was, according to a study done by Aktiebolagskommittén, that all member states except Sweden allow public limited companies to repurchase own

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shares in accordance with the second directive. In the Article 19.1b in the second directive, it states that the total possession of own shares is not allowed to exceed 10% of the total outstanding shares in the company. According to Article 19.1d, the purchase could only comprise shares that have been fully paid for. (Thorell P, 1993)

EC's fourth directive gives two alternatives when it comes to accounting for own shares. In Article 8 to 10 in the directive, there are two alternative statement concerning the company's balance sheet. If a member state stipulates both of these forms, the government has to make the company choose between them. The *first* alternative gives the opportunity to account for own shares on the asset side of the balance sheet. When using this alternative, the company shall transact a corresponding amount to a reserve on the equity side. A hold of own shares shall be accounted as a financial asset or as a short-termed investment. The amount on the equity side shall be accounted for as an equity reserve, called "Reserves for own shares". This is conducted in accordance with Article 22.1 b in the second directive. In Article 35 in the fourth directive, it states that a financial asset shall be adjusted in order to give them a lower value on the closing day. These adjustments shall be accounted for in the income statement and be recorded separately. The lower value is not allowed to be maintained if the reasons for the adjustments has ended. If own shares are accounted as short-term investments, the same regulation is valid in accordance with Article 39. The *second* alternative is that own shares are not accounted for as an asset. If a member state regulates in accordance with the second alternative, it is stated in Article 9 in the fourth directive that this state chose an individual regulation on how to account for own shares. The member state must, however consider whether there is cover for equity after the repurchase in accordance with Article 19.1c. Exactly which account in equity that shall be adjusted when using the second alternative is not regulated in either of the EC directives. This is regulated by each member states' own laws and recommendations. (Thorell P, 1993)

4.7 Government's proposal of accounting in Sweden

4.7.1 Own shares as an asset?

When purchasing and endorsing own shares, the question occurs as to how the shares should be accounted for. The regulation must be developed in accordance with the already existing accounting regulation, the demands of the EC-law, and the international development on this issue. As mentioned before, the EC-law has two alternatives when accounting for own shares. Before the change of the Companies Act, Sweden used the method that corresponds to the second alternative. The own shares shall be accounted for on the asset side of the balance sheet without any value. This regulation was for companies who either used one of the three exceptions from the regulation prohibiting own shares, or those who have acquired own shares in conflict with the law. These companies were obliged to sell the own shares as soon as possible without making a loss, but not later than three years after the purchase.

Accounting for own shares as an asset is not a method that the Swedish government prefers, since it gives the impression that the equity in the company is at the same amount before, as well as after the acquisition, even though the acquisition has caused a decreased of asset without any real value has been provided to the company. The impression of the equity will thereby be incorrect, which makes those calculations of key ratios also incorrect. The method is not in accordance with SIC – 16 and, therefore, should this method not be used in Sweden when accounting for own shares. The method used earlier in Sweden, mentioned above as the second alternative, does not have the same disadvantages as the first alternative. This could be said to have a more limited purpose, which is to inform others that the company has own shares. This kind of information could be mentioned in the notes to the accounts as well or in the director's report. The earlier Swedish method is, furthermore, less combined with the fourth directive. The directive has no particular information about whether the own shares should be accounted for as an asset without any value. This directive has as a main principle that a possession of own shares should, if accounted at

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all as an asset in the balance sheet, be treated as any other possession of shares and could, thereby, have a value. (Proposition 1999/2000:34)

The government has stated in the 4th Chapter 14§, Annual Accounts Act (1995:1554) that, “*own shares shall not be accounted for as an asset in the balance sheet*”. It is not correct to claim that the company can own a part of itself. Own shares could be sold for cash but that does not make them an asset. The repurchase of own shares does not signify that the company has acquired an asset, but only reduced its capitalisation. (Kieso D E, Weygandt J J, 1995) Own shares shall be given in a special information part in the director’s report. The changes in the Companies Act concerning own shares affect the Annual Accounts Act concerning own shares as an asset, treatment of payments and the contents of the director’s report.

4.7.2 Accounting for payments of own shares

In the treatment of payments that the company receives when selling own shares, the government thinks that the payments should not be accounted for in the income statement. The change of equity that occurs when selling own shares should not be seen as a profit or loss, but as a transaction between the remaining shareholders and those who has decided to give up their shares in accordance with IAS 32. Furthermore, the government as well as the SIC16 states that a purchase does not change the company’s financial position and should, therefore, not be accounted for in the financial statement. Both IAS 32 and SIC 16 conclude that all transactions with purchase or sell of own shares shall not be accounted for in the income statement, but as a reduction or a contribution directly from the non-restricted equity. The reduction shall be equal to the expenses that the company had when purchasing the shares. In a situation of endorsement the non-restricted equity shall increase with the net-income of the sale. The change of non-restricted equity shall be specified in notes or in the balance sheet, if this is not in conflict with the concept of materiality. The EC-law does not regulate which part of the non-restricted equity should be adjusted in a purchase or selling of own shares. (Proposition 1999/2000:34)

“Payments to and from the company in connection with repurchase and selling of own shares should not be taken up as income, but should be accounted for directly to non-restricted equity and should not effect the restricted equity” (5th Chapter 14§, Annual Accounts Act (1995:1554)).

4.7.3 Own shares in the director’s report

In accordance with the second and fourth directives, the director’s report shall contain information about:

- The reason why the company purchased own shares during the financial year.
- The number of shares and the nominal amount of those that has been purchased or sold during the financial year and the part of the total numbers of outstanding shares that these own shares consist of.
- Information about the price that has been paid out or received for the own shares.
- The number and nominal amount of *all* own shares held by the company as well as the part of the total number of the outstanding shares that the own shares consists of.

“The director’s report shall give information about possessions of own shares; for example, the number of own shares that the company possesses and the payment for the acquisition of the shares” (6th Chapter 1§, Annual Accounts Act (1995:1554)).

4.7.4 Summary of accounting for own shares in Sweden

In the proposed law, the government suggests that own shares should not be accounted for as an asset in the balance sheet. Instead, the director’s report should include information concerning the possession of own shares and the purchase and endorsement that have occurred during the year. The payments derived from purchase and sale shall not be accounted for in the income statement, but shall be accounted for directly as non-restricted equity. It does not state which part of the non-restricted equity shall be used or if it should be deducted in proportion with the different posts within non-restricted equity.

5. Interview compilation

In this Chapter the interview results will be presented. More than 30 companies have proclaimed that they have an interest in repurchasing their own shares. We have interviewed companies in order to find how this new equity instrument influences them. By this layout the interviews have a purpose to answer how to account for own shares. Accounting standard setting bodies, and likewise auditors, have also been interviewed since they have a broader perspective in the accounting issue, that is the connection between the legal and the accounting aspects. These two groups are presented under the same heading since their starting point is similar.

We have chosen to interview people that have been involved, effected by the proposal and people that have a great knowledge in the accounting area. In this Chapter, we first make a short presentation of the respondents, and then present a summary of the information received. This will be presented issue by issue, since it is the compilation of all respondents' opinions and answers that is of importance. In each issue, there is a separation into two groups. The first group consists of companies, while standard setters and auditors are combined in the other group. All six companies have answered the same questions, while the other group has had individually constructed questions, depending on each person's position, although the questions were within the same problem areas. The attitude to own shares is dependent on the situation of each respondent. The companies have all repurchased shares and has thereby their experience from this. The other respondents have more of a theoretical and external view of the issue. Therefore, a separation is made between the two groups, which facilitates the comprehension of the compilation.

5.1 Respondents

5.1.1 Companies

Ann-Sofie Danielsson

is chief accountant within *NCC*, which has a program to buy a maximum of 10% of the total number of outstanding shares. On September 27th 2000, the possession of the own shares were 2,53%. The purpose of the repurchase is to cover the assign of option to 170 managers in the company. The endorsement within the option program does not give any dilution of the shareholders present ownership. The purchase is made through transactions on the stock exchange. (NCC, 2000-09-27)

Lennart Ekelund

is financial manager in *Wallenstam*. The board has permission from the Annual General Meeting to buy 10% of the total number of shares and has so far bought 2.07% on September 15th 2000. The motive behind the purchase is so the shares can be bought with substantive discount* on 65%. With the purchase, *Wallenstam* can distribute the repurchased own shares discount to the existing shareholders at the same time as several of the company's key ratios improve. The shares have been acquired on the Stockholm stock exchange. (Wallenstam, 2000-09-27)

* A substantive discount occurs when the stock market value is below the value of the assets in a company.

Stefan Karlsson

works with investor relations at *Volvo AB*. Volvo has now a possession 10% of its own shares. The purposes of the purchase are to be able to continuously adjust Volvos capital structure* to the company's capital needs, and to be able to transfer shares as a method of financing acquisitions. Volvo will acquire Renault's truck business in exchange for 15% of the shares in Volvo. The purchase was made through offers to the shareholders. Volvo will transfer 10% of the shares in AB Volvo as a partial payment to Renault in exchange for 100% of the shares in Renault VI/Mack. Volvo intends to acquire the remaining 5 % on the market. (Volvo, 2000-09-27)

Carl-Henrik Lindgren

is chief accountant in *Electrolux*. They have the intention to buy 10% of the total number of outstanding shares. On the 30th September, the company has purchased 4,3% of the outstanding shares. The purpose is, among other things, to continuously be able to adapt the capital structure to the needs of the company and thereby increase the shareholders value. Another thing is when financing potential company acquisition as well as in the group's option program. The purchase was made through transactions on the stock exchange to prevailing market prices. (Electrolux, 2000-09-27)

* The capital structure is the relation of a company's financing between external capital (liabilities) and internal capital (equity). One key ratio to measure the interrelation is debt/equity ratio.

Bertil Raihle is chief controller in *Swedish Match*. They had a possession of 5% on September 25th 2000. In an Extraordinary General Meeting that will be hold in 27th October, a decision about extending the repurchase program to 10 % will be taken. The purpose of the repurchased shares is to reduce the share capital and, thereby, create more value for their shareholders. The shares have been acquired on the Stockholm Stock Exchange. (Swedish Match, 2000-09-27)

Stefan Schéle is the manager of division corporate finance within the *Skanska* group. Skanska has a program to repurchase 10% of the total number of shares and, on September 27th the company had repurchased approximately 4.3%. The intention of the purchase program is to adjust the group's capital structure. The purchases were made on the Stockholm Stock Exchange. (Skanska, 2000-09-27).

5.1.2 Standard setters and auditors

Margit Knutsson is a member of the Swedish Financial Accounting Standards Council and is responsible for accounting issues and company law in Federation of Swedish Industries (Industriförbundet).

Staffan Landén is authorised public accountant within Ernst & Young in Göteborg.

Lennart Larin is authorised public accountant within KPMG in Göteborg.

Rolf Skog

is secretary in the Aktiemarknadskommittén. He has a past experience within Aktiebolagskommittén and was involved in the preparatory work that was presented as SOU 1997:22 dealing with the issue of purchase of own shares.

5.2 Background issues

5.2.1 Companies

5.2.1.1 Change of legislation

The companies are positive to the change of legislation and having the opportunity to repurchase, hold and endorse own shares. All changes in these kinds of issues take time to implement and all companies have respect for this, although some believe that the change has taken too long time to implement. These companies had the desire to use this instrument before the law became valid. In the past few years they have made redemption programs in order to adjust the capital structure. If they had been allowed to purchase own shares at an earlier stage then maybe the companies would have chosen this instrument to conduct the adjustments instead. The opinion is that the instrument of own shares is a better way to optimise the capital structure, compared to redemption. One company however questions whether own shares is a significant financial instrument in comparison with other types of instruments for adjusting the capital needs of a company, and claims that it is a rather small instrument without any greater importance.

In those cases where companies had the strategy of diversification in the past, the instrument would not have been useful earlier. Diversification has been achieved through a combination of a number of mergers and acquisitions throughout the years. From that perspective, groups had a high level of liabilities and, therefore, no desire to further reduce equity by repurchasing own shares. During the last years, the strategy has been for the company to concentrate on core business and, consequently, sales have been conducted of other business than core business. This has lead to groups becoming excess

capitalised and the debt/equity ratio becomes lower than the optimal ratio for each group. Therefore, it is positive that the change of legislation has been conducted at this moment of time.

When own shares are to be used as payment in an acquisition, this instrument is useful. Before the change of the legislation, this kind of transaction, where ownership is given in exchange for an asset, had to be done through a directed share issue. Such a transaction is used to finance the acquisition by a share issue, where existing shareholders' preferential rights are by-passed. This is a complicated, time consuming, and more costly way to achieve an acquisition, in comparison with the instrument of own shares.

One company has not taken any consideration earlier to this form of possibility; so, in that point of view, it is neither negative or positive that the change has been conducted at this point in time. The time aspect in itself does not matter, but now, when this opportunity exists, the company decided to use this instrument. Although the companies had a unanimous opinion that all forms of improvement of the company regulation are always welcome.

5.2.1.2 Advantages and disadvantages with own shares

The companies lay emphasis on a distinction being made between different perspectives when discussing advantages and disadvantages with own shares. The primary advantage is that own shares gives a flexible opportunity to adjust the capital structure compared to new share issue and redemption. One opinion is that it is an important issue for the company against the shareholders, to ensure that the group has an optimal debt/equity ratio. By making this adjustment, the company creates value for the shareholders. A repurchase of own shares is also a good instrument for creating such value, even though there are other options, such as dividend or distribution of businesses.

There are other advantages, such as the possibility for a company to use own shares as payment when acquiring another company and, thereby, the company does not have to make a new share issue, which saves capital and time. At the same time, it is positive if the company can possess own shares to use as payment if the company wishes to

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make acquisitions in the future. Another advantage is that the shares could be used when the company has option programs for management and employees.

One company points out that a repurchase of own shares could be used as a signal to the market that the company thinks that their shares are worth buying, that is the share is low valued. By allowing this kind of transaction, companies could try to effect the share price. A repurchase decreases the number of outstanding shares on the market, which implies that the results of the company are divided between a less number of shares, making the share more attractive since the value of each share increases. Another view is that the company could repurchase their shares cheap. This is applicable for companies that are traded on the market with a high substantial discount. One company declares that it is difficult to find such investments otherwise on the market. If the company has available capital and the repurchase does not impact on other investments, one opinion is that it then should be used, since it gives positive effects to the shareholders, and at the same time, is a good investment.

One disadvantage that could occur is when the instrument is used in another way than what the legislator had in mind. The fear is that the company abuses the system when repurchasing own shares and, thereby, tries to rig the market. On the other hand, like one of the companies says, this is difficult to notice in practice since analysts observe the companies on the market. The experience so far, indicates that the share prices do not rise when the company makes a repurchase. Several of the companies that have repurchased their own shares have had a set back in the share price and the opinion is that a turnaround is not possible to achieve by making a minor repurchase. Another view is that suspicions of insider trade could be created, because the company is insider in the respect of own shares. Although, in Sweden, the regulation concerning insider and trade with own shares are strict; for example, the time aspects.

Other disadvantages or risks could be that the company technically increases debt/equity ratio and, thereby, equity decreases, which is suppose to be a reserve for the company when business slows down. A

final view is that a repurchase of own shares could be considered as a defensive action, since the capital should be used or generated by the company's business.

5.2.2 Standard setters and auditors

5.2.2.1 Change of legislation

The general opinion is that it is good for Swedish companies to have the opportunity to repurchase their own shares in order to more effectively use their capital and gain access to a convenient form of payment for acquisitions of companies and other property. The reasons why it has taken more than a century to abolish the prohibition on own shares is, among other things, the fear that it could result in a deficit of equity in the creditor perspective. When a company is allowed to repurchase, the risk of abusing the company's capital increases and there has been a desire to protect the capital base in the company, primarily for creditors. Although one respondent claims that this has been satisfied by the law concerning own shares. Another respondent remarks that it has been considered as a suspicious act to allow companies to repurchase a part of itself and that it is against the basic idea of a limited liability company to own itself.

One reason why the change was conducted at this time were the great demands from the Swedish industry and commerce to obtain the possibility to repurchase, hold and sell own shares. Their arguments were that it has been available for quite some time in comparable countries. Sweden, as a member of the EU, is obliged to follow the EC-law. It is regulated in this law that a company should have the possibility to repurchase its own shares. Before the change, Sweden, together with Liechtenstein, were the two only countries within the EEA that had a prohibition against this. Therefore, the possibility for Swedish companies to purchase own shares is an instrument to increase harmonisation within Europe. At the same time, our neighbour countries, Norway and Finland have, in the past few years, changed their legislation, allowing this instrument. The debate about this allowance has, during the last years, taken many turns. At one moment, the opinion has been completely in favour of allowing the repurchase of own shares and then nothing happened due to the fear of

manipulation of the share price, the setting aside of the principle of equal treatment, and the desire to protect the creditors. This is why it has taken so many years, according to one respondent.

The intention of changing the legislation concerning own shares has been developed during a long period of time. Aktiebolagskommitten has been working during this period with the issue, but it is controversial from both political and the shareholders' perspective. When Aktiebolagskommitten handed over the proposal to the government and the government later submitted the proposal to interested parties for comments, it was well received by several of these parties; for example, the Swedish Institute of Authorised Public Accountants (Föreningen Auktoriserade Revisorer, FAR) and the Swedish Stock Exchange in Stockholm. One interested party that did not accept the proposal as a whole was the Swedish Association of Shareholders (Aktiespararnas Riksförbund). They had the opinion that shares repurchased by the company should not be resold but used only to reduce the share capital. The Association of Shareholders was afraid that if the company could sell the repurchased shares, this could effect the equal treatment of shareholders.

5.2.2.2 Advantages and disadvantages with own shares

The advantages, in the respondents' opinions, are that own shares is a useful instrument for Swedish companies in a number of different aspects. It could be used to distribute capital to the shareholders and to help a company to adjust the capital need in a more flexible way than new share issue and redemption. One respondent points out one advantage that was not widely discussed in advance; namely, that it is an alternative form of payment in mergers and acquisitions where Volvo is a good example.

The disadvantages could be those arguments that has been discussed under several years in this issue as reasons for not allowing companies to repurchase their own shares. For example, companies, by purchasing and selling own shares, could try to set aside the regulation on reduction and redemption. Another disadvantage is that a company could try to rig the market by manipulating the share price. On the other hand, this has now been strictly regulated by certain rules in

order to prevent such manipulations; for example, the regulation concerning trade from the Industry and Commerce Stock Exchange Committee.

One respondent identifies a dilemma that was just recently discovered; that is, the fact that the liquidity in the share decreases. This was not considered before repurchases were possible. A decreased liquidity in the share normally implies that it becomes more difficult to sell the share and consequently the price decreases. A disadvantage, agreed with the companies' opinions, is that a repurchase of own shares could in a way, announces that the management has no strategy what do with the capital in the company. This could give a negative indication to the stock market that the company has no future visions.

5.3 Own shares and the Swedish law

5.3.1 Companies

5.3.1.1 The 10% limitation

There are different opinions concerning the sufficiency of the 10% limit, that is 10% of possession in one time. Some companies have not considered whether if it should be more or less extensive. The companies that argued that the limit is insufficient claimed that 10% is too low, since such limitations do not exist in other comparable countries outside EU. It is important that the regulations are as similar as possible and when Swedish companies have a different set of rules than their international competitors it is obstacles. Another opinion is that the limitation is unnecessary due to the fact that it is the Annual General Meeting that makes the decision to repurchase. Thus, the company cannot make a repurchase in conflict with the decision of this meeting. One contributed view is that the importance of a limitation depends on a variable of how spread out the company's share is. If the share is well spread then the risk of manipulation diminishes. In a company with many small owners, the risk of manipulation with the 10% limit should be lower than in the case of the opposite.

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If the company needs to purchase more than 10% it has to be done in several steps, unless it is conducted by an offer to the shareholders. First, the company has to endorse the 10% before making a new repurchase. If it could have been done in one step, it would have saved both time and capital for the company and its shareholders. At the same time, the fact that the limit of 10% was set up in order to prevent attempts to try to rig the market must be respected. The limit in connection with regulations on how many own shares that a company is allowed to purchase in one day makes it difficult for the companies to reach and exceed this level. A company's purchase or selling of own shares during a day are not allowed to exceed 25 % of the average day turnover (including own trade), during the four calendar weeks immediately preceding the week during which the company made the trade on the actual stock exchange market. The decision is taken at the Annual General Meeting for the time period of normally a year and then a new decision is taken on the next general meeting. One opinion is that if the company wants to buy more than 10%, it only has to take the decision again when the first 10% are retired, so the limit is sufficient.

5.3.1.2 Profitable for all parties?

It is difficult to prove that a repurchase of own shares would be profitable for all parties involved, stresses the companies. In the matter of adjusting the capital structure and under the conditions that the stock- and credit markets are rational, all parties should profit through a repurchase. When adjusting the capital structure by reducing the number of outstanding shares, the same value as earlier is given to the *shareholders*, although the capital base is lower. Because of this, the result is distributed on less number of shares and, by regular mathematics, this should give a better valuation of the share, and thus, a higher shareholder value. The risk could be that only some shareholders benefit from such a transaction. The shareholders are dependent on how the company performs in this question, as in other issues. A company that is efficient in every aspect, including the financial, also profits *employees*.

A strong borrower profits a *creditor*, and by using some of the capital to repurchase shares, the balance sheet is destabilised from a creditor

perspective. Thereby, the creditor does not profit from the repurchase. From another perspective, a creditor could benefit since the borrower has an efficient and suitable balance sheet, which could imply that the company has to borrow more capital later on.

5.3.1.3 Conditions of competition

From the perspective that the possibility exists to repurchase own shares, Swedish multinational companies have now been given the same conditions of competition as international competitors. Thus, to really answer the question, a complete analysis of all countries' legislation would be necessary. Own shares is only one aspect of competition in comparison between competitors internationally. It is one step for harmonisation to get the same conditions as in other countries. One view in the matter of competition is that when two companies are competing to acquire another company, then the company that has own shares to use has a more favourable negotiating position. On the other hand, the level of 10% is not equal to other countries since this level is lower than for comparable countries outside the EU, for example, the USA. In that aspect, competitors outside EU have better conditions. It is better if companies at all stock exchanges have the same regulation, and this instrument is one of many that could contribute to harmonisation.

5.3.2 Standard setters and auditors

5.3.2.1 The 10% limitation

The limit of 10% is restricted in accordance with the EC directives and implemented in all countries within the union. The 10% limit has its origin in Germany and Denmark and, when the directive was conducted, the limit was transferred into the directive. The original 10% from the German Company Law has its background in the 1930's and has served as a protection for creditors. One respondent wonders if it has any practical significance for the protection of creditors today, and questions the importance of the limitation in that aspect.

Another respondent, however, implies that since the limitation is restricted in accordance with the second EC directive it is a suitable

limit since the level of harmonisation increases. If the limitation were more restricted it would not have any effect at all. In practice, the repurchase could be more than 10% if the company choose to do it step by step. The limitation of 10% is sufficient since it avoids great variations, compared to if a company was allowed to purchase as much as they wanted to. Thereby, the limitation creates a form of stability.

The 10% limit for own shares has no connection to the protective rules for the minority that exist in the Companies Act and that also have protection limits. Aktiebolagskommittén never discussed any connection between the protection rules for the minority and the possession of own shares. The reason why the minority must be protected is that it would be too risky for a potential shareholder to invest capital in the company and become a minority and thus be dependent on the view of the majority. For example, if the company wants to change the relations between the outstanding shares, shareholders that together own at least 1/10 of the shares can oppose to this change and, thereby, hinder it. The aspects of minority protection are something that has been discovered just recently since, when repurchasing own shares, the company achieves a change in company control.

Another aspect of the limitation is that if the company is controlled by one major shareholder then a repurchase of the shares has a great impact on the shares liquidity. In this aspect a 10% repurchase limit could be discussed from a stock market perspective to be a sufficient limit.

5.3.2.2 Profitable for all parties?

It is difficult to identify whether own shares are profitable for all parties. One situation where it is profitable for the shareholders is when the company repurchases shares through an offer, as in the Volvo case. In such cases, the shareholders are offered a price that is X% over the present share price on the stock market. It is more certain for the shareholders that a repurchase is profitable when the company directs the offer and the price is set, than a repurchase on the stock exchange at the current share price. The experience so far, the law has only been valid for a few months, is that the share prices have not increased to

the extent that was predicted before the implementation of the law; rather the opposite.

5.3.2.3 Private companies questions

The proposal from Aktiebolagskommitten was that all companies should have the possibility to purchase own shares without any competitive difference between private and public limited companies. For private companies the proposal was to have no limitation of 10%, since those kind of limitations would be insufficient in a situation of change of company control between generations. This could, for example, be of great importance in situations where company control is transferred from one generation to another. In such companies, it could be a question of money where the rest of the shareholders do not have the money to pay the shareholder that wants to renounce the company. In such a case, the company could purchase the shares from this shareholder and, thereby, solve the situation. Thereby, there is a disadvantage that only public limited liability companies are allowed under the law to purchase own shares. All forms of limited liability companies should have been included in the law.

The issue of excluding private limited liability companies is a question of tax-regulation. In the beginning of preparing the law the intention was that all companies should have this instrument, but the National Tax Board (Riksskatteverket, RSV) feared that tax-avoidance would increase. In the existing tax regulation, there are rules limiting the freedom of action for closed companies. Since these companies have not been included in the law at this time, but will have similar regulation in the future when the tax problems are solved, there might be a reason to consider the experiences that have occurred from the existing law. One respondent argues that the tax reasons claimed by the National Tax Board are not sufficient in order for the government to prevent private companies from repurchasing own shares as this is primarily a stock market issue and should be discussed from that point of view.

It could exist reasons to study more closely certain questions, such as protection regulation for minority since it exists minorities even in these kinds of companies. One respondent points out that the eventual

problem is not similar in the different cases, since the problems in this issue are not the same in a listed public company as in a non-listed private company. The number of those companies that have this instrument is limited, in comparison to the total number of limited companies that exists in Sweden. It was considered that listed companies was a sufficient number of companies to use as a starting point. The final reflection is that it is more important for the private companies to have this instrument than listed companies.

5.3.2.4 Conditions of competitions

Swedish multinational companies now have the same conditions of competition as their international competitors in the aspect of own shares. This is due to Swedish regulations being adjusted to an international level, which were one of the main arguments from the industry and commerce to implement this law. The importance increases to the same extent as the company become more international, and, thereby, has the same regulations in all of the international markets. Own shares is a good instrument for company financing, but it is dependent on each company's individual situation, finishes one respondent.

5.4 Accounting for own shares in Sweden

5.4.1 Companies

5.4.1.1 Own shares as an asset?

This issue of considering own shares as an asset can be seen from different perspectives. If the purpose of the repurchase is to adjust the capital structure, since the company is excess capitalised, then the Swedish regulation is suitable; that is, that own shares is not an asset. In such a situation, it would otherwise be that the company takes capital from cash and bank, short-term investments or other financial assets and replace this capital with own shares. Thus, nothing has changed in the issue of the excess capitalisation in the company; the capital has only been transferred from one account to another in practice, changing one asset for another. On the other hand, if own shares could be recognised as an asset, surplus and deficits should be

recorded in the income statement as any transaction that generates a profit or a loss.

Another aspect is that it would have been positive to have the possibility to account for own shares as an asset in a transition period in those cases where the purpose with own shares is to acquire another company. This is because the process of acquisition is long and time consuming, but the motive is still to endorse these shares. First, a declaration of intent of the acquirement has to be done. An agreement then has to be entered between the parties and this has to be approved by authorities of competition involved. During this extensive period, until the agreement is approved, the company can only hold the shares. In such a situation, it would have been better to account for these shares as an asset. With the Swedish regulation equity decreases with the liquid capital that the company paid for these shares, and thereby, also affecting the key ratios of the group. A decrease of equity is conducted with the price paid for the shares including a premium if the shares are purchased through an offer. When the shares later on are endorsed then the shares are supplied at another price in accordance with conditions in the agreement. The Swedish regulation is correct even though it would have been better to have the possibility, for accounting for these shares as an asset while awaiting the decision from the authorities of competition.

Some companies have not considered if it is positive or negative to recognise the shares as an asset. It is pointed out that the trade regulation of own shares implies that the company could not buy 10% of the shares in a short period. The possession is, therefore, limited in some cases and, thus, the issue of recognising own shares as an asset becomes irrelevant. At the same time the opinion is that own shares is an instrument to adjust equity and shall, therefore, be accounted for as a set-off post to equity. It is reasonable that own shares is not recognised as an asset in this view. This would create a strange situation since these shares only present a value already existing in other posts on the balance sheet.

5.4.1.2 Accounting regulation

The companies believe that the government should not regulate the accounting issue at all. It would have been better to give the initiative to standard setting bodies to issue norms and recommendations on how to account for own shares. The tradition of accounting regulation in Sweden is that few areas are stated in the law with a great exception, the Annual Accounts Act. Considering the tradition that large companies and standard setting bodies creates good business practice, it is positive that they create norms and recommendations on how to account for own shares. Own shares is a new phenomenon in Sweden and the main issue is that regulation to follow and refer to exists, otherwise questions could occur. Listed companies are observed carefully by financial analysts and it is good to refer to the regulations. This subject will develop in the future and improvements will be done step by step.

The weak spot with the Swedish accounting on own shares could be that the decision about the endorsement has to be taken by the Annual General Meeting. Thus, the shares could not be endorsed until a new decision is taken, which could become a time consuming process. One difficulty with own shares is that when making a valuation of the company, consideration must be given to how many own shares the company holds and how much it reduces equity. One company points out that if the repurchase is made in order to adjust the substantive value, then analysts must adjust their methods of calculations and include a post for own shares.

5.4.1.3 Preparation in accounting for own shares

The companies have not prepared the accounting questions of own shares to a great extent. There are regulations in the contracts with the stock exchange that regulates what posts of information shall be included in the semi-annual report and interim reports. At the same time, there are regulations in the Annual Accounts Act on this issue. The accounting process has been conducted in accordance with these regulations. The companies also have an ongoing discussion with their auditor firms to get their input, not only as an organ of control but as consultants. Another way of preparing is to obtain information from

the stockbroker who made the purchase for the company and to follow the recommendations that has been issued by Swedish Society of Financial Analyst (Finansanalytikerna), for example. The preparation on the accounting questions also consists of examining the material and discussions with other companies. For companies that made redemption programs in combination with the repurchase, the accounting issue became more extensive. On the other hand, those companies that have made redemption programs before have the entire supported documents that are needed for accounting. These companies are already prepared by this redemption program; the issue is not new in the group even if a program of redemption is more administratively extensive.

The law concerning own shares became valid in March but, in practice, the first repurchase programs were conducted later since the decision has to be taken on the Annual General Meeting. Therefore, own shares made no greater impact on the semi-annual report of 2000. The first report that is really effected is the third quarterly report for the same year, which all the companies were preparing during the interview period. None of the companies conducts trade with own shares during the period of interim reports because they are insiders according to the regulation; that is, they have insight in the result of this report.

5.4.1.4 Own shares in the reports

There are different views concerning own shares in the reports. One company explains that they have, in the cash-flow analysis of this report, a column of “Dividend” which now is renamed as “Dividend and repurchase of own shares”. In the annual report there will be a single named column of “Own shares” in the financial analysis. The reduction from equity has been conducted to non-restricted reserves. Another company has in the book of account a separate account for own shares. The option to reduce own shares from the profit of the year is not to be considered by this company. In the note to equity, own shares should be presented separately as “repurchased shares for X SEK”, that reduces the non-restricted equity. In the balance sheet, own shares are not to be presented separately, but as a part of non-restricted equity. A net amount is recorded and then a specification of events that

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has occurred and that has impacted equity is presented in a note, including the repurchase of own shares.

The general opinion is that a repurchase shall reduce the non-restricted equity. At the same time, it is regulated that own shares are not be recorded in the financial statement and effect the profit of the year. Profit of the year should be presented the same in the balance sheet as well as in the income statement. Therefore, the remaining post is retained earnings to account own shares against. The same discussion makes that a surplus or deficit should also be recorded to retained earnings and not profit of the year. One company has a different opinion, in conflict with the previous ones, and thinks that it is irrelevant if the reduction is conducted from retained earnings or profit of the year. The argument is that a specification between the two posts on the balance sheet is not interesting to do. If the company decides to hold the shares for several periods they will make a note to equity in the annual report. Even if the share price rises or declines there is no effect in equity. If the share price rises, a hidden surplus value occurs. The same is valid if the share price declines and a hidden undervaluation occurs. Non - restricted equity should be reduced with the amount that the company repurchases at, then it does not matter in what direction the share price is headed.

5.4.2 Standard setters and auditors

5.4.2.1 Background of accounting for own shares

The accounting issue was discussed late in the process of developing the proposed law. This could be because the Department of Justice did not consider that accounting was an issue - own shares was considered to be only a stock market issue. After a while, the Department of Justice realised that the accounting issues also had to be treated. During the spring 1999, the question of accounting for own shares was discussed for the first time. A memorandum* from the Department of Justice concerning the accounting for own shares was established and,

* A memorandum in this content is a writing of a department's view within a certain issue.

during the summer of 1999, a hearing* was conducted. At this hearing, several interested parties participated; for example the Swedish Accounting Standards Board (Bokföringsnämnden, BFN), the Swedish Institute of Authorised Public Accountants and the Financial Supervisory Authority. During the autumn of 1999, the present regulation of accounting was prepared. One respondent claims that the procedure was rather swift and, therefore, all aspects within the issue were not treated sufficiently. The reason why the government wanted non-restricted equity to be reduced is that the government had the opinion that the regulations of own shares should be similar to those of dividend. If a connection is created from own shares to dividend it becomes customary to account for it against non-restricted equity. One situation where it could be considered to account for own shares against restricted equity is in a situation of redemption but this would have created a situation where the regulation is inconsistent; that is, if own shares are to be treated differently in different situations.

5.4.2.2 Own shares as an asset?

It is positive that the government did not choose the “EC-method” that considers own shares as an asset due to the fact that it is then difficult to get a correct and fair view of equity. It should be mentioned in this context that the aim of Swedish accounting is to follow the IASC regulation, even though EU in some issues has different regulations. There is an agreement between the respondents and the legislator’s opinion that own shares is not an asset. Own shares could be considered as an asset in accordance with the accepted accounting criterions, it is an asset in the aspect that it can be sold for capital. Although there is a risk that the liquidity in the shares is so limited that the asset aspect is not to be considered, since it is too difficult to sell the shares. If non-listed companies were allowed to purchase own share then this aspect would be more obvious since it could be very difficult to find a buyer. A more thorough valuation has to be done of the balance sheet in those cases, in order to avoid such situations. These arguments imply that own shares is not to be considered as an asset and, therefore, it is positive that the acquisition cost is accounted

* A hearing in this content is a form of interrogation where professionals within the subject are given opportunity to have a discussion about the matter.

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for, as a reduction from equity. In the “EC-method” an account on the liability side must be created as a reserve for these shares. The amount contributed to the purchase shall be transferred from non-restricted reserves to restricted reserves.

The three exceptions from the earlier prohibition made it possible for Swedish companies to hold own shares. At this time, these shares were considered to be an asset, but without any value. The three exceptions were when the company acquired another company and this corporation has shares in the acquiring company. It has also been allowed in a situation of redemption where company control has been abused. The final situation was when a company acquired shares on an auction for unpaid receivables. It was very rare that the company could hold shares by any of these exceptions even if it did exist.

One respondent made the conclusion that the shares do not represent any value besides what already exists in other accounts on the balance sheet. A repurchase of own shares only contributes to a change of ownership in the company. Therefore, it is correct that it should only be accounted for within the amounts available in equity, as is now the case in Sweden.

5.4.2.3 Accounting regulation

It is a limitation that the government has chosen not to discuss any of the internationally used methods; that is, the cost and par value method. One respondent claims that the government has chosen an easy way of legislating, by not discussing any internationally used methods and only legislated that it should be accounted for as a reduction post within the non-restricted equity. When one respondent studied the international practice, it became clear that it is not that easy, since it contains a number of different methods. The opinion that the Swedish government has made it easy by only choosing one option, thereby, increases. The government should have refrained from the legislation within the accounting issue. Some questions of own shares should have been regulated, as now is the case; that is, the 10% limit and the company having an amount corresponding to the repurchase amount available in the non-restricted reserves and, the formal regulations about making the decision. The opinions of the respondents

are that accounting for own shares should be an issue for the Swedish Financial Accounting Standards Council and the Swedish Accounting Standards Board. The Swedish Financial Accounting Standards Council is not working, at the moment, with any recommendation on this subject. It is possible that Akutgruppen* within the Swedish Financial Accounting Standards Council will issue a statement concerning SIC 16 in the future. The Swedish Financial Accounting Standards Council has the intention to implement all IASC's recommendations into Swedish accounting; anything more than this is most unlikely at the moment.

The accounting firms have prepared themselves in this accounting issue more general that is like they always do in these kind of matters. They have prepared internal material in order to inform the auditors within the firm. Discussions forums have been arranged in order to further increase the level of knowledge about own shares and other aspects of company law that have been simultaneously issued.

5.4.2.4 Accounting for payments

All cost of acquisition should be included in payments that is, the payments itself, as well as expenditures for commissions and fees to auditors and solicitors. This is the same as if the company should purchase any other shares. In accordance with SIC 17, the net amount is used when the shares are sold, which also is pointed out in the proposed law.

The presumption of how to account for this it that it should be recorded against retained earnings and information in notes ought to be enclosed. One opinion on what part of the non-restricted should be effected is that profit of the year should not be used. This is because it is stated in the Annual Accounts Act what is comprised in profit of the year. The aspect is then, that own shares should not be comprised in profit of the year and, thereby, remain only retained earnings from the posts in the non-restricted equity. The amounts paid shall be the gross

* The organisation acts through the Council and Akutgruppen. Akutgruppen works with urgent matters of accounting.

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expenditure and amounts received shall be accounted for as the net income. These amounts shall be reduced respectively added to retained earnings. When selling own shares the expenditures, for example prospectus, commission and similar, reassembles with the expenditures that the company have when making a new share issue. Therefore, these expenditures shall be treated like a new shares issue case; that is, they shall reduce retained earnings.

One respondent had a different opinion of how the payments should be accounted for. The acquisition cost when purchasing own shares should be accounted in non-restricted equity. This view states that different accounts within the non-restricted equity, such as profit of the year and retained earnings, are summarised as one post of non-restricted equity. Profit of the year is from the financial statement, while retained earnings is a reserve of the earlier year's profit. The opinion is that which accounts within the non-restricted equity are used does not matter, neither should a proportion of the payments between those two accounts be made. A lump amount corresponding to the amount that the company has used to repurchase own shares should be reduced from the summarised post of non-restricted equity.

5.4.2.5 Own shares for several periods

When the company holds own shares for several periods, the acquisition cost shall be accounted for as reduction, so that non-restricted equity is presented as a net amount. Information on the shares from previous years shall be presented in the director's report in accordance with the disclosure requirements. There is no reason to specify the amount of purchased shares for more than the acquisition year since it could give the wrong impression. There is a risk that misunderstandings can occur. Shareholders could believe that this capital will be received automatically by the company, which is most uncertain since it is depending on the present share price. It is sufficient for the information to be given in the director's report. Such information could state how many shares the company has purchased in an earlier year and so on. For the year when the repurchase is made, information should be disclosed in the notes. Compared to dividend, there are no problems since this is explained in the note and the next year the information is not included. Thereby, the information about

own shares only should be included for the year it is current. Some kind of account must be maintained since the acquisition cost must be kept for the future. If some shares are sold during the years then this account must be entered with this transaction.

One respondent thinks that the information that is to be presented in the director's report should be included in notes to equity. It is interesting for the reader, when studying the share capital, to obtain information about how many shares that is held by the company itself compared to how many have been purchased during earlier years and how many have been purchased under the current year. It could also be enclosed how many have been endorsed during the financial year – that is the change in the possession of the own shares. This is the kind of information that has a direct connection to the posts of the balance sheet. For a foreign reader, that is not familiar with the director's report due to the fact that director's report is not that common in other countries, of the financial information this would facilitate the reading of the reports. Such a reader would expect to find that information in a note to the balance sheet. By placing the information in the director's report, the government has somewhat diminished the level of comparability within this issue between Swedish companies and foreign competitors. How other countries have decided to present this information is outside the respondent's knowledge, but, in the EC directive, it is specified that the company shall inform about own shares but not where and how this should be done.

5.4.2.6 Treatment of surplus and deficits

A surplus or a deficit when selling own shares shall be accounted to retained earnings and the amount shall be adjusted with all costs of selling, likewise when accounting for the expenditures. The amount of the payments when selling own shares shall be added to retained earnings decreased with the expenditures for the selling; that is, the net amount. No specification shall be made as to whether this is a transaction of surplus or deficit. When making a repurchase or a sale, the price itself has no importance. Only the amount paid or received should be recorded to non-restricted equity. One respondent compares a repurchase with redemption, which is a similar situation. If the company makes redemption and some years later makes a new share

issue, then there is no discussion on what surplus or deficit that has occurred for these two transactions.

5.5 Future issues

5.5.1 Companies

The general opinion of the companies is that they will use this instrument in the future. One view is that it is a part of the management's ongoing responsibility to observe the capital structure and needs of the company. The usage of own shares should be dependent on a continuous valuation of the key ratios that the company has stated. The future will predict if this instrument will be necessary and should be a part of the ongoing analysis of the capital structure. Own shares will be useful in situations where the company is excess capitalised and wants to make a transfer of capital to its shareholders. This is another form of capital transfer although it is not as general as dividend and redemption. Own shares is a rather flexible and simple instrument to use when adjusting the capital needs according to one company.

One company has two requirements that have to be fulfilled if the company is to make another repurchase program. It should be positive for the capital market and, at the same time, it is not to be an obstacle to the company's business. There are other factors making this uncertain, such as the change in the business. The issue will most certainly occur at several future occasions, but this instrument will be one of many.

5.5.2 Standard setters and auditors

The instrument will be used in the future, but the respondents think that it is difficult to predict to what extent. Up to this date, a number of companies have used the possibility to repurchase own shares during the Spring and the Summer of 2000. The reason for the high level of usage this year could not be absolutely certain. One respondent says that it could be due to the fact that companies have great amounts of

profit and a need for distributing this surplus to the shareholders. This will be clarified when the economy enters another phase and profits decreases, in how many repurchases will be conducted. The companies will use all available instruments in order to maintain their competitiveness internationally. A comparison to the USA regulations where repurchase of own shares has been allowed for a long time could be done. The American regulations have some similarities with the Swedish; for example, a repurchase must not exceed what is available in the non-restricted equity. In the USA, 1/3 of all companies have programs for repurchasing own shares continuously, which could give some kind of hint about the future development in Sweden.

6. Analysis

In this section we analyse the interview,- as well as the theoretical material, which includes finding a correlation between events and explaining, which we believe are interesting phenomena. We have divided the analysis into two different Chapters. In this Chapter the issues of background, aspects of legislation and future issues of this equity instrument are analysed. This is done in order to create an understanding for this instrument before the accounting issues are treated in the next Chapter.

6.1 Background

6.1.1 Change of legislation

Since the first Companies Act of 1895, it has been forbidden for limited liability companies to purchase, hold and endorse own shares. On March 10th 2000, the Swedish government abolished this prohibition and Swedish companies now have, as the last country within EU, a possibility to use the instrument of own shares. The law has been well received by many external interested parties. The only body that had objections, before the revision of the law, was the Association of Shareholders, which feared that this would threaten the equal treatment of shareholders; that is, that one shareholder is benefited on the behalf of another. One aspect, that the change has been conducted at this moment of time is that Sweden, together with Liechtenstein are the two only countries in the entire EEA that prohibited companies from trading with their own shares. We agree with the opinion that it is positive that the legislation has been changed. Since own shares is allowed in other comparable countries in the industrialised hemisphere, this opportunity should also exist for Swedish companies.

This is a controversial issue, that a company could own a part of itself, and that the company is given an instrument to change the interrelation of the company control. Sweden has had a conservative view in company matters and restricting companies from owning themselves is

one aspect of this. The protection for creditors of the company has been an important part of the company regulation. The government has, by allowing repurchases, holding and endorsement of own shares, somewhat abandoned this view to amend to the Anglo-Saxon view in accordance with other aspects of the company regulation and accounting. We believe that own shares is only one part of a changing company regulation in Sweden.

We have found that it is not certain that a great need existed from all companies before the law was changed. Some Swedish companies has amended the strategy of diversification in the past, with a diverse set of different business and this has in some cases caused a high level of liabilities. When purchasing own shares, equity decreases and, thus, the instrument of own shares would not have been useful in this strategy. When the companies during the 90's abandoned this strategy and started to concentrate on core business, a number of businesses were sold out, leading to a situation where the companies became excess capitalised, that is, the connection between internal and external capital changes from the optimal level. The earlier options for the companies were to pay dividend, sell out the business or use the instrument of redemption to reduce the share capital and, thereby, transfer capital to the shareholders.

The level of dividend will in this situation become extremely high on one year while returning to some kind of normal level the next. This sort of variation is not appreciated from a market point of view, since shareholders desire to have a long-term investment without great variations. The other option, selling the business to the shareholders, is more complicated because the shares are to be sold to a third party in order to trade the business for capital for the shareholder. The instrument of redemption makes a permanent reduction of the equity, which may not be desirable from the company since the capital need might increase some years later and the company must then restore equity to the previous level by making a new share issue. That is, the combination of a redemption to reduce equity and new share issue to increase the same is more time consuming and more administrative extensive. The instrument of own shares is, in this context, a more flexible instrument since the company can, by repurchasing, decrease

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equity in a situation where the capital need is low and later in a situation where the capital need is great, resell the shares on the market for capital.

Before the legislation was changed a way existed for a company to purchase their own shares by synthetic options, although the company could never hold or endorse these shares. This could be exemplified by Custos where the Board of Directors, in April 1999, got the mandate to synthetically purchase five million of Custos' own shares. The company was very eager to have the possibility to repurchase own shares since the implementation of the revised 7th Chapter was delayed. The transaction was conducted by entering into a swap-agreement with Handelsbanken Markets, in which Custos swapped interest for the total return on the Custos shares. The economic consequence of this agreement equals a purchase of own shares at market price. The agreement was ended when Custos made a redemption of own shares to Handelsbanken Markets, thus eliminating the shares on which the swap-agreement was based. This is not a common phenomenon, and, since own shares is now allowed, this form of rather complicated agreement is not necessary anymore.

6.1.2 Advantages and disadvantages

There are a number of advantages in allowing companies to repurchase their own shares. One essential advantage is that the companies using this instrument can more easily adjust the capital structure, and the relation between equity and liabilities. The instrument of own shares is easier to use, and is thus less costly and time consuming than the previous mentioned redemption and new share issue. At the same time, own shares do not have any permanent effect on the share capital since the company can endorse the repurchased shares at any time in accordance with the regulation of trades and after that the Annual General Meeting has taken such decision. Own shares can also be used for a pure distribution of capital to the shareholders. At the same time, the capital that has been transferred from the company to the shareholder can be used to reinvest in other business. This makes own shares contribute to an increased movement on the stock market and

increases the level of investments, which is profitable from a societal-economics view.

Another advantage is that own shares can be a part of the company's strategy, since it is an instrument both in the view to accomplish changes in the internal relations, and in the relation to other companies. Own shares can be used as payment when acquiring another business, such as in the Volvo case. By repurchasing shares from the shareholders, the company can use existing equity as payment and avoid making a directed new share issue. The shareholders that do not wish to remain control only have to sell the shares to the company, while those shareholders that wants to remain their level of control do not sell. The company, as well as any other actor on the market, cannot force a shareholder to give up the rights to a share.

A further advantage to be discussed is that the company can repurchase the shares to give them to management and employees as part of options programs. Equity does not have to be diluted by new shareholders being given shares. This issue is rather difficult since the management receives the shares that have been repurchased from the company's shareholders. The Swedish legislation of the LEO-law, that was implemented to hinder management to get inappropriate benefits, has also been declared valid in the situation of own shares. It could be questioned whether it is appropriate for the management to receive shares purchased by the company, the conflict of which interest the management acts occurs, who is the principal and who is the agent? That management does not have any vested interest in this matter would be naive to believe. Therefore, it is good that the government has regulated this matter so that a 9/10 majority is necessary from the shareholders to approve such an endorsement from the company to its management.

Another view on making a repurchase is that the company gives an indication to the market that the company's share is worth buying. In this aspect own shares are useful for real estate companies that are traded on the market with a discount for the substantial value. The company can repurchase their own shares to a favourable price. The total value of the assets is thereby divided on a less number of shares,

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which should make the shares more worth to buy for investors. At the same time, the company makes a sort of investment that can be used later to resell the shares and increase equity; whereas, the value for the shareholders is increased.

The disadvantages are in many cases the same fears that have existed in Sweden as reasons for prohibiting own shares. The primary fear is that the company can use the instrument in an abusive way, which is that they repurchase shares in order to try to rig the market. We feel though that this has been regulated thoroughly by the legislator, in order to prevent such transactions. In one view, the company is an insider when purchasing own shares, since they have information that other actors on the market does not have access to. On the other hand, the company has been restricted when trading in connection with reports.

Own shares transactions have serious ethical and legal dimensions. A company that repurchases its own shares must be extremely careful that its disclosures of information are complete and correct. Otherwise, a shareholder who sold the shares back to the company may claim that he or she was deceived into selling the shares at too low a price. This could be the case if the company that had purchased own shares only a few days later announces a technological breakthrough that will generate a huge amount of profit. The share price would likely increase in response to the new information. If it could be proved that management withheld the information, a shareholder selling shares back to the company may file a lawsuit to gain the difference per share. The shareholder would claim that with knowledge of the technological advance, he or she would have held the stock until after the price increase.

In the matter of the relationship with the shareholders, a transaction with own shares could increase the risk that not all shareholders are treated equally, and that would be in conflict with the principle of equal treatment. The government has restricted that companies cannot make an agreement with a single shareholder, only with all shareholders or a certain group of shareholders. This is as far as it could be regulated, and we think that this regulation has eliminated the

risk of unequal treatment. Although it should be pointed out that it will always exist indifferences in the spread on the stock exchange from one transaction to another. If the company makes the repurchase on the market, they make a bid and ask, just as any other market actor, which the shareholder can accept or reject. If the company makes an offer to the shareholders the same situation occurs, and the principle of equal treatment is thereby maintained.

We believe that the fear that companies could try to set aside the regulation on redemption is somewhat exaggerated, since own shares and redemption are not the same instrument. The regulation of redemption has not been altered and there are situations where this is more suitable, such as when companies make a permanent reduction of the share capital. Redemption does not effect other parts of equity than the restricted, as own share does.

A more distinguished disadvantage to repurchases of own shares is that the liquidity of the share decreases since the number of outstanding shares on the market becomes less. This is more valid in companies with one strong shareholder where the liquidity decreases more since the limitation on a maximum hold of 10% do not aim at the shares on the market, it is 10% of the total number of outstanding shares. An example to illustrate this is, if a shareholder holds 85% of the shares in a company while 15% are traded on the market, the liquidity impact is higher in this case than in the one of a well-diversified share where no shareholder has a major possession. Since only 5% remains to trade with after the repurchase, the aspect that the share becomes less liquid must be considered. It could become more complicated to endorse the shares in the future since the market for the shares adjust to the fact that only 5% remains. If the company then puts out additional 10%, the impact on the liquidity as well as on the market price will be higher. A practical example to illustrate this is the Lundberg group that already had a low level of liquidity in the share, before the repurchase. The ownership structure of the group includes one dominating shareholder, which makes the repurchase a low-cost procedure to increase the control of the group instead of using the instrument of redemption. We believe that there could exist a risk from the shareholders perspective to let the dominating shareholder use own shares to gain more control,

the shareholders should consider to be more restrictive when endorsing the shares to this owner.

The final disadvantage to discuss is the fact that, by repurchasing own shares, the market could interpret this as a signal from the company's management that there is a lack of strategy on how to use the capital. Instead of ideas and investments, the companies uses the excess capitalisation to transfer the capital to the shareholders. This is a more abstract disadvantage, but it does exist and will be considered when evaluating the company's future considering the markets expectations for the future.

6.2 Own shares and the Swedish law

6.2.1 The 10% limitation

The background of the 10% limit of possession of own shares is from the EC directive and it was transferred without any discussion into the proposed law. The origin from German company law, where it from the beginning served as a protection for creditors, is not a matter that has been considered by the legislator. The importance in that aspect is relative – if the company could purchase as much of own shares as they want without any restrictions, the risk for creditors would increase since then there are no control on the effects on equity. The issues, therefore, is not if the limit should exist, but rather the level of this limitation.

In this context, it is important to discuss the protection regulation for minorities, also stated in the Companies Act. The resemblance between the protection for own shares and the minority would imply that a connection should be considered, but there was no such connection made in the statutory work about own shares. A protection aspect for the minority when discussing own shares is though that it is the Annual General Meeting that makes the decision, with a 2/3 majority, both to repurchase the shares and what to use the shares for. In that aspect, the company could not have made a repurchase exceeding the mandates from the meeting. The combined regulation of own shares, stating that it is the general annual meeting that makes decision about own shares

and the LEO-law, declaring that it requires 9/10 majority when the shares are used in options programs for the management, gives an existing minority protection in the regulation of own shares.

The number of votes has no consideration in the aspect of the 10% limit. Since it is 10% out of the number of existing shares, the number of votes on each share can though become important in a situation with one dominant shareholder. We assume that there are a total number of 6.000.000 votes in a company distributed on 1.500.000 shares. There is an interrelation between the A-shares and the B-shares, where A-shares are worth 10 times more in the voting aspect. This means that the 500.000 A-shares of the company have a total of 5.000.000 votes, and the B-share has 1.000.000 votes distributed on 1.000.000 shares. If one shareholder holds all A-shares in the company, this shareholder controls 83,33% of the votes in the company. If the company then makes a repurchase of 10% of the shares on the market, that is 150.000 B-shares, then this shareholder controls 85,5% votes of the remaining outstanding shares. With such a strong owner, a repurchase will greatly increase the control for this shareholder on the behalf of the minority. This illustrates that the shareholder increases the company control at the same time as the capital responsibility remains at a low level, since this owner controls 85,5% of the votes, but only 1/3 of the capital in the company. Thus, the owner could increase the company control while the company takes the risk for the capital. When the share is well diversified this aspect is not current since the liquidity of the share is greater and the impact from the 10% level is of less importance thereby. Once again, the example of Lundberg illustrates the fact that a repurchase of own shares contributes to a greater change in control compared to a well-diversified share.

There are different opinions about the sufficiency of the 10% limit of holding own shares. The general opinion though is that it is suitable, even though the companies are more critical to this limit than the standard setters and auditors. All agree that it should not have been less than 10%. The limit is sufficient in comparison with other members of the EU, but when considering other markets outside the EU, companies are critical to that the limitation is not extensive enough. By having a

similar limit in all countries the level of harmonisation will increase and this is valid in the European perspective.

In some cases, companies have a certain purpose in mind with a repurchase. In that context the limit of 10% could be too limited. The company could, for example, have a strategy to purchase another company in exchange for a shareholder post that exceeds 10%. In that view, 10% is a restriction since the company must make the entire repurchase in several steps, which is more time consuming and costly than if they could repurchase all at one time. Although it is difficult for a company to reach the 10% level by making one or a few repurchases considering the trade regulations, this would imply that 10% is sufficient. There are no regulations that state that if a company has reached 10% it is not allowed to reach the level again after using the shares for the purpose that the company has.

6.2.2 Profitable for all parties?

Own shares both directly and indirectly profit shareholders. Direct in the sense that they have a possibility to choose. Those shareholders, who desire a short-term investment, can sell off the share to the company and receive capital. Shareholders, who desire a long-term return on the investment turn down the offer and hold the shares for the future. Shareholders benefit indirectly by the fact that the company can use this instrument, and, by using it, the company saves time and capital which increases profit for the company and, thereby, the profit for the shareholders. The employees and other stakeholders do not profit directly by a repurchase in that sense meaning that they make any benefit on the transaction. On the other hand, the company can use own shares to achieve an optimal financing and a well-organised company is in that aspect profitable for all parties.

When making a repurchase on the stock market, the company must maintain the bid within the spread on the stock exchange in accordance with the trade regulations. When making an offer to the shareholders, the company does not have to consider this regulation and can offer a premium for the shares, and, thereby, transfer extra capital to the shareholders. Since the companies can offer the premium of X% above

the current share price, shareholders benefit in comparison with selling on the share market. At the same time, if the repurchase will have the effect that the share price on the market rises, then shareholders benefit in the view that their investment will be worth more. The expectations before the implementation of the law was that repurchases would increase the share prices, but the experience from the Swedish Stock market has so far been rather the opposite. Swedish shareholders have not benefited and, at the same time, Swedish companies have repurchased shares to a price higher than the share market value for these shares causing equity to diminish. The reason for this development in Sweden is, in our opinion, the fact that the share valuation on the market is based on future expectations.

From the creditor's perspective, the issue of profit is divided into two parts. The first aspect, in accordance with the fear of allowing own shares, is that the risk for the creditor increases since the company transfers capital from the company to the shareholders, while the creditor has securities in the remaining parts of the company. Since current assets and cash are used there is a higher level of non-current assets that makes liquidity decrease. On the other hand, own shares can contribute to a more abstract form of profitability for the creditor. The company can more easily adjust to the business environment of the company and, thereby, become more profitable. The creditor is thus served by the fact that the credit risk decreases.

The management and employees can profit from a repurchase since the shares can be used in options programs. They can, thereby, profit by receiving the shares that already exist instead of the number of shares increasing by a new share issue. Profits divided on a less number of shares increases value and control of each share.

6.2.3 Purposes with own shares

The purposes with using the instrument of own shares are several, but some purposes are more common. The most common by "our companies" is the possibility to use own shares in order to adjust the capital structure of the company. It can be used to increase the leverage

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of liabilities and decrease equity, at the same time as the company has the opportunity to resell the shares on a later occasion for capital.

The motive to use the shares as an attempt to increase the share price is somewhat uncertain since it is based on the fact that, by decreasing the number of shares on the market, the results will be divided on a less number of shares. This indicates that the key ratios will increase, making the shares worth more to buy for the investors. This aim must then be based on the stock market is desire for a share with a higher level of profit of the shares, but, with an irrational market basing the valuation of a share on future expectations, this argument will not have that much impact on the share price. The purpose in using the shares as payment in an acquisition, is a good form of using own shares. By using existing equity, the procedures of making an acquisition become easier and less extensive since it is easier to sell own shares than make a directed new share issue.

The purpose of using the shares in options programs for the management and employees faces the same advantages as in acquisition; the share capital does not have to be increased but only to use existing shares. The management has a conflict of interests in this matter which makes it uncertain, since they should make everything to create value for the owners. The fact of that it is the Annual General Meeting that makes the decision and the LEO-law sets a high level of demands for this purpose.

There are three options available for the company when they have received the shares. The first is that the company has a strategy to endorse the shares to another party, such as shareholders in an acquired company or to management and employees. If the company purchases the shares and then holds them until they know what to use them for, the aspect that it could give the impression that the management lacks of strategy of how to use the company's capital could be discussed. However, to hold shares is not negative since the third option of making a reduction of the share capital is a more permanent effect on equity. If the company holds the shares they can easily be resold again on a later occasion.

6.2.4 Conditions of competition

To some extent, Swedish companies have received the same potential to compete using an equity instrument. Once again it is the view of within EU, or outside EU, that has to be considered. If the company is competing on the European market the regulation is similar, but for competition outside this market the conditions are not as similar. The primary aspect of competition is the fact that the company can use its shares as payment, which could be an advantage in a situation where there is competition with another company to make a strategic acquisition. This is the case if the shareholders in the acquired company desire control in the acquiring company as payment or that they want to avoid participating in a directed new share issue. The companies though are more critical of the regulation of own shares than the standard setters and auditors. The importance of similar company regulation increases, just as in other aspects, in accordance with the level of internationalisation of the business.

6.2.5 Private companies issues

The intention from the beginning of preparing a revised Companies Act was that all limited liability companies should have this instrument, but, after that the National Tax Board stressed the tax issues for private companies, the government regulated that only listed limited liability companies would get this instrument. Own shares are more useful in a private company since there are further reasons for them to use the instrument. Private companies can use the shares when transferring company control within family business, for example. This could be the case if a company manager is retiring and desires that company control should be transferred within the family; whereas the members of the family do not have the funds necessary to make a take over. In this situation, the instrument of own shares would have been useful in order to make it easier to transfer the control over a period of time. Since the government has postponed the implementation of own shares for private companies, an opportunity exists to use the knowledge of the existing regulation when making regulation that is suitable for these companies, even though the requirements will not be the same. We agree with one respondent, that the tax reasons are

somewhat strange to blame on for not allowing all companies to have this instrument. The need is greater for private companies. In this case it has existed a need for a long time compared to the listed companies. The aspect of the stock market questions must be considered though, and for a listed company it is easy to set a price for the shares since there exists a market for the share. This is not the case for private companies and valuation problems will certainly occur when allowing them to use this instrument. There is a risk that dubious will occur about the company has paid or received a fair price; that is, speculations that the company has been used to benefit the owners. We think that the opinion that the repurchase will effect equity is more valid in these cases, since it could be more difficult for a private company to resell the shares in the future, compared to a listed company.

6.3 Future issues

Own shares is an instrument that has been allowed during 2000 and that has been used by some companies during this year. There is an agreement between companies, standard setters and auditors that the instrument will be useful in the future. To predict whether it will be used to a lesser or greater extent is not possible. This will be shown in the future and will depend on the situation of each company. The instrument cannot be said to be revolutionarily, but it is one instrument in the company regulation that has been added to the already existing equity instruments. The earlier instruments of redemption and new share issue have the same aim as own shares, although this aim can now can be more flexible achieved. The fact that own shares can be used as payment in a situation of acquiring companies where the regulation of directed new share issues could be avoided also speaks on the behalf that Swedish companies will use own shares.

The companies must be careful, and only use the instrument when capital is available; that is, the instrument is useful in situations where it does not effect other parts of the company. The usage of the instrument in the future can be seen to the background what happened when the law was revised during 2000; a number of companies immediately announced that they would start repurchase programs.

Real estate companies are frequently represented in companies that have repurchased own shares so far. This could be explained by the substantial discount that exists on these shares and that they believe that own shares can be used to increase the share price and, thus, decrease this discount.

7. Accounting method for own shares in Sweden

In this part we present how to account for own shares in Sweden. This is based on an analysis of the theoretical and empirical material. The government has made some guidelines in the proposed law and we have compiled this with the opinions from the empirical part and, thus, made an analysis of how to account for own shares in Sweden. This part also includes a declaration of the differences and similarities between this method and the cost method, par value method and the “EC-method”. We will also analyse the advantages and disadvantages with the Swedish method, compared to the three other methods.

7.1 Accounting background

The accounting issue within the whole regulation of own shares was discussed rather late. No person with accounting background was involved in developing the regulation on own shares, which can explain why own shares was considered as an issue of company regulation only. This had the effect that the accounting questions were disregarded and thereby prepared under the lack of time when it became current. The accounting issue was dealt with for the first time by the Department of Justice. This illustrates that persons with economic insight are important in the development of such issues. This is not common in Sweden where the tradition is that persons with legal background that make this form of preparatory work.

The respondents’ opinions are that an accounting regulation of own shares should not have been conducted. It would have been better to let the standard setting bodies make recommendations instead. The government did not discuss any of the other considerable methods, which could result from the fact that it was considered to be a limited issue and, therefore, was not thoroughly dealt with. The regulation on trade with own shares is correct since it is required some sort of regulation in this field. It is sufficient to regulate this, but the accounting questions should have been left free.

The Swedish Financial Accounting Council and the Swedish Accounting Standards Board are not working at the moment on any

recommendation in this issue. What could be expected in the future is a translation of the recommendations from IASC. It will become difficult to implement these recommendations considering the method chosen by the Swedish government, since current IASC recommendations are too broad compared to the Swedish regulations. There will not be any revolutionary changes in this issue conducted within the near future. It will develop over time, just as all others in this context, considering that own shares has been prohibited in Sweden before and is a new phenomenon.

The preparation in accounting for own shares has not been extensive by “our companies” because they believe that there are no great questions within this area. Companies only have to follow the regulations in the Annual Accounts Act and the contents of their contract with the Stock Exchange. They have also been able to use the knowledge existing within the broker firms that have conducted the repurchases, as well as studying statutory material. In some cases, they have discussed with other companies and with their auditing firms, in the form of consultants. The preparation of the auditors has been ordinary, just as in any other new issue within this area. They have studied the law material and made internal guidelines. Those companies that has made a redemption program during the past few years have some help from these, since there are similarities between them and own shares, and the experience can be used to account for own shares as well.

7.2 The international norms and recommendations

The international norms and recommendations that we have examined, and that have influenced the Swedish accounting regulation on own shares, are quite comprehensive in their design. IASC, treats the purchase of own shares in IAS 32, states that the amount shall be recorded to equity. Therefore, it should not be recorded as an asset and should not be recorded as income. SIC 16, that is based on IAS 32, is relatively broad in its design and only adds that the company shall disclose in a note how the equity has changed. This draft regulates how to treat own shares within equity and gives three options on how to conduct this. These options have some resemblance with the cost and

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the par value method on how to account for own shares, although these methods are not presented by IASC. The content of this recommendation, that is a draft interpretation of a current standard, should be used as a source for a future establishment of a standard. This should be a combination of SIC 16 and SIC 17, treating costs for equity instrument, where all forms of transactions with own equity instruments are treated. Sweden has followed IASC regulations before and, if IASC makes such a standard, this could imply a more harmonised view from Swedish accounting to the standpoint of IASC.

The EC-law concerning the issue of own shares are in the second and the fourth directives. The second directive regulates the issue of own shares, while the fourth handles the transaction of accounting. There are two alternatives in the EC-law of how to account for own shares. The first alternative is that own shares is recognised as an asset, and there are regulations in the directive of how to account for these shares. The other alternative is that own shares is not recognised as an asset and, in this case, each member state can have individual regulation, within some limitations; for example, a company is not allowed to exceed the amount that is available in the non-restricted equity. This makes the regulation broad in its design and this could be a disadvantage since it restricts the harmonisation. We interpret that by only regulating if own shares are recognised as an asset, the EC directive recommends this view of own shares.

That the EU has recognised own shares as an asset is rather surprising considering that the USA has abandoned the asset idea. This increases the risk that the accounting will only become more comprehensive for the companies instead of making it easier for them. EU works to achieve harmonisation within Europe, but the economy is becoming more international and, from a Swedish point of view, more consideration should be taken to the standards of IASC. The chosen accounting method illustrates that Sweden harmonises more with the IASC standards than with the EC-law.

7.3 Accounting transactions discussion

7.3.1 Accounting for payments

When accounting for own shares, the Swedish method implies that the payments for a repurchased share shall be reduced from non-restricted equity. The restricted equity of a company is, as mentioned above, a protection for the share capital that is the basic financing by the owners of the company. At the same time, the purpose in Sweden is that this capital shall serve as a protection for creditors. The creditor has no decision control in the company and if the shareholders could use equity as they prefer, this would increase the risk for creditors that the owners capital is transferred out of the company leaving the company with liabilities only. Therefore, the Companies Act states that restricted reserve, as well as the share capital, is not allowed to be used by the shareholders. The statutory reserve shall serve as a protection if the company makes losses to the extent that the non-restricted equity vanishes. Other reserves, such as the premium reserve and revaluation reserve, have similar purposes, but shall be used if shareholders are willing to pay more in order to acquire a part of the company and where this surplus price can be saved for future protection of the capital base.

When repurchasing own shares the company acquires an instrument of control from the shareholders and holds it within the company. Thus, it is an exchange of capital between the company and its shareholders without any interference from the external stakeholders. Therefore, own shares shall be accounted for in equity. The restricted equity is not to be used for transfer of capital to the shareholders, which implies that the intention of the legislator that accounting for own shares shall be conducted to the non-restricted equity is correct. The next question is what post within this non-restricted equity that shall be effected by the repurchase, later on also effected by an endorsement or a usage of the shares to reduce the share capital.

Non-restricted equity in Sweden consists of primary retained earnings and, profit of the year. The first account is a collection account of profits from previous year, which can be used to use as a dividend to

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the shareholders or be used in the company's business in the future. This account could also be presented as a loss carried forward in case the company made losses during the previous years. Profit of the year is a transfer account from the company's financial statement. It is the result of how the company used the assets in the company to achieve efforts, creating a profit for the shareholders.

Theoretically own shares could be accounted for in the profit of the year, since the transactions occurred during the financial year. This is not correct though since the regulations in the Annual Accounts Act, which define what shall be comprised in profit of the year, disqualifies own shares as a part of the financial statement. At the same time, own shares is a transaction between the company and the shareholders, while the financial statement shall present how the company has performed during the year.

The next consideration is if own shares could be accounted for from both the accounts in non-restricted equity, that is that a kind of proportion is conducted whereas one part is reduced from profit of the year while the other is taken from retained earnings. This situation would be somewhat inconsequential since it would be difficult to state what each part of the non-restricted equity would be representing. At the same time, own shares would effect the profit of the year, which should be presented the same in the balance sheet as in the income statement. Profit of the year is, therefore, not an alternative to use as account for own shares.

The third and final alternative is to account for own shares in retained earnings. This is the accounting method that was preferred by most of our respondents. The government intends that own shares shall resemble dividend and, therefore, retained earnings is more suitable. Considering the fact that the companies in some cases were excess capitalised and this has occurred during previous years, this capital is allocated in the retained earnings and since the companies by repurchasing wants to accomplish a transfer to the shareholders, the account of retained earnings is suitable. By reducing the retained earnings, equity is reduced in accordance with the intention of the companies to achieve a more suitable level between internal and

external capital. Therefore, own shares is preferably accounted for in retained earnings only.

When repurchasing and selling own shares costs occur. These costs consist of a commission to the broker or costs for prospects when making an offer to the shareholders. It could also be fees to auditors or solicitors; that is, all external costs that the company has for repurchasing own shares. The costs for repurchasing and endorsing own shares resembles the costs for redemption and new share issues. These costs, presented as capital costs, shall reduce equity and not be a part of the financial statement. This implies that the government's choice of how to treat the costs when repurchasing own shares is good, since they want to achieve a harmonisation between the different instruments. At the same time, SIC 17 states that the transaction cost when repurchasing equity instrument shall not be presented in the financial statement but as a reduction of equity. This implies that transaction cost shall be accounted for in the same manner as own shares; that is, by reducing the non-restricted equity.

7.3.2 Treatment of surplus and deficits

When considering the question of profits or losses, a consideration must be taken of what this consists of. When a company purchases an asset at one price and resells this asset to a higher price, a profit occurs. When trading with own shares, this definition of profit or loss is not valid. If the company resells the shares on the market to another price than it was repurchased at, then a profit could not said to occur. The first argument is that own shares is not an asset but an instrument between the company and its shareholders. This implies that it is more proper to discuss a surplus or deficits of payments instead of profit or loss in that context. The government and the respondents also had the opinion that a transaction does not make that a profit occurs if a company resells the shares at a higher price than the acquisition price.

The payments to and from the company, when trading with own shares, shall be recorded to non-restricted equity. No consideration is taken whether the payments when selling the shares are more or less in comparison to the acquisition cost. One important limitation is that the

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company can only repurchase shares in accordance with the amount available in non-restricted equity. That is, it is not possible to repurchase shares and contribute to a deficit in non-restricted equity, which, in that case, would make the effect that the cover in restricted equity becomes insufficient. This restriction does not matter if a deficit occurs when the shares are resold on the market, since it implies that a payment is contributed to the company. That is, if the company repurchases shares for SEK 5.000.000 and then resells them for SEK 3.000.000, the non-restricted equity is still increased with the SEK 3.000.000. Considering the trade regulation in Sweden, this situation is though most unlikely to occur with the restrictions in time and numbers of shares. We believe that it is not practical applicable due to the fact that if the entire account of retained earnings is used, there will be a number of consequences for the company. Consideration must be taken to the consolidated need for the company, liquidity aspects and good business practice.

7.3.3. Own shares in the reports

The impacts that own shares have on the reporting are not so extensive. An account for own shares has been added to the financial analysis where a repurchase of own shares makes an outflow of cash and an endorsement makes an inflow. Own shares do make an impact in this context, which implies that it should be presented separately. The impact on the semi-annual and quarterly reports will not be so widely, the greatest impact on reports will be on the annual report. Equity does not have to be divided into restricted and non-restricted reserves in the interim reports in accordance with the Annual Accounts Act, as in the annual report, which means that the changes are not so extensive.

The greatest changes are those in the director's report. The government chose to emphasize the information in this report, but we feel that information left in the note to equity is just as necessary. The requirements, on what to comprise in this report, are rather detailed. The company shall declare the purpose of why they repurchase own shares. This is not a problem since the company already declares why they want to repurchase, hold and endorse own shares, when making the decision at the general meeting. This gives a verbal declaration,

which could be good for the reader of the annual report. The price paid should also be disclosed, which gives an indication to the reader on how much the company has paid in relation to the current share price. The same is valid for those shares that have been sold during the year. It shall also be presented how much those shares are, in relation to the total number of outstanding shares. Finally, it shall be presented how many shares the company holds at the end of the financial year and how much these shares are, out of the total numbers of shares. This gives the reader an opportunity to analyse how many shares the company has repurchased and if there is a possibility that further repurchases will be conducted in the future.

7.3.4 Own shares for several periods

When the company repurchases own shares and decides to hold them for several periods, no special aspects have to be considered. The shares are still presented in the director's report, in accordance with the regulation, and the reader of the annual report can thus be informed that the company holds shares repurchased during earlier years. If the company makes a special presentation in the balance sheet that own shares have been repurchased during earlier years, there is a risk that confusion could occur. Since the reader would get the impression that the shares have effected the balance sheet for the current year, and the comparability would decrease. Therefore, no special reporting will be conducted when companies hold shares for several periods, with exception of what is presented in the directors report.

7.4 The Swedish method of accounting for own shares

To illustrate how own shares should be accounted for in Sweden we use the same fictive company that was used in **Chapter 4**. In order to increase the comparability between the Swedish method and the three international methods, we have excluded the aspects of expenditure to include in the transaction. This is an important part of the trade with own shares and all expenditures shall effect the amounts paid or received for own shares. In order to facilitate the reader, we have decided to use the note system to equity. Even though it is not regulated in the law, we believe as several of “our companies” do that

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this increases the clarity. If the company does not present own shares in the note system, the reader must use the director's report to get information on own shares.

First we repeat the conditions for our fictive company. The company has a balance sheet total on December 31st year X1 as shown below. There are 1.000.000 shares of SEK 10 par value of outstanding shares. This gives a share capital of SEK 10.000.000. The company has also SEK 2.000.000 of restricted reserves and SEK 5.000.000 of unrestricted reserves. The company's total equity is SEK 17.000.000. Assets and liabilities are as presented below.

Fixed Assets	25.000.000	Share Capital	10.000.000
Current Assets	10.000.000	Restricted Reserves	2.000.000
Cash	5.000.000	Non-Restricted Reserves	5.000.000
		Long-Term Liabilities	15.000.000
		Current Liabilities	8.000.000
	<u>40.000.000</u>		<u>40.000.000</u>

Balance Sheet 12: Balance sheet total December 31st year X1

Source: Our own

7.4.1 Purchase of own shares

Assume that the company makes an offer on January 1st X2 to purchase 100.000 shares at the price of SEK 15 for each share. The company could thereby purchase 10% of the shares at one occasion. The date of liquidity for the offer is on January 31st. The repurchase transaction is recorded so that "Cash" or a similar account is credited with the amount for the repurchase of SEK 1.500.000*. "Non-restricted equity" is debited with the corresponding amount of SEK 1.500.000. The company reduces retained earnings, within non-restricted equity, the appropriate account to use.

It is only the acquisition cost for the shares that is used. Note that "Own shares" do not have an own account. The shares are recorded in

* 100.000 shares multiplied with SEK 15

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the non-restricted equity, and, without information in the note, the reader of the report cannot make a complete view. The share capital is not effected by this transaction, but the number of outstanding shares has diminished and the number of outstanding shares is now 900.000. The entry is recorded as follows:

	Debit	Credit
Cash		1.500.000
Non-Restricted Reserves	1.500.000	

Transaction: Accounts effected by the repurchase transaction.

Non-Current Assets	25.000.000	Share Capital	10.000.000
Current Assets	10.000.000	Restricted Reserves	2.000.000
Cash	3.500.000	Non-Restricted Reserves⁽¹⁾	3.500.000
		Long-Term Liabilities	15.000.000
		Short-Term Liabilities	8.000.000
	38.500.000		38.500.000

Balance sheet 13: Balance sheet total February 1st X2 (after repurchase, under the conditions that no other transactions have occurred)

Source: Our own

If the company presents this information in the notes to equity, the impact on the non-restricted reserves will be as follows:

Non-Restricted Reserves	5.000.000
(Repurchased own shares)	-1.500.000
Total net Non-restricted reserves	3.500.000

Note 1: Note of non-restricted equity after purchase transaction

The company has repurchased and holds 100.000 shares with the nominal value of SEK 10, or SEK 1.000.000 totally. The price paid is SEK 15, each with a total amount effecting non-restricted equity of SEK 1.500.000. Under the conditions that no further transactions will occur during the year, this information will be presented in the director's report.

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7.4.2 Sale of own shares

There are no major differences when selling the shares to a price above or below the acquisition cost. The difference that does occur is the effect on the available funds in the non-restricted reserve. When selling the shares to a price above the acquisition cost, the company thereby increases the funds totally. If the shares are sold below this cost, the total funds available are decreased. This implies that if the selling price of own shares is equal to the cost, the sale makes no difference in the funds available. Both above and below cost will be presented, to increase the comparability with the three other methods.

7.4.2.1 Sale of own shares above acquisition cost

The company now decides to sell 50.000 of the repurchased shares, previously acquired for SEK 15, at a price of SEK 20 per share on June 30th X2. The account of “Cash” is debited with the amount of SEK 1.000.000, which is the number of shares sold multiplied with the resale price. “Non-restricted reserves” is credited with the corresponding amount of SEK 1.000.000. The entry is as follows:

	Debit	Credit
Cash	1.000.000	
Non-Restricted Reserves		1.000.000

Transaction: Accounts effected by the endorsement transaction.

Non-Current Assets	25.000.000	Share Capital	10.000.000
Current Assets	10.000.000	Restricted Reserves	2.000.000
Cash	4.500.000	Non-Restricted Reserves⁽²⁾	4.500.000
		Long-Term Liabilities	15.000.000
		Short-Term Liabilities	8.000.000
	<u>39.500.000</u>		<u>39.500.000</u>

Balance sheet 14: Balance sheet total July 1st X2 (after sale, under the conditions that no other transactions have occurred)

Source: Our own

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Non-Restricted Reserves	5.000.000
Repurchased own shares	(1.500.000)
Payment from sale of own shares	1.000.000
Total net Non-restricted reserves	4.500.000

Note 2: Note of non-restricted equity after endorsement transaction

The company has sold 50.000 own shares at the price of SEK 20 each, totally SEK 1.000.000. The company holds 50.000 shares effecting the “Non-restricted reserves” with a total amount of SEK 750.000, at a repurchase price of SEK 15 each. It should be pointed out that, if the company had sold all the repurchased shares at the price of SEK 20, the total funds in non-restricted equity would have been SEK 5.500.000. This implies that the company would have a surplus of 500.000 compared to the original situation, which could be distributed to the shareholders.

7.4.2.2 Sale of own shares below acquisition cost

If we assume that one month later, July 31st X2, a new sale is conducted at a price below the acquisition cost. This time the market price for these shares is SEK 12 each, so the company only sells 20.000 shares. “Cash” is debited with the amount received; SEK 240.000*, while “Non-restricted reserves” is debited with the associated amount. After posting these entries, the balance sheet will show the following balance on August 1st X2:

	Debit	Credit
Cash	240.000	
Non-Restricted Reserves		240.000

Transaction: Accounts effected by the endorsement transaction.

* 20.000 shares multiplied with SEK 12

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Non-Current Assets	25.000.000	Share Capital	10.000.000
Current Assets	10.000.000	Restricted Reserves	2.000.000
Cash	4.740.000	Non-Restricted Reserves⁽³⁾	4.740.000
		Long-Term Liabilities	15.000.000
		Short-Term Liabilities	8.000.000
	39.740.000		39.740.000

Balance sheet 15: Balance sheet total August 1st X2 (after sale, under the conditions that no other transactions have occurred)

Source: Our own

Non-Restricted Reserves	5.000.000
(Repurchased own shares)	(1.500.000)
Payment from sale of own shares*	1.240.000
Total net Non-restricted reserves	4.740.000

Note 3: Note of non-restricted equity after endorsement transaction

The company has sold additional 20.000 own shares at the price of SEK 12 each. The company holds a total of 30.000 shares effecting non-restricted equity with SEK 450.000[†].

If we instead assume that the company has sold all 100.000 shares at the price of SEK 12 each, the shareholders of the company would not have benefited. The non-restricted equity would be SEK 4.700.000, which implies a decrease of SEK 300.000[‡] compared to the original funds in the non-restricted reserve of SEK 5.000.000.

* 50.000 shares multiplied with SEK 20 added with 20.000 shares multiplied with SEK 12 equals 1.240.000. The average price is thus SEK 17.71.

† 30.000 shares multiplied with the acquisition cost of SEK 15

‡ 100.000 shares multiplied with the difference between the acquisition cost of SEK 15 and the reselling price of SEK 12.

7.4.3 Director's report

In order to get a complete view of the changes and the possession of own shares in the company, the reader of the annual report must study the director's report to get this information. In the director's report for the year X2, issued in January X3, the director's report has the following presentation of the company's transactions with own shares:

Director's Report

The repurchase program is a part of the company's intention to adjust the capital structure.

The Company has during the year X2 repurchased 100.000 shares at a price of SEK 15 per share; the nominal amount of these shares is SEK 10 each and the total, which has reduced the non-restricted equity. These 100.000 shares correspond to 10% of the total numbers of shares.

During the year, 70.000 shares have been sold at the average price of SEK 17.71 on each shares, contributing to a payment of SEK 1.240.000. These shares relate to 7% of the total numbers of shares. On December 31st X2, the total possession of shares was 30.000 with a nominal amount of SEK 10 each. The shares correspond to 3% of the total number of the company's shares.

Director's report: Contents on transactions of own shares during the year X2 in accordance with the Annual Accounts Act.

Source: Our own.

7.4.4 Retirement of own shares

The company has reconsidered the opportunity to sell the shares and decides to use the shares to make a permanent reduction of the share capital instead; all the 100.000 shares are thus retired on June 30th X2. This transaction follows the regulation of redemption in the 6th Chapter of the Companies Act, whereas the nominal amounts of these shares are reducing the "Share capital". The regulation of reducing the share capital in the Companies Act states that the restricted equity shall, under no circumstances, be effected and cannot be transferred to non-restricted equity. The reserves in restricted equity cannot be used for

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the difference since it would imply that the cover would become insufficient. The difference between the nominal value and the repurchase price, that is the surplus price that the company has paid for the shares, do not effect the restricted equity, but remain in non-restricted equity. The company has repurchased 100.000 shares with a nominal amount of SEK 10 each, so SEK 1.000.000 will be reduced from “Share capital”, while “Non-restricted reserves” is credited with the associated amount. The difference between the acquisition cost and the nominal value remain in non-restricted reserve and is not effected by this transaction. The entry is as follows:

	Debit	Credit
Share Capital	1.000.000	
Non-Restricted Reserves		1.000.000

Transaction: Accounts effected by the retirement transaction.

Non-Current Assets	25.000.000	Share Capital	9.000.000
Current Assets	10.000.000	Restricted Reserves	2.000.000
Cash	3.500.000	Non-Restricted Reserves⁽⁴⁾	4.500.000
		Long-Term Liabilities	15.000.000
		Short-Term Liabilities	8.000.000
	<u>38.500.000</u>		<u>38.500.000</u>

Balance sheet 16: Balance sheet total July 1st X2 (after reduction, under the conditions that no other transactions have occurred)

Source: Our own

Non-Restricted Reserves	5.000.000
(Repurchased own shares)	(1.500.000)
Retirement of 100.000 shares	1.000.000
Total net Non-restricted reserves	4.500.000

Note 4: Note of non-restricted equity after retirement transaction

The effect of this transaction is that the company, after the retirement, does not hold any own shares and the share capital now consists of 900.000 shares with a nominal value of SEK 10 each.

7.5 International accounting methods

In the proposed law it is identified that the legislator had only examined IAS, SIC and the EC directives. The government chose to follow SIC 16 on the issue that own shares should be accounted for as a reduction from equity. Which post within equity is not regulated in SIC 16. In this question the government turned to the EC-law to get support. In the second directive, it states that purchase of own shares should not exceed the amount available in the non-restricted equity. Thus, a cover for the restricted equity after the repurchase, must exist. This follows the traditional consideration within the Swedish regulation of equity. We think that this further implies that the Swedish method on accounting for own shares is suitable for Swedish conditions.

The cost- and the par value method that we have described in this thesis are not mentioned in the proposed law, as was confirmed by interviews. The advantage with not considering any other theories, is according to us, that the legislators only take initials from Swedish relations, and, therefore, adapts the Swedish accounting to those relations. One of the respondents pointed out that the government has made it easy by not looking at any internationally used method, such as the cost- and par value method; an argument with which we agree. The disadvantage of not considering the international used accounting methods is that the legislator could lose some of the advantages that could contribute to an improved Swedish method, at the same time as the harmonisation is set back.

7.5.1 Cost method

In the USA the cost method is the most common accounting theory. We think that the advantage of this method is that it is easy to use since only a few accounts are involved in the repurchase and the endorsement. Moreover, it could be described as a cautious method since the restricted equity is used when the shares are sold over acquisition cost. This is because the surplus, the difference between the resell price and the acquisition cost, is not recorded to non-restricted equity. The capital in these accounts is available for distribution to the

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shareholders. The use of restricted equity reduces discussions that the company has used own shares for speculative purposes, since eventual surplus on purchasing and endorsing can only be used within certain restrictions. The restricted equity is regulated to serve as protection for share capital, and the surplus could thereby be used to increase the share capital in the future. Thus, shareholders will benefit this way, at the same time as the capital base in the company is strengthened.

Moreover, this method implies that own shares is not an asset, to which the Swedish method also agrees. Another advantage with the cost method is that the total acquisition cost for the shares could directly be shown in the balance sheet. It is not necessary to read the directors report in order to obtain more important information that is vital for making a complete analysis of the company's transaction with own shares. This increases the harmonisation between countries and the comparability between companies, since director's report and the requirements on what to include are different between countries.

The disadvantage that we have identified with the cost method is that it does not give a fair view of what the shares current value is, since the method only recognises the value at the time for the repurchase. The shares could have a value that is considerably above the price at the time for acquisition, which would suggest that the company possesses, a kind of "hidden equity reserve". This is also valid for the Swedish method. The value that is represented in the balance sheet for own shares could differ a lot from the present stock market price for the shares, especially if they are held for a long period of time. This disadvantage is most important in the aspect that the shares are valued higher then when they were repurchased. If the share price on the market is lower, a similar "hidden equity undervaluation" occurs, but this is not as important, since the capital will be paid to the company anyway. The purpose in using this method is primarily that the company will resell the shares on a later occasion. If the company's purpose is to use it to reduce the share capital, this easy method to conduct will turn somewhat more complicated. In that aspect, it could be a disadvantage to use this method for those companies that have other purposes with the repurchase than to endorse the shares.

If we compare the Swedish accounting method with the cost method we can identify that both methods are easy to use since the accounting transactions are few and simple as only the acquisition cost is taken in to consideration. The first difference is the fact that own shares are presented directly on the balance sheet when using the cost method, which is not the case when using the Swedish method. This makes the cost method more easy to read. Another difference between the two methods is how they treat difference in the payment between resale price and acquisition cost both over- and undervalues when reselling the shares. The cost method transfers a surplus to restricted reserves, while this surplus remains within retained earnings when using the Swedish method. The same is valid when reselling at a deficit. The advantage for the shareholders in using the Swedish method, compared to the cost method, is that a surplus upon selling the shares can be distributed directly to the shareholders. The same aspect is when the company makes a deficit when endorsing the shares. In the cost method this deficit effects the restricted equity, while the Swedish method effects non-restricted equity. From a shareholder perspective, the cost method is not as positive since distributable funds decrease, although it would be more correct considering the capital protection purposes in the Swedish law.

7.5.2 Par value method

The par value method is used in the USA accounting as well, but is not as common as the cost method. This mostly depends on the fact that it is more complicated to use. According to us, the advantage with the par value method is that it gives an overall view and the reader of the annual report can immediately identify own shares recorded as a post directly under the share capital. The share capital is effected with the nominal value in accordance with the procedures in the original share issue and the premium is also recorded in the restricted reserve. The difference between acquisition cost and the premium issue price are recorded to non-restricted equity. This is a more complicated method to use when reselling the shares, but the purpose of this method is to use the shares to reduce the share capital. When reselling the shares on the market with a surplus, the difference between the nominal value and the resell price is placed in the restricted reserve. The result is the

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same when selling below acquisition cost as long as the price is above the nominal value. In that aspect it could seem like the company increases equity as long as the price of the resale is above the nominal value, while it, in reality, decreases since the company resell shares at a deficit compared to the acquisition cost.

An advantage with this method is that if the purpose of the repurchase is to retire the shares and thereby reduce the share capital, this is a more simple procedure than other methods. This is because the recording of share premium is done directly to each account, making it easier to identify the consequences when making the retirement later on. Therefore, for companies that want to use the shares to reduce the share capital, this method is preferable.

A disadvantage with the par value method is that reader cannot directly identify in the balance sheet, the acquisition cost without comparing several accounts. The nominal amount has to be taken from the share capital, while there must be considerations if the company has issued the shares at a premium, and, finally, the difference between this price and the acquisition cost has to be found in a third place. For a reader who is interested in the aspects of how much the company has paid for the shares this method is rather complicated. This also effects harmonisation since it decreases the level of comparability.

There are major differences between this method and the Swedish since the basic in this method is to directly record own shares to restricted equity and only the difference price to non-restricted equity. When selling the shares, the surplus or the deficit only effects the restricted equity. The par-value method is not applicable in Sweden due to the effects it has on the restricted equity, which is not in line with the intentions of the Swedish accounting regulation. If the repurchase were allowed to impact on the restricted reserves in Sweden, as it does using the par value method, this would create a situation where the basic relation between the company and its shareholders would be effected. Own shares is a transaction between the company and the shareholders, which makes the par value method not favourable to use in Sweden.

7.5.3 “EC-method”

The “EC-method” recognises own shares as an asset, in difference with the cost method, the par value method and the method used in Sweden. Own shares could be said to be an asset according to the criterions that have to be fulfilled in order to classify an item as an asset. Own shares are expected to contribute economic benefits in the future since the shares could be sold for capital or be used as a payment in an acquisition. The criterion that the company must control the asset is also fulfilled since there is no other party that can benefit from these shares as long as the company holds them. The company has paid capital in order to receive the shares and the right of possession has been transferred to the company, fulfilling the third criterion. Some of our respondents claim that the question of whether own shares is an asset or not is of no importance, while other strongly believe that it is a form of conducting a change of equity only, and should, therefore, be accounted for within equity.

The “EC-method” impacts not only on the debit side of the balance sheet, but also on the credit side, since the company must create a reserve where capital in non-restricted equity is transferred to restricted equity. This could be advantageous since, by doing this, the company cannot use this reserve as long as the shares are held; thereby, some kind of protection is created for the company’s capital.

The situation where it could be an advantage to recognise own shares as an asset is when the shares are to be held for a limited period of time, and there is a decision made, to endorse the shares. By placing them as an asset, the impact on the equity, and, thereby, on important key ratios, would not be so great, which must be considered as positive. In that case, a sale of own shares, and a following surplus or deficit, would be presented in the financial statement as a change of capital. Then the Swedish government would have to make a separation for this sort of situation and problems could occur when using this alternative. The shares could also be considered as an asset in the aspect that they could be resold to the market after a decision by the Annual General Meeting. On the other hand, it should be pointed out that a difficulty would occur to sort the shares into one kind of asset. It could be questioned if they should be considered to be a

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current asset, since it takes a while before the decision can be made on the Annual General Meeting. On the other hand, the endorsement is dependent on the fact that 2/3 of the shareholders agree to resell the shares, which implies the difficulties in recognising own shares as an asset. The “EC-method” places own shares as a current asset, which is in accordance with how to recognise other short-term possessions of shares. Once again, this choice could be questioned since it is uncertain how long the company intends to keep the shares. A current asset is an asset that should be used within one year, while non-current assets have a time horizon of over one year. The company has no obligation to sell the shares or use them to reduce the share capital, so they might wish to keep them for several years. In this case, it would not be a current, but rather a non-current asset.

To recognise own shares as an asset would be a disadvantage if the company is excess capitalised and uses own shares to change this situation it would make no difference. By placing them on the asset side of the balance sheet, the situation would be that the company only changes one asset for another, and the capital situation in the company remains the same. Any real value has not been added to the company and equity becomes misrepresented, as well as key ratios, that is all key ratios that relate to equity and the balance sheet total. Assume that the company’s result decreases, which would make the shares become less attractive on the share market. This implies that the company must write-down the value of those shares, which would lead to the assets of the company becoming less valued and the result for the next period being effected, and so on, like a negative spiral. When accounting for own shares as an asset, a continuous revaluation must be conducted of these shares, which makes this method somewhat more complicated to use, since changes in values for assets demands a revaluation of the share. It will also impact the restricted equity, given that an overvalue of one asset shall be transferred to a revaluation reserve.

One aspect, which also must be pointed out when discussing own shares as an asset, is the fact that as the company removes the shares from the market the liquidity in the share decreases. This will be the case for those companies that have a small number of shares on the market and decides to further limit the number of available shares on

the market through a repurchase. When the company later decides to resell the shares, the market could have valued the shares at a much lower price since the risk of holding this share has increased due to the limited liquidity in the share, making the asset less valued for the company. This is another argument for not recognising own shares as an asset, but as a part of equity without any impact from the market valuation or liquidity.

If the government refrained from legislating what method to use, each company would decide what method is preferable in their case. This would create a situation with a number of different methods where companies that want to adjust the capital structure would use, for example, the cost method, while companies with other purposes would use the “EC-method”. This would create a disorderly situation. The “EC-method” is not used in the USA, which implies that companies active on the American market would have to use two different methods simultaneously. Sweden also has a tradition to follow the norms and recommendation of IASC, and the “EC-method” is not suggested by IASC, which increases the opinion that it is right to not recognise own shares as an asset but as deduction respectively addition from equity.

Even though the “EC-method” is recorded on the opposite side of the balance sheet, there are similarities between this method and the Swedish as both initiate from the acquisition cost. There are still some major differences because the shares are placed on the asset side, and a reserve is created in the restricted equity, which is different from the Swedish method. Another major difference is that the balance sheet total is not effected, even though the company has decreased equity. The fact that the EC directives do not regulate what accounts to use when selling the shares makes it up to each country to decide what to use. We think that this makes difficulties for company regulation, a regulation of purchase demands for regulation of endorsement. The risk is that what EU wants to protect purchase regulation to some extent could be set aside when the company resells the shares to the market. Harmonisation does not benefit through this form of regulation, which is one of the purposes with the EC directives.

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This method is doubtful from the point of view that it can be questioned if it is an asset to own a part of the company itself. It is, in some aspects, against the whole idea of Limited Liability Companies and the regulation of these, that a company should own a part of themselves. If there were no regulation to own shares, this would make the company a separate entity, without any control from the shareholders, since the owner of the company would become an independent entity. The main question then would be who to blame if the company violates laws and regulation.

8. Conclusions and reflections

Our conclusions to questions on how the accounting is influenced by the allowance to purchase, hold and endorse own shares are presented in this Chapter. In this thesis we have studied the background behind the change of the law and what is stated in the revised 7th Chapter of the Companies Act. We have also explored the accounting theories that have influenced the Swedish regulation on own shares. Furthermore, we have investigated the practical methods that are used internationally on accounting for own shares. We will now present the conclusions we have made, making this study, and present an improved Swedish method for accounting for own shares, as well as some suggestions for other areas of research on this issue.

Background issues

It is good that the change in the legislation has been conducted at this moment of time. It is suitable considering that many Swedish companies have become excess capitalised by concentrating on core business. There are no indications, by the companies interviewed, for that it has existed a great need before the revision. Companies seem to have managed with those instruments that were available. The instrument now exists and it is positive for companies to have this additional tool in their toolbox for adjusting equity. We think that own shares is a more useful instrument, in comparison to dividend, redemption and new share issue, because it is more flexible and gives more freedom of choice to a company.

There are a number of advantages with own shares, such as that it is a time and capital saving instrument in comparison with redemption and new share issue to adjust the capital structure of a company, and that shares can be used as payment in an acquisition. The disadvantages, or risks, with own shares have, in most cases, been satisfactorily regulated by the law, with the exception of the abstract situation that the market could consider own shares as a defensive action.

The law and regulation on own shares

Like our respondents we think, that it is positive that Swedish companies now have the possibility to purchase, hold and endorse own

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shares. This instrument extends the companies' flexibility and adaptability concerning the companies' capital. We also think that this is positive for the development of the financial markets in that companies now can, to some extent, trade with their own equity, which gives a higher efficient use of a company's capital. The protection for the creditor is provided by the regulation on own shares, since the law is detailed.

In our opinion, the law is somewhat too detailed within some areas, which makes transactions on own shares more complicated than necessary. A good example of this is that the companies must announce public the purchase of own shares every day, irrespective of the number of shares. Another example is that the shares that the company has purchased are not allowed to be sold until three months after the purchase. This is regulated due to a fear from the legislator that company would use own shares in short-term speculations. Although this detailed regulation contributes that there is no doubt on how the company should act in a repurchase situations, every company will act the same. This gives some kind of certainty to the creditors and other stakeholders. The advantage with this detailed regulation is that it reduces the risk for abuses and unethical acts.

Another detailed regulation in the law is that the companies are not allowed to purchase own shares 30 days before a report, in order to hinder insider trading. This regulation implies that four of the year's twelve months vanish and the companies can not regularly purchase own shares. We think that this regulation is somewhat too exaggerated, which company is not an insider in its own business today. We believe that it should not matter when the company could trade; they still have a understanding more then 30 days before about the contents of the report.

There are no indications today that Swedish companies can rig the market. The government has made extensive restrictions in how many shares the company is allowed to trade and hold. A reason for a change of legislation was that it would raise the possibility for companies to protect themselves from a hostile take-over. The opinion was that the repurchase of own shares mostly leads to a higher stock market value

of the share when the number of shares decreases. This gives a higher profit on each remaining share, thereby increasing the market value. The experience so far indicates rather the opposite, stock prices have in most repurchasing companies had a setback rather than an increase. In the USA, the share price rises with approximately 10%, but in Sweden there have been no indications in this direction so far. Skanska was an exception in the beginning with a rise of the stock price. This implies that the market takes no greater consideration to repurchase programs but to other factors in the companies such as expectations for the future.

There are a number of different purposes in repurchasing, holding and endorsing own shares that could be discussed. The most common purpose in “our companies” was to use own shares to adjust the capital structure. The best way of using this instrument, according to us, is when the company uses the shares as a form of payment in an acquisition. This is due to the fact that it is less costly and time consuming and a simpler procedure compared to a directed new share issue at the same time as the company can offer company control as payment. There is no conflict of interest between the management and the shareholders in most cases, with the exception for one - when shares are to be used in options programs. In such a case, it is a dangerous balance for the management which interests they shall represent, is it the shareholders or themselves that shall benefit from the repurchase?

The most frequently used way to repurchase own shares has been to acquire the shares on the stock exchange. In our study, only Volvo used the possibility of making a repurchase offer to the shareholders. The shareholders in Volvo were thereby given a premium of 30% above the share price, in contradiction to those companies that made a repurchase on the stock exchange where the shareholders received only the current market price. This implies that the shareholders benefit more by an offer, than if the company makes the purchase on the Stock Exchange.

The regulation on own shares has no official connection with the statutes of minorities. We have become aware that two relations exists

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in the form of the decision regulation and the connection to the LEO-law. Own shares cannot be abused in order to get rid of a non-wanted majority in the company since the company cannot force the shareholder to accept the offer or the deal on the stock exchange. It is difficult for a company to reach the 10% level at one occasion due to trade regulation, which makes this limit sufficient. When using an offer to the shareholder, the limit is though, reached directly on the day of liquidity. Companies are more critical to the 10% limitation than the standard setters and auditors since they have a more international view than only the European market and USA has no similar regulation, whereas the American market is important.

The accounting for own shares

One method when accounting for own shares is to recognise the shares as an asset. There are certain criterions that have to be fulfilled for an asset to be recorded in the active side of the balance sheet. Although own shares could be consider as an asset according to these criterions, we think it is fair that the Swedish government decided that own shares is not an asset. Own shares that are recorded as an asset in the books of account is less liquid in small companies, because the turn over in the shares is less. This implies that the asset aspect is difficult to fulfil. Own shares, as an asset, demand a higher level of knowledge by the readers of the reports, since they have to decide what valuation of the company that can be relied on.

Repurchasing and selling of own shares is a transaction between the company and its shareholders. Own shares is therefore, not an asset, but a part of equity which is representing this relationship between owner and entity. At the same time, own shares does only represent values that already exist in other accounts on the balance sheet. By making own shares an asset the same value is presented twice on the balance sheet. Therefore, the Swedish government choice of method is preferable to the “EC-method”.

There are major differences between the Swedish method of accounting and the par value method. Considering that a share and the capital of this share consist of more then only the nominal value, the par value method would have been more adequate. This would mean

that when reselling the shares, effects should be on those reserves. We feel that this method is not applicable in Sweden since the method uses the restricted equity, which is in conflict with the protection purposes of this equity in Sweden.

The Swedish method of accounting mostly resembles with the cost method. The cost method's strength is that any surplus is recorded in restricted equity, making it unreachable for the company and its shareholders and that it then could be used to increase the capital base of the company instead. This method affects the restricted equity to some extent and is therefore, not applicable in Sweden, for the same reasons as mentioned above.

Both the cost- and the par value method have purposes when to use them. The cost method is used when the shares are to be resold in the future and the par value when the shares are to be used in order to reduce the share capital. The “EC-method” has no similar purpose but only that own shares is an asset that could be re-valued. In the aspect that the companies have different purposes when trading with own shares, it would have been better in Sweden to give each company the opportunity to choose which method that suits them best. The government though has made a Swedish method on how to account for own shares. We think though that it is positive that the government made this regulation. In the Swedish method, there is not any special purpose with the method, but, since the similarities are greatest with the cost method, we interpret that the primary purpose with the Swedish method is that the shares are to be put back on the market. At the same time, the instrument of redemption exists, when the company wants to reduce the share capital.

The reason why the government wants only the non-restricted equity to be adjusted is that they prefer the same regulation in this issue, as when the company makes a dividend to the shareholders. That is, to the same extent that the company could divide profit to the shareholder they should also have the possibility to purchase own shares. If we make a connection to dividend, it is natural to account for own shares within the non-restricted equity. We think that it is good that the government regulated that only the non-restricted equity should be used. Otherwise,

it could create situations where the company could use the restricted equity when it suits them, which would be a violation to basic principles of the Companies Act. The Swedish method gives the company a choice, what to use the capital for when selling the shares, by placing the surplus of an endorsement into non-restricted equity. The company could transfer the funds to restricted equity or to the shareholders by dividend.

Our opinion, on the question of which account within the non-restricted equity that should be used, is that it shall be retained earnings only. Profit of the year is from the financial statement and shall represent the actions of how the company has used its assets during the year, whereas own shares is not asset and is not to be presented on the financial statement. Therefore, retained earnings is the proper account to use.

In the Swedish proposal of accounting for own shares, the government compares the selling of own shares with new share issue. We think that this comparison is difficult to make in some aspects. When the company makes a new share issue the premium is recorded to the restricted equity, while a surplus in a sale of own shares is recorded to the non-restricted equity. These are two different areas; a premium is an overvaluation of the share conducted at the time for the new share issue and cannot be transferred from restricted equity to the shareholders. A surplus when endorsing shares on the stock exchange arises when company has purchased the instrument at one occasion and later resold the same into the market at a different price. This surplus can be used to strengthen the restricted equity or be distributed to the shareholders. It is important, in this context, to underline the fact that a transaction of own shares gives no profit or losses as when selling another asset. So to discuss a profit would be incorrect. The proper definition is a surplus or a deficit; that is, differences between resale price and acquisition price.

Sweden has chosen a more restricted accounting method than IASC and there is a risk that difficulties could occur in the future for Swedish companies to follow international practice within this issue. It is possible that IASC will issue a more detailed recommendation on own

shares by making the interpretations of SIC 16 and 17 a standard. We think that it would be better if the Swedish regulation on accounting for own shares would have been left up to standard setting bodies to form. The legislators have, in this case, hindered the Swedish standards setters in developing a good set of norms and recommendations.

No Swedish recommendations are prepared at the moment, and it is uncertain if there will be any issued within the near future. None of the Swedish standard setting bodies are working with the issue of own shares at the moment, but will most certainly release some kind of recommendation adjusted to Swedish conditions in the future, probably based on the IASC standards and draft interpretations. However, SIC 16 is broader than the limitations of the Swedish accounting for own shares, which we think could be a future problem. Sweden follows more of the Anglo-Saxon accounting and decreases the influences from the conservatism which increase the arguments that Sweden has chosen a method that is comparable with the cost method, an American accounting method.

Our suggestion for a revised Swedish accounting method

After analysing all material in this thesis, we have found that some improvements in the Swedish accounting method could be made. We have found that the cost method is easier to read than the Swedish since this method presents own shares as an own account directly on the balance sheet. On the other hand, the cost method uses the account of restricted reserves for surplus and deficit which make the method not applicable in Sweden. The primary advantage with our method is that own shares is presented directly on the balance sheet, which also makes it clearer when holding own shares for more than one period. Another aspect is that, the information in notes becomes clearer.

We have not found any hindrance in the Annual Accounts Acts, EC-law or the Companies Act, to present own shares as a separate account within non-restricted equity. We believe that this was not considered by the legislator because they did not study any other accountings method for own shares besides the recommendations from IASC and the EC directives.

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The fundamental accounting principles of the Annual Accounts Act, in the 2nd and 3rd Chapter, about clearness and the contents of an annual report makes no hindrance to presenting own shares as a separate account within non-restricted equity. This method is also valid in accordance with the Swedish General Accepted Accounting Principles (GAAP) and the principle of a true and fair view. The problem that exists is the new formulating of 5 Chapter 14§ Annual Accounts Act about how to present and specify equity in the annual report. This statute was revised at the same time as the 7th Chapter of the Companies Act and treats own shares within equity. A minor adjustment must be made in order to implement our method; that is, to state that own shares should be presented separately on the balance sheet as a sub-account to non-restricted equity, thus equalising own shares with other accounts, such as profit of the year and retained earnings. The aspects of the concept of materiality must be considered. If the repurchase or the possession is minor and this principle cannot be fulfilled, then the company can record own shares directly in retained earnings, which is the case now in Sweden. This has to be considered in each individual case, just as with any other posts that are presented on the balance sheet.

When the company makes a new share issue or a repurchase of own shares, cost of capital occurs and the difference is that we present own shares as a separate account while costs for a new share issue is recorded directly to each part of equity. We think that own shares is more important to present separately on the balance sheet than other costs of capital. There are two reasons for this. First, there are more costs involved in a transaction of own shares, including both the acquisition cost and all external costs. The other reason is that costs for a new share issue occurs on one occasion while the costs for own shares becomes current on several occasion; for example, in connection with an endorsement.

This method that we are suggesting is in accordance with the requirements of the Swedish legislation which also makes it valid to the regulations of the EC directives and the Companies Act.

Chapter 8 – Conclusions and reflections

In order to illustrate this method, we use the same fictive company as before. Thus, the company repurchases 100.000 outstanding shares at the price of SEK 15 each on January 31st X2. “Cash” is credited with the amount for the repurchase, SEK 1.500.000. The corresponding account will then be “Own shares”, a sub-account to non-restricted reserves. The entry is as follows:

	Debit	Credit
Cash		1.500.000
Own shares	1.500.000	

Transaction: Accounts effected by the repurchase transaction.

Non-Current Assets	25.000.000	Share Capital	10.000.000
Current Assets	10.000.000	Restricted Reserves	2.000.000
Cash	3.500.000	Non-Restricted Reserves	5.000.000
		Own shares	(1.500.000)
		Long-Term Liabilities	15.000.000
		Short-Term Liabilities	8.000.000
	<u>38.500.000</u>		<u>38.500.000</u>

Balance sheet 17: Balance sheet total February 1st X2 (after repurchase, under the conditions that no other transactions have occurred)

On June 30th X2, the company resells the shares to the market, where the current share price is SEK 20. All 100.000 shares are resold and then the account of “Cash” is credited with the amount received, which is SEK 2.000.000. The account “Own shares” is credited with the associated amount. The difference between the resale price and the acquisition cost, the surplus of SEK 500.000, is transferred to “Non-restricted equity” and the balance of “Own shares” account is SEK 0 since the company now do not hold any shares. The entry is as follows:

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	Debit	Credit
Cash	2.000.000	
Own shares		1.500.000
Non-Restricted Reserves		500.000

Transaction: Accounts effected by the repurchase transaction.

Non-Current Assets	25.000.000	Share Capital	10.000.000
Current Assets	10.000.000	Restricted Reserves	2.000.000
Cash	5.500.000	Non-Restricted Reserves	5.500.000
		Own shares	0
		Long-Term Liabilities	15.000.000
		Short-Term Liabilities	8.000.000
	<u>40.500.000</u>		<u>40.500.000</u>

Balance sheet 18: Balance sheet total July 1st X2 (after repurchase, under the conditions that no other transactions have occurred)

If the company uses the shares to make a reduction of the share capital on June 30th X2, and, in accordance with the consideration of the Swedish accounting regulation, then “Share capital” is debited with SEK 1.000.000, which is the nominal value of the 100.000 shares. “Own shares” is credited with total amount of the acquisition cost, thus SEK 1.000.000. The difference between the nominal value and the acquisition cost is transferred from “Own shares” to “Non-restricted Reserves”, thus, SEK 500.000 as a cost of capital. The account of “Own shares” is thereby credited with SEK 1.500.000. The entry is as follows:

	Debit	Credit
Share capital	1.000.000	
Own shares		1.000.000
Non-Restricted Reserves	500.000	

The balance sheet is presented as follows after this entry:

Chapter 8 – Conclusions and reflections

Non-Current Assets	25.000.000	Share Capital	9.000.000
Current Assets	10.000.000	Restricted Reserves	2.000.000
Cash	3.500.000	Non-Restricted Reserves	4.500.000
		Own shares	0
		Long-Term Liabilities	15.000.000
		Short-Term Liabilities	8.000.000
	38.500.000		38.500.000

Balance sheet 19: Balance sheet total July 1st X2 (after repurchase, under the conditions that no other transactions have occurred)

Our improved model contributes to an increased clearness since the shares are presented directly in the balance sheet. This increases harmonisation because a foreign reader of a Swedish annual report can more easily analyse the information about the company's transactions with own shares. It is only the non-restricted equity that is effected, never restricted equity, and, when endorsing the shares, the non-restricted equity is restored.

Further Research

When making this thesis the aspect of share prices occurred continuously. Therefore, as a suggestion for further research within this interesting subject, we suggest a study of how the share prices have been developed for those companies that used repurchase programs during 2000. It would be interesting to find out if share prices really have been effected by repurchase programs and if there are any differences between different companies, or maybe in comparison with other countries that also allows repurchase programs.

We agree with the opinion that own shares would have been more useful in private limited liabilities companies. Therefore, it would be interesting to study how the company- and tax regulation can be altered in order to make repurchase, hold and endorsement available for private companies.

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Appendix – Interview Questions

Interview Questions: Companies

- Background
 - 1) Is it positive that the change of legislation has been conducted at this moment of time to X or has it taken too long a time before the law was changed?
 - 2) Has it been desirable to acquire own shares before the legislation was implemented?
 - 3) What are the primary advantages and disadvantages in allowing companies to repurchase, hold and endorse own shares?

- Legislation/own shares
 - 4) Is 10%, as a limit of holding in one time, sufficient or should it have been more or less extensive?
 - 5) Is a repurchase of own shares profitable for all parties involved?
 - 6) Is own shares a good instrument for X's financial strategies?
 - 7) Are there any other considerable purposes, besides the main purpose, for own shares for X?
 - 8) Does You believe that X, together with other Swedish multinational companies, has been given the same conditions of competition as your international competitors?

- Accounting
 - 9) Does X believe that it is positive that the government did not choose the "EC method" that considers own shares as an asset?
 - 10) Does X believe that it is good that the government has give the standard setting bodies in Sweden the assignment to give norms and recommendations on how to account for own shares?
 - 11) How has X prepared the accounting issue on own shares and how does the work process proceed e.g. when preparing the semi-annual report?

- The future
 - 12) Will X use this instrument in the future and will it be used to a wide extent?

Interview Questions: Auditors

- Background
 - 1) Why has it, in your opinion, taken more than a century to abolish the prohibition on own shares and why has the law been changed at this moment of time?
 - 2) What are the primary advantages and disadvantages in allowing companies to repurchase, hold and endorse own shares?

- Legislation/ own shares
 - 3) Is 10%, as limit of holding in one time, sufficient or should it have been more or less extensive?
 - 4) Is a repurchase of own shares profitable for all parties involved?
 - 5) Is it a disadvantage that only listed public limited liability companies are allowed to repurchase, hold and endorse own shares?
 - 6) Is own shares a good instrument for financial strategies?
 - 7) Have Swedish multinational companies been given the same conditions of competition as their international competitors?

- Accounting
 - 8) Is it positive that the government did not choose the EC method that considers own shares as an asset?
 - 9) Do you find it positive that the government has chosen not to recommend any of the internationally used methods (cost or par value method)?
 - 10) Is it good that the government has given the standard setting bodies in Sweden the assignment to give norms and recommendations on how to account for own shares?
 - 11) How has X prepared on the accounting issue on own shares and how does the work process proceed e.g. when auditing the semi-annual report?
 - 12) How should the accounting on own shares be conducted in Sweden?
 - 12.1) How will the accounting in the directors report be formulated?
 - 12.2) How will payments when purchasing and selling own shares be accounted?

Appendix – Interview questions

- 12.3) What shall be included in the accounted payments? The payments itself as expenditures for commission and similar?
- 12.4) How should these payments be accounted for when the company holds the own shares for several periods?
- 12.5) How shall surplus or a loss be treated when selling own shares?
- 12.6) How should it be accounted for when the company chose to retire the shares?

- Future

- 13) Will own shares be an instrument used by Swedish companies in the future and will it be used to a wide extent?

Interview Questions: Margit Knutsson

- Background

- 1) Why has it, in your opinion, taken more than a century to abolish the prohibition on own shares and why has the law been changed at this moment of time?

- Legislation/ own shares

- 2) Is 10%, as limit of holding in one time, sufficient or should it have been more or less extensive?
- 3) Is a repurchase of own shares profitable for all parties involved?
- 4) Is it a disadvantage that only listed public limited liability companies are allowed to repurchase, hold and endorse own shares?
- 5) Is own shares a good instrument for financial strategies?
- 6) Have Swedish multinational companies been given the same conditions of competition as their international competitors?

- Accounting

- 7) Is it positive that the government did not choose the EC method that considers own shares as an asset?
- 8) Do you find it positive that the government has chosen not to recommend any of the internationally used methods (cost or par value method)?

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- 9) Is it good that the government has given the standard setting bodies in Sweden the assignment to give norms and recommendations on how to account for own shares?
- 10) How does Redovisningsrådet work with the issue of own shares?
- 11) Which considerations will be taken to IASC when issuing recommendations in this matter, e.g. SIC 16?
- 12) How should the accounting on own shares be conducted in Sweden?
 - 12.1) How will the accounting in the directors report be formulated?
 - 12.2) How will payments when purchasing and selling own shares be accounted?
 - 12.3) What shall be included in the accounted payments? The payments itself as expenditures for commission and similar?
 - 12.4) How should these payments be accounted for when the company holds the own shares for several periods?
 - 12.5) How shall surplus or a loss be treated when selling own shares?
 - 12.6) How should it be accounted for when the company chose to retire the shares?
- Future
- 13) Will own shares be an instrument used by Swedish companies in the future and will it be used to a wide extent?

Interview Questions: Rolf Skog

- Background
 - 1) Why did Aktiebolagskommitten get the assignment to change the legislation concerning own shares and why do you believe the changes were done at this moment of time?
 - 2) What are the primary advantages and disadvantages in allowing companies to repurchase, hold and endorse own shares?
- Legislation/ own shares
 - 3) Why the 10% limit of holding in one time? Were there any other reasons than that 10% is regulated in the EC-directives? Did

Appendix – Interview questions

Aktiebolagskommitten discuss the protection of the minority shareholders?

- 4) Is it a disadvantage that only listed public limited liability companies are allowed to repurchase, hold and endorse own shares?
 - 5) Have Swedish multinational companies been given the same conditions of competition as their international competitors?
- Accounting
- 6) Why did not Aktiebolagskommitten recommend any of the internationally used methods (cost or par value method)?
 - 7) What is your opinion on accounting for own shares in Sweden and the chosen why to conduct this?
- Future
- 8) Will own shares be an instrument used by Swedish companies in the future and will it be used in wide extent?