Accounting is Broken. Here's how to fix it: A radical manifesto

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Background

The progression of globalization is one of the largest social developments humanity has ever tackled. That's why its influence on the global economy is enormous and therefore the accounting sector is critical. The author stresses that accounting and corporate governance are in an immense dilemma but not due to a few companies that have overlooked the regulations. The crisis is that the accounting rules are old and wrong, and corporate governance is enduring the consequences. Accounting is not yet close to measuring economic reality. In an effort to serve many masters, it is not helping any well and is deserting its most critical community — the intelligent, professional shareholder.

There are large points of criticism of conventional accounting. The criticism started soon after accounting began to rise in eminence and stature in the early part of this century: this was especially the case in the USA and the UK. The problems of conventional accounting can be summarized as follows:

• The aims of conventional accounting are centered on decision usefulness therefore it seeks to concentrate and accumulate wealth for certain sections of society.

• Neither the conjectures of perfect liberal economic democracy nor the developed exchange economy with a developed stock market are valid for many societies.

• The accounting principles on which conventional accounting reports are prepared may be inappropriate for the direct and indirect equitable distribution of wealth.

• The negative economic and social consequences of conventional accounting on the environment, society and individuals are unacceptable.

One of the central theme of this paper is to show that conventional accounting does not provide accurate information. The author stresses that the conventional method ignores changes in the purchasing power of the dollar. For example, a piece of property is purchased for X dollars and, some years later, when the purchasing power of the dollar has declined to half its prior value, the property is sold for 2X dollars. Conventional accounting says that is a 100% gain in the amount of capital that has occurred, but common sense tells us that it is the measuring unit that has changed, not the amount of capital.

The author spearheads the idea that EVA is one of the most popular measures of performance and has widespread application across industries and continents. It is critical to remember that the nature and number of accounting adjustments done for calculation of EVA is tailored to suit the needs of the company that is implementing it. No two companies calculate EVA in the same manner. EVA as a tool for value enhancement does motivate managers to perform better and take decisions that are consistent with the shareholder value maximization goal of corporations.

EVA offers a more full measure of profitability than traditional measures because it indicates how well a firm has performed in relation to the amount of capital employed. It is based on the notion that a thriving firm should earn at least its cost of capital. Firms that earn higher returns than financing costs help shareholders and account for increased shareholder value.

In its simplest form, EVA can be expressed as the following equation:

EVA = Operating Profit After Tax (NOPAT) - Cost of Capital

EVA, on the other hand, through its adjustment efforts, aims to reduce the effect of accounting alterations while healing the influence of financing costs more comprehensively in its capital cost charge. Hence, a truer measure of economic profit is provided by EVA than that provided by the use of traditional GAAP-based measures. This may be important since some companies spend heavily on R&D and the accounting treatment for this and certain intangibles is not included on GAAP-based balance sheets. EVA provides a way to compare performance among firms impacted by these accounting weaknesses.

Citation:
Please cite this article as: Abdulrazak Abyad. Accounting is Broken here's how to fix it: A radical manifesto. *Middle East Journal of Business.* 2018; 13(1): 32-34
DOI: 10.5742/MEJB.2018.93232

The victory of the EVA framework and its constant growth necessitates that CPAs appreciate not only its basic characteristics, but also the complex underpinnings of its derivation. As more companies go on to adopt EVA, the role of accountants as consultants and independent auditors of EVA is likely to increase. In addition, as more investors and other external users come to rely on EVA as a performance measure, companies will be more inclined to disclose their EVA and components of its calculation.

A series of international accounting standards will allow the original prospect for development owing to the fact that comparative examination of the rates of returns recognized based on the balance sheets and profit and loss account between the companies being in competition, become relevant. The author suggests that accounting rules need to be modified on a continuous basis rather than following a conventional approach of reviewing after long periods which usually continue for years.

The Capitalist manifesto

Shared capitalism intends to stimulate employees by offering them a bigger financial stake in their companies. There are diverse forms of employee ownership, by which workers are rewarded for firm performance. Together, these ample sets of ownership and compensation models have been named by researchers as "shared capitalism."

• Employee stock ownership program (ESOP): A firm-sponsored trust that works as a tax-qualified, defined-contribution retirement plan for worker-owners.

• Stock options: In heart this is an offer of ownership. It gives a worker the prospect or opportunity, to buy or sell company stock by a specified date and at a specified (and usually advantageous) price matched up to fair market value.

• Employee stock purchase plan (ESPP): Analogous to stock options, an ESPP allows workers to buy company stock at a predetermined and discounted price from fair market value. Whereas stock options require no action or investment until they're exercised, ESPPs are a direct and immediate purchase of company stock, but at a discounted price.

• Profit sharing: A compensation agreement where an employer distributes some of its profits to employees. Normally made in cash, this compensation can also come in stocks or bonds. It can be dispersed directly or deferred until retirement. Gain sharing is an alternative of this form and is based on departmental or plant contributions to company performance.

In the extreme competitive marketplace of the global economy, policymakers and managers carry on to fight with alternatives to encourage and reward employees that endorse competitiveness and worker well-being. One approach championed by some clouds the traditional lines between capital and labour. It augment workers' financial stakes in their companies through pay-for-performance and stock ownership plans and increases employee decision-making. This has been called "shared capitalism" (1,2).

At the EU level, employee financial participation has been the focus of two PEPPER (Promotion of Employee Participation in Profit and Enterprise Results) reports (1991 and 1996), a Commission Communication ("On a framework for the promotion of employee financial participation"), and additional activities by the European Economic and Social Committee and the European Parliament.

"Worker capitalism" sounded promising when Congress approved the ESOP program in 1974. Any company could transfer some or all of its stock to a trust, which then allocated the shares to workers. Employees would feel they had a stake in the firm's success and build up savings with their own stock. Since 1975 about 3,000 firms, most of them small, have begun ESOP programs by turning over some stock to employees.

Studies are inconclusive as to whether workers are more productive as shareholders rather than ordinary time-clock punchers. A University of Michigan project indicated that employee-owned companies can be 1.5 times as profitable as competing firms because there is less waste and absenteeism and greater productivity. But when worker ownership is spread out among hundreds of employees, and outside managers run the firm's operations, there is little benefit. Concludes James O'Toole, an associate professor of management at the University of Southern California:"Few companies have found a measurable effect on worker motivation, performance or productivity resulting directly from stock ownership. Little increase is visible in job satisfaction, morale or company loyalty."

Broad-based employee share ownership (ESO) is a significant economic phenomenon. The two most common types of plans which encourage ESO are Employee Stock Ownership Plans (ESOPs) and 401-K plans with employer stocks. Earlier studies have revealed that worker productivity increases following adoption of ESO plans (3,4). The finance literature reveals positive stock price reactions to the declaration of ESOP adoptions that are not implemented under takeover pressure (5; 6). On the other hand there is little data on how ESO plans affect employee compensation.

There are usually four non-mutually exclusive motives to establish ESOPs:

(1) an attempt to improve incentives and team efforts to enhance worker productivity,

(2) management-worker alliance to thwart hostile takeover threats,

(3) cash conservation by poorly performing firms by substituting stocks for cash wages, and

(4) tax benefits.

A. Productivity gains

The most over and over again mentioned goal of ESO is to augment firm value by improving employee incentives. Shareholders normally do not supervise non-managerial employees; instead, they entrust the monitoring to management. As a supplement to delegated monitoring and to better align employee incentives with shareholder values, firms may encourage ESO as an incentive device.

B. Employee compensation

How are these productivity gains shared between employees and shareholders? When ESOPs give marked control rights to employees, as in large ESOPs, workers may use their improved

negotiating power to extract higher compensation and benefits.

ESOPs may lead to employees embracing less diversified portfolios and have liquidity fears. ESOP shares cannot be sold until employees leave the company, with the exception of diversification requirements triggered at 55 and 60 years of age. Usually this will lead to augmenting employee compensation.

C. Cash conservation

Core and Guay (7) pointed out that stock option plans for non-executive employees are usually employed at firms which look cash-constrained. Likewise, issuing stocks through ESOPs may be the result of cash constrained firms substituting stocks for cash wages. Since sales is the primary sources of cash inflows, we define an ESOP restructuring if it is adopted by a firm suffering sales decline in the year of the plan initiation. Such ESOPs are likely to lower cash wages without changing total employee compensation. While the decision to substitute equity for cash wages may be optimal for firms facing cash shortage, it is doubtful that such plans will have the same strong uplifting effect on employee morale, team effects, and collective behavior as non-restructuring ESOPs will. Therefore , we expect no marked productivity gains from having restructuring ESOPs and, hence, no compensation increases or shareholder value gains.

D. Tax effects

ESOPs are usually established through a trust which borrows money to buy company stock. Over time, the company repays the loan taken by the trust which, in turn, distributes its shares to employee accounts. These loan payments (interest and principle) are treated as wages and, thus, are tax deductible, within certain payroll limits. Tax benefits unique to leveraged ESOPs arise when dividends paid to stocks, held by the trust, are used to pay down debt. These dividends are effectively deducted twice from the firm's taxable income, once as wages and then again as interest payments.(7) If this tax benefit has an important impact on shareholder value, leveraged ESOPs will have more favorable impact on firm valuation than non-leveraged ESOPs.

Conclusion

In this paper the author discussed whether adopting broad-based employee stock ownership enhances firm performance by improving employee incentives and team effects. That is, does employee capitalism work? If so, how are gains divided between shareholders and employees? Our results suggest ESOPs increase productivity, which, by a process of elimination, we attribute to incentive and team effects.

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