



Contradictions in market capitalisation computation

The legalisation of share repurchases has brought inconsistencies in the way JSE-listed companies report their market capitalisation.

_____ by Pieter Bester, Willie Hamman, Leon Brummer, Nicolene Wesson and Wilna Steyn-Bruwer

For many years, the rule prohibiting a company from buying back its own shares was one of the cornerstones of maintaining share capital in South Africa. The Companies Amendment Act 37 of 1999, however, relaxed this ruling by allowing South African companies to repurchase their own shares or shares of their holding companies.

This change has not come without problems. Specifically, certain repurchase transactions can easily lead to contradictory interpretations. For instance, when subsidiaries acquire shares of the holding company, the situation arises where the number of company shares differs from the number of group shares. A simple example illustrates this situation.

As shown in the table on the right, the initial number of shares issued by the company is 100. At a later point, the company repurchases

	CLOSING NUMBER OF SHARES	
	Company	Consolidated at group level
100 shares issued by company	100	100
6 shares repurchased by company (and cancelled)	94	94
5 shares bought by subsidiary of company (but not cancelled)	94	89

six shares, in which case these shares have to be cancelled. The closing number of shares of

both the company and the group will now stand at 94. However, suppose a further five shares

are bought by a subsidiary of the company and are therefore not cancelled, but kept as treasury shares. Upon consolidation, the closing number of the company's shares is still 94, but the closing number of the group's shares reduces to 89.

An obvious question presents itself: which number of shares should be used when one computes market capitalisation – the company's, or the group's?

The calculation of market capitalisation is left largely to the discretion of companies' accountants

Officially, the situation is vague

There is no clarity on this issue. In the case of mandatory annual report ratios, like earnings per share (EPS) and headline earnings per share (HEPS), clear accounting guidance exists. Both these ratios should be based on the *weighted number of group shares* – the consolidated number of shares, or the 89 in the example. Therefore, it may make sense to follow the same principle in the interpretation of market capitalisation. But is a similar view held in practice?

From a statutory and governance perspective, the answer is wanting. In the first place, it is not mandatory for companies to publish their market capitalisation in the annual report. Secondly, there is no specific formal guidance as to which number of shares to use when calculating market capitalisation. Thirdly, unlike ratios such as EPS and HEPS that are subject to rigorous checking and verification by auditors, market capitalisation appears in a section of the report that is not verified by auditors. The auditors only check that this section does not include material inconsistencies. In short, the calculation of market capitalisation is left largely to the discretion of companies' accountants.

Furthermore, it is interesting to note that it is to the advantage of companies to use the number of group shares, as prescribed, to calculate EPS and HEPS. In the simple example (**left**), taking the figure of 89 instead of 94 means dividing by a smaller number, which will show higher values of EPS and HEPS. But the opposite is true for market capitalisation. In this case, the formula is *price per share multiplied by the number of shares*. A higher number of shares will result in a higher market capitalisation figure. Market

capitalisation is a reflection of a company's size and total market value, and also a criterion for inclusion in some of the prestigious stock market indices such as the JSE Top 40. One can easily speculate that companies have an incentive to use the larger number of shares – the example company's closing number of 94 rather than the group's 89 – when they calculate market capitalisation.

What happens in practice?

Researchers at the University of Stellenbosch Business School (USB) became intrigued by the ambiguous state of affairs, and decided to launch an in-depth research project to investigate the matter. The main aim was to establish how this issue is interpreted in practice by finding out which number JSE-listed companies use to calculate market capitalisation for publication in their annual reports. Would companies depart from the principles governing EPS and HEPS and opt rather to use the number of company shares, which in turn will show an inflated market capitalisation?

The results of the research confirmed the suspicion that many companies would take advantage of the slack situation. By far the majority – close to 75% – of companies investigated had calculated their market capitalisation based on the number of company shares. In other words, they omitted to deduct subsidiary repurchases

the annual movement in the number of issued company shares and the number of shares held by subsidiaries and share trusts (treasury shares), as well as the closing share price and published market capitalisation at financial year-end. While accurate data for the number of issued company shares and the year-end closing share price are available from financial databases like McGregor BFA, Reuters and INET-Bridge, these do not fully reflect shares held by subsidiaries and share trusts resulting from share repurchase activities.

The USB therefore started building its own comprehensive database of all share repurchases since 1999 of JSE-listed companies in selected industrial sectors. The database excludes the Mining, Financials, Development Capital and Alternative Exchange sectors. At the time of the research, it contained 129 companies involved in share repurchases or consolidation of share trusts for the period 1999 to 2007, after excluding companies that had been de-listed or suspended.

Further data and supporting information about the companies in the USB database were obtained by studying the following sources:

- The electronic database of the Securities Exchange News Service (SENS) for announcements of companies' intentions to repurchase as well as the incremental 3% repurchase announcements of actual general share repurchases.
- All the companies' annual reports from 1999 to 2007, and noting changes in the number of shares issued and changes in treasury shares held by subsidiaries or share trusts.

The focus year of the study was 2006 as it was, at that time, the most recent, completed financial

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or trust consolidations in their calculation of the number of shares. Thus, only 25% of companies based market capitalisation on the number of group shares, which is assumed to be the more correct way, or at least consistent with EPS and HEPS calculations.

Compiling the data

The data required for this research include

year. Consequently, the study covered those companies in the USB database that published 2006 annual reports, and that reported market capitalisation in their reports. Of the 129 companies, a total of 63 met these criteria.

Why this debate matters

The debate about the correct calculation of market capitalisation is important. Even though it is not »

SHARE REPURCHASE REGULATORY PROVISIONS

The repurchase of shares is governed by various legislative and statutory requirements contained in the Companies Act, the Companies Amendment Act and the JSE Listing Requirements. Furthermore, share repurchases by the company are deemed to be dividends, implying that such transactions also have to conform to the Income Tax Act.

The Companies Act, Act 61 of 1973 (RSA, 1973), was amended through the Companies Amendment Act, Act 37 of 1999 (RSA, 1999), to allow companies to buy back their own shares. The provisions governing share repurchases are contained in Section 39 of the Companies Act, as well as Sections 85 to 90 of the Companies Amendment Act. The relevant provisions of the Act are summarised as follows:

- A company, if authorised by its articles, may, by a special resolution of the company, acquire its own shares [Section 85(1)].
- The approval by resolution may either be for repurchase under a general or a specific authority. If the approval is for a general repurchase, it will only be valid until the next annual general meeting [Section 85(3)].
- Shares issued by a company and subsequently acquired will be cancelled as issued shares and restored to the status of authorised shares [Section 85(8)].
- Section 89 allows subsidiary companies (in total) to acquire shares in their holding company to a maximum of 10% of the issued share capital of the holding company.
- Shares in the company may not be repurchased under Section 85 if, following such acquisition, there would no longer be any shares in issue other than convertible or redeemable shares.
- Listed companies are further compelled to comply with additional conditions as determined by the relevant stock exchange [Section 87(5)].

Note: In accountancy terms, shares bought in the holding company by subsidiaries are known as treasury shares.

an audited financial ratio, the market capitalisation should reflect a fair overall value of the company. It can be considered as the amount an investor who wishes to buy the whole company can expect to pay. The study therefore contends that a company misleads potential investors by publishing an inflated market capitalisation.

At present, there is a void as far as official standards regarding the calculation and publication of market capitalisation are concerned. The impact of such a void is clear from the research findings, which show that company accountants interpret market capitalisation in inconsistent ways. Companies may even be inclined to abuse the situation and take the option that suits them best. While the difference in the case of some of the companies studied was small and hardly relevant, on average the overstatement was 8.8%, which is substantial. And the maximum overstate-

ment was found to be as high as 50.4%.

South African legislation differs from similar legislation in the USA and UK in that South African companies are forced to cancel the shares they repurchase from their issued share capital. Without overseas precedents to follow, the implications of the SA legislation may have been underestimated. These implications have to be studied and the problematic issues exposed. The general understanding around South African share repurchase mechanisms has to be broadened.

Accounting standards would bring clarity

The study suggests, based on these findings, that accounting standardisation be adopted in order to assist the accounting practice with the calculation of market capitalisation. The fact that SA legislation differs from certain international

legislation re-emphasises the need for better accounting guidance on this matter.

One specific reason why better accounting standards are important pertains to the provision of Section 89 that allows subsidiaries to hold a maximum of 10% of shares in the holding company. It was found that a few companies exceed this 10% owing to, for example, additional share repurchases by the company after subsidiaries repurchased close to 10%. Clarity on the correct basis of this 10% is needed.

Another reason is that it has become clear, as part of the investigation, that the JSE calculates market capitalisation based on the number of company shares when it compiles the Top 40 index. Thus, it also ignores subsidiary repurchases and trust consolidations. Among the companies investigated, at least one company found to be in the Top 40 would not have qualified for inclusion if the market capitalisation of the group had been used as basis. ■



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The research is part of a more comprehensive research programme launched by the University of Stellenbosch Business School (USB) to investigate the share buy-back context in South Africa since the legalisation of share repurchasing in 1999. Prof Willie Hamman, emeritus professor in Finance at USB, leads the research. An important component of the data required for the research was covered by the MBA research project of Pieter Bester (pictured). His research, *Shareholder distribution choices for industrial companies listed on the JSE: Share-buy-backs versus dividends*, was supervised by Prof Hamman and completed in December 2008. As regards the other co-researchers, Leon Brummer is from McGregor BFA, while Nicolene Wesson and Prof Wilna Steyn-Bruwer are from the Accountancy Department of the University of Stellenbosch.



Write to us: What lies behind the differences in opinion on how to calculate the number of shares used for market capitalisation?
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