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Article

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Accounting treatment recommendations for bottom-up shareholding increase

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ABSTRACT

An increasing number of companies in China are adopting bottom-up shareholding increases to incentivize employees and stabilize stock prices. However, a research gap exists regarding China's current accounting regulations for handling bottom-up equity incentives. This study aims to address this research gap by clarifying the accounting treatment of bottom-up shareholding increases by publicly traded companies in China. Specifically, it seeks to analyze the economic essence of such transactions and propose a framework for their accounting treatment. To achieve the objectives, this study conducts a comprehensive analysis of the relevant provisions of current corporate accounting standards in China. Additionally, it considers perspectives from contract law to provide a holistic understanding of the issue. Based on the analytical results, this study proposes that the economic essence of a publicly traded company's implementation of a bottom-up shareholding increase is akin to the sponsor's equity donation to the company. Consequently, it suggests that such transactions can be accounted for similarly to capital donations by controlling shareholders to publicly traded companies. Hence, this research offers valuable reference and guidance for the accounting treatment of bottom-up shareholding increases by publicly traded companies in China. Furthermore, it holds significant importance in the context of further standardizing China's corporate accounting practices and contributes to international accounting standards.

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1. Introduction

The research problem addressed in this study is rooted in the significant market events of the 2015 stock market crash, which precipitated a surge in 'bottom-up shareholding increase' or equity incentives by publicly traded companies in China. These measures were aimed at encouraging employees to invest in company stocks, with the companies' actual controllers promising downside protection. Despite the regulatory attention and the issuance of the 'Notice on Strengthening Information Disclosure for Publicly Traded Companies' Controlling Shareholders and Actual Controllers Issuing Share Increase Proposals to Company Employees' by the Shenzhen Stock Exchange on June 8, 2017, as reported by Zhong (2017), there remains a conspicuous absence of specific accounting treatment guidelines for such equity incentives within the existing Chinese accounting standards. This regulatory oversight has led to a diversity of accounting practices among companies implementing these incentives, underscoring a pressing need for standardized accounting treatments.

Nie (2019) and Lin (2018) suggest that bottom-up shareholding increases, or equity incentives are essentially put options for stock-based payments and should be accounted for in accordance with the current accounting standards for stock-based payments in China. However, the accounting treatment for companies that have already implemented bottom-up equity incentives varies. Despite the popularity of

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these incentives for their potential to motivate employees and stabilize stock prices, a significant gap exists in the regulatory and accounting frameworks governing these practices. Specifically, the research problem centers on the lack of specific accounting treatment recommendations for bottom-up equity incentives within current Chinese accounting standards, even international accounting standards. This gap has resulted in varied accounting practices among companies that have implemented such incentives, highlighting a critical need for standardized accounting treatment. Given the controversies surrounding the accounting treatment of bottom-up equity incentives in current Chinese accounting standards, and the lack of a clear basis for practical accounting treatment for publicly traded companies, this paper aims to fill this gap by analyzing the essence and appropriate accounting treatment of bottom-up shareholding increases or equity incentives from the perspective of Chinese accounting standards. The goal is to provide a standardized framework for accounting treatments of these incentives, thereby offering both theoretical and practical guidance for enhancing the robustness of China's corporate accounting standards. Hence, this research is pivotal for aligning China's corporate accounting practices with international standards, ensuring consistency and transparency in financial reporting related to equity incentives.

2. Literature review

2.1. Practical basis

As of March 31, 2020, official reports from the Shenzhen and Shanghai Stock Exchanges reveal that a total of 121 publicly listed companies in China had implemented equity incentive plans by bottom-up shareholding increases. Remarkably, among these companies, 118 of them, which represents 97.5% of the total, were of the opinion that such bottom-up equity incentives did not constitute stock-based payments, thus negating the need for specific accounting treatments. The remaining three companies, despite not classifying these incentives as stock-based payments, acknowledged the necessity for accounting treatments, albeit through differing approaches.

Two of these companies regarded bottom-up shareholding as a form of compensation by the controlling shareholders for the losses employees might incur from increasing stock holdings. They categorized this as a unique form of employee compensation that differs from share-based payments. For accounting purposes, they recorded the profits and losses during the commitment period under 'Other long-term employee benefits.' This treatment implies a recognition of these incentives as a special employee benefit rather than a transaction in equity. Another company took a different stance by accounting for all compensation related to losses incurred by employees from increased stock holdings directly in the current Profits and Losses account. This approach led to the recognition of such compensations as capital reserves. This method suggests a direct impact on the company's financial statements, reflecting the compensation as an adjustment to the capital reserves rather than a periodic expense or benefit.

This divergence in accounting treatments highlights the complexity and variability in interpreting and applying accounting standards to equity incentive plans. It underscores the need for clear guidelines and standards to ensure consistent and transparent financial reporting in relation to equity incentives.

2.2. Theoretical basis

The development of accounting standards often trails the evolution of business practices, a fact highlighted by the delay until May 18, 2021, when the Chinese Ministry of Finance issued the 'Application Case of Share-based Payment Standards – Big Shareholder Backdoor Equity Incentive Plan.' This document provided a detailed case study to elucidate the guidelines surrounding incremental equity acquisition through a bottom-up shareholding increase¹:

[Illustrative Example]: Under an equity incentive scheme, Company A repurchases its shares from the secondary market at their fair market value and allocates these shares to employees who opt into the plan. The pricing of these shares at issuance is pegged to their market value on the date of grant. Employees become entitled to these shares after a tenure of three years with Company A. Additionally, the equity incentive plan

specifies that the controlling shareholder of Company A will be responsible for compensating employees for any losses incurred due to stock price fluctuations prior to the unlocking date. In other words, if the stock prices of Company A increase, the employees will benefit from the profits, whereas if the stock prices decrease, the controlling shareholder will bear the losses and provide cash compensation.

[Analysis]: This shows that the transaction between the controlling shareholder of Company A and its employees is considered a share-based payment. In this transaction, the controlling shareholder bears the losses incurred by the employees due to the decline in stock prices. The transaction is arranged in such a way that the employees receive income (stock appreciation income) without bearing depreciation losses. To be eligible for this transaction, employees must have provided services to the company for three consecutive years. The consideration of the transaction is closely tied to the future value of the company's shares. Therefore, it meets the definition of share-based payment and is subject to the share-based payment standards. The amount of cash delivered by the controlling shareholder is determined based on the downside risk of Company A's stock price. In the consolidated statements of the controlling shareholder, the transaction should be settled in cash as part of share-based payment processing. However, as a service-receiving enterprise, Company A has no settlement obligation and should treat the transaction as an equity-settled share-based payment.

3. Research methodology and analysis

3.1. Research methodology

To achieve our research purpose, this article adopts a widely accepted qualitative research method (Wang et al., 2020), at the same time, we also use examples to clearly articulate and explain our viewpoints.

Firstly, we meticulously analyze the announcement of bottom-up increase issued by publicly listed companies, examining each word and sentence, and subsequently explain its significance in relation to relevant accounting standards or legal provisions. Our aim is to offer our perspectives on this matter.

Secondly, based on the content of the bottom-up increase announcement, we assume that publicly listed companies should make specific accounting treatments under different states. In this regard, we provide our reasons to support these viewpoints.

3.2. Economic substance and accounting treatment analysis of bottom-up shareholding increase

3.2.1. Economic substance analysis of bottom-up shareholding increase

3.2.1.1. From the perspective of current Chinese accounting standards. The economic essence of a publicly traded company's implementation of a bottom-up shareholding increase incentive proposal is that employees purchase the company's stock at the current market price. The initiator of the proposal commits to providing downside protection for the stock holdings of the employees for a certain period in the future. The purpose of the bottom-up incentive is to boost employee motivation and maintain the company's stock price. However, the publicly traded company, as the direct beneficiary of the bottom-up behavior, does not incur any expenses. Instead, the initiator covers the publicly traded company in compensating employees for any losses that should have been borne by the company itself. 'Case Analysis of Publicly traded Companies Implementing Enterprise Accounting Standards in 2020' issued by the China Securities Regulatory Commission (2020) lists four main types of shareholder donation behaviors by controlling shareholders or their related parties: (1) Direct cash donations to publicly traded companies or other physical assets; (2) Purchase assets from publicly traded companies at an obviously unfair price (generally higher than fair price) or sell assets to publicly traded companies (generally lower than fair price); (3) Directly exempt publicly traded companies from debts or agency The publicly traded company pays off its debts externally; (4) Directly or indirectly arranges unfair transactions between the publicly traded company and a third party that are beneficial to the publicly traded company. According to the bottom-up shareholding announcement issued by a publicly traded company, the controlling shareholder, actual controller or chairman of the publicly traded company is the initiator of the bottom-up shareholding increase. They are the 'controlling shareholders or their related parties' of the publicly traded company, and are determined by the initiator. Repaying the employee's contingent liabilities (covered promise) on behalf of the publicly traded company falls into the above type (3) of 'directly exempting the publicly traded company's debts or repaying external debts on behalf of the publicly traded company'. From this, it can be judged that the cover-up holding increase behavior in economic

essence, is a donation made by the controlling shareholder or its related party (initiator) to the publicly traded company.

Regarding the accounting treatment of donation behavior by controlling shareholders or their related parties, Chinese regulatory authorities have issued several provisions. Firstly, 'Finance and Accounting Letter No. 60 of 2008' issued by the Chinese Ministry of Finance (2008) stipulates that if an enterprise accepts donations and debt exemptions from non-shareholders, it should be recognized as current income in accordance with accounting standards. If a direct or indirect donation is accepted from the controlling shareholder or its related parties, its economic substance is judged to be the controlling shareholder's capital investment in the enterprise, which is an equity transaction. The enterprise's relevant gains cannot be recognized as current income. Instead, they should be recorded in the capital reserves of the owner's equity.

Secondly, 'Announcement on Relevant Matters Concerning the Preparation, Disclosure, and Audit of 2010 Annual Reports' [2010] No. 37, issued by the China Securities Regulatory Commission (2011), stipulates that companies should distinguish between contributions by shareholders and market-based transactions based on normal commercial purposes. For direct or indirect donations (including cash or physical assets, direct waivers, or debt repayments) from controlling shareholders or their related parties to the publicly traded company, the economic essence indicates a specific relationship between the publicly traded company and the donor. When the nature of the transaction is a capital injection, the gains of the publicly traded company also need to be recorded in capital reserves, rather than in current profit and loss. At the same time, transactions between the publicly traded company and potential controlling shareholders or their related parties that involve benefits transfer should also be judged and regulated according to this principle.

Thirdly, the 'Analysis of Cases on the Implementation of Accounting Standards for Business Enterprises by Publicly Traded Companies' released by the China Securities Regulatory Commission (2020) publicly traded the 'Answers to Supervision Questions on the Implementation of Accounting Standards for Business Enterprises by Publicly Traded Companies (Issue 2, 2009)' which provides detailed answers to the questions about the implementation of accounting standards for enterprises. If the controlling shareholder or its related parties transfer benefits to a publicly traded company and its economic substance is judged to be of the nature of the capital investment, the profits generated by the publicly traded company must also be included in the capital reserve and cannot be included in the current profit and loss. It also stipulates that the above-mentioned transactions between publicly traded companies and potential controlling shareholders or their related parties should also be judged and supervised in accordance with this principle.

Fourthly, 'Interpretation No. 5 of Accounting Standards for Business Enterprises' issued by the Ministry of Finance (2012) clarifies the accounting treatment of direct or indirect (including debt repayment and debt exemption) donations by enterprises. If the donor is a non-controlling shareholder or its related party, according to the provisions of the Accounting Standards for Business Enterprises, it can be recognized as current income; if the donor is the controlling shareholder or its related party, it cannot be included in the current profit and loss, but the relevant profits should be directly included in the owner's equity (capital reserve).

It can be found that based on the above relevant provisions, the accounting treatment of donations needs to be based on professional judgment (Li, 2019), which can be analyzed from two aspects. First, whether there is an affiliation between the donor and the benefiting enterprise. According to the initiative announcement, the potential compensator in bottom-up commitments is often the controlling shareholder, actual controller, or chairman of the publicly traded company, and there is a clear affiliation with the publicly traded company, making them a related party. Second, the judgment of capital investment. In practical judgment, the judgment of identity is only the preliminary step in determining accounting treatment, while the judgment of the nature of economic business is the substantive judgment and an important link in determining accounting treatment. In the transaction between the publicly traded company and the sponsor, the publicly traded company clearly benefited unilaterally at zero consideration. The transaction was not a fair market transaction based on normal commercial purposes, and the publicly traded company did not need to repay the sponsor's investment. This type of increase in holdings is a capital investment rather than a debt investment.

3.2.1.2. from the perspective of China's contract law. According to the 'Contract Law of the People's Republic of China' promulgated in 1999 and the 'Civil Code of the People's Republic of China' revised in 2020 (hereinafter collectively referred to as the 'Contract Law'), a gift contract refers to the act of giving one's own property free of charge to the recipient and is accepted by the recipient. A donation contract has the following characteristics: (1) It is a contract to transfer the ownership of the subject matter; (2) It is a gratuitous contract. (3) It is a unilateral contract. (4) It is a kind of promise contract, that is, its effectiveness is weak, and it can be reached as long as the two parties agree on their intentions, and the donor party's obligation to deliver the subject matter or other payment obligations is the contractual obligation.

According to the Contract Law, a gift contract is not based on transaction consideration and is gratuitous. In the bottom-up holding initiative, the bottom-up holding agreement between the sponsor and the publicly traded company transfers the ownership of the underlying monetary funds in the form of monetary fund payment after it takes effect. In addition, the requirement in the initiative announcement that company employees purchase stocks and hold them for a certain period of time and remain employed during this period can be regarded as an agreed condition for this incentive between the publicly traded company and its employees. If employees do not comply with this requirement, the incentive will not take effect. This agreement is separate from the gift contract and does not affect its validity; on the other hand, it can be regarded as an additional obligation of the sponsor for the gift contract. If the recipient employee fails to fulfill this obligation, the proponent shall have the right to revoke the donation in accordance with the Contract Law (now Article 661 of the Civil Code). Since this obligation does not form a relationship of mutual payment of consideration, the sole nature and gratuitous nature of the gift contract cannot be denied because the gift is accompanied by an obligation.

As for the 'losses incurred due to the increase in shareholding and unrealized expected gains' promised in the announcement, these are considered terms of the gift contract's effectiveness. These terms do not affect the formation of the gift contract. That is, the gift contract is subject to the conditions. It will take effect when it is realized, and the sponsor will contribute capital on behalf of the publicly traded company to make up for employee losses or expected profits. If the conditions are not realized, it will be established but not effective. This additional condition will not affect the sole and gratuitous nature of the contract. Based on the above analysis, it can be found that the bottom-up holding behavior is completely consistent with the economic essence of the gift contract.

3.2.2. Accounting treatment analysis of bottom-up holding increases

Based on the economic substance analysis of the bottom-up holding increase, this article aims to explore the accounting treatment of bottom-up holding increases using examples. Assuming the initiators of a bottom-up holding increase initiative, as stated in a certain publicly traded company's announcement, make the following proposal:

Our company's controlling shareholder XX has made the proposal and commitment to those employees of the company or the company's holding or wholly-owned subsidiaries who use their own funds to net purchase the company's stocks through the secondary market from June 7, 20X1, to June 30, 20X1, and hold the company's shares for a continuous period of 24 months or more and remain employed. If the yield during the holding period is less than 20% (i.e., an annualized yield of not less than 10%, calculated from July 1, 20X1), the sponsors promise to compensate those employee shareholders with 20% of the holding income. However, if the holding period is less than 24 months due to partial sales, no compensation will be provided for the reduced portion. Additionally, if an employee leaves the company within 24 months from the date of purchase, no compensation will be provided. If the yield on the purchased shares exceeds 20%, all proceeds will belong to the purchasing employees, and the sponsors will no longer provide compensation.

(1) Detailed implementation rules

(2) Calculation of Compensation Time:

Purchase date: From June 7, 20X1, to June 30, 20X1.

Sale date: Within 10 trading days starting from June 31, 20X3.

Compensation amount calculation equation:

$$\text{Compensation amount} = (\text{average net purchase transaction price} * (1 + 20\%) - \text{average selling price}) * \text{actual quantity of shares sold} \quad (1)$$

where,

the average purchase price is the average price of all stock purchases during the 'purchase date' period.

the selling price is the average price of all stock sales during the 'sale date' period;

the actual quantity of shares sold refers to the stocks actually sold by the employees who are the participants of the initiative during the 'purchase date' period on the 'sale date.'

If the compensation amount is greater than zero, it involves promised compensation. At this time, if all the stocks are sold within the stipulated sale date, the compensation will be calculated based on 'compensation amount = total purchase amount – total sales amount'; if not sold within the stipulated sale date, part of the shares will be sold and calculated according to the above formula (1) and compensation will be calculated. No compensation will be given for shares that have not been sold.

If a major event occurs that causes the company's stock to be suspended or the stock to be unavailable for trading, or the expiration date falls on a trading suspension day such as a holiday, the above corresponding dates will be postponed accordingly.

(3) Compensation Method and Funding Source

The form of compensation is cash; the source of funds is from the controlling shareholder XX's own or self-raised funds.

(4) Progress of the initiative

During the buying initiative period (i.e., from June 7, 20X1 to June 30, 20X1), a total of XX employees of the company and employees of wholly-owned subsidiaries and holding subsidiaries increased their holdings of company stocks through the secondary market, a total of 1 million shares of the company's stock were increased, with an average purchase price of 10 yuan/share (RMB, the same below). The total increase amount is of RMB 10 million yuan.

(5) Accounting treatment (assuming that employee departures during the bottom-up investment initiative is not considered)

Waiting period: December 31, 20X1

On December 31, 20X1, assuming the closing price of the stock is lower than $10 \times (1 + (20\%/2)/2) = 10.05$ yuan/share, if the closing price is 10.02 yuan/share, the sponsor's potential back-up compensation is $(10.05 - 10.02) \times 100 = 30,000$ yuan.

In financial accounting, this is recorded as a debit to 'management expenses' and a credit to 'capital reserves – other capital reserves'.

If, on December 31, 20X1, the closing price of the company's stock is higher than or equal to $10 \times (1 + (20\%/2)/2) = 10.5$ yuan per share, for example, 11 yuan per share, there is no need for accounting treatment.

(6) Waiting period: December 31, 20X2

When the closing price of the company's stock on December 31, 20X2 is lower than $10 \times (1 + 20\% \times 1.5/2) = 11.5$ yuan/share:

If there is no record of debit to 'Management Expenses' and credit to 'Capital Reserves – Other Capital Reserves' in the books on December 31, 20X1, the sponsor's potential bottom-up compensation will be recorded. This is recorded as a debit to 'Management Expenses' and a credit to 'Capital Reserves – Other Capital Reserves' and other accounts. The amount is calculated as $(11.5 - \text{average purchase price}) \times \text{total number of shares held under the bottom-up cover scheme}$.

If there are records in the books on December 31, 20X1, that is, 'management expenses' have been debited and 'capital reserves – other capital reserves' and other accounts have been credited, the difference will be made up on the record on December 31, 20X2. That is, debit 'management expenses' and credit 'capital reserve – other capital reserve' and other accounts, and make the balance of 'capital reserve – other capital reserve' and other accounts equal to the balance as of December 31, 20X2. The sponsor calculates the promised amount to be paid based on the promised rate of return.

(7) When the closing price of the company's stock on December 31, 20X2 is higher than $10 \times (1 + 20\% \times 1.5/2) = 11.5$ yuan/share:

If there was no record of debit to 'management expenses' and credit to 'capital reserves – other capital reserves' or other accounts on December 31, 20X1, there is no need for accounting treatment this year.

If there are records of debit 'management expenses' and credit 'capital reserves – other capital reserves' and other account balances in the books on December 31, 20X1, then the current year needs to reverse the previous year's records, that is, debit the balance of accounts such as 'capital reserve – other capital reserve' and credit 'management expenses'.

It can be found that if the actual price of the stock is higher than the stock price calculated based on the bottom-line commitment at the end of the accounting reporting period, no accounting treatment is required, but corresponding information disclosure is still required.

(8) Expiration date: June 30, 20X3

After the commitment period expires, the sponsor and the publicly traded company specifically calculate the commitment payable based on the initiative commitment. As mentioned above, the publicly traded company will make up the book balance or reversely offset the book balance. When making the specific payment, the publicly traded company does not need to perform accounting treatment, and the proponent can debit the contingent liability and credit the bank deposit.

Of course, if any participating employees choose to resign or sell the company stocks they previously increased their holdings within a specific period of time, there is no need to consider the market price and rate of return of the stocks. The difference in provision for this part of the shares can be directly offset, and the subsequent accounting treatment will be carried out. Remove it from the total increase in shares.

4. Discussions, conclusions, limitations and future research

4.1. Discussions

With the continuous evolution and development of China's capital market, new incentive methods for publicly traded companies are also constantly emerging. However, there is a certain lag in the relevant standards and regulations.

Firstly, bottom-up shareholding increase is a unique phenomenon in China that has not yet occurred in other countries. Therefore, there are no relevant accounting standards in other countries, even developed countries to guide the accounting treatment of this behavior issued by listing companies.

Secondly, the phenomenon of bottom-up shareholding increase was first observed in China in 2015. However, the guidance on accounting treatment application cases was only proposed in May 2021. Unfortunately, the current guidance does not accurately reflect the economic essence of bottom-up holdings. Therefore, the application case guidance provided by the Chinese government is currently not very accurate.

In view of this, it is necessary for us to present our views through this article and hope to work together with international scholars to improve the accounting treatment for bottom-up shareholding increase.

4.2. Conclusions and implications

This study aims to clarify the accounting treatment of bottom-up shareholding increases by publicly traded companies in China. We conduct a comprehensive example analysis by analyzing the economic substance and accounting treatment of bottom-up holding increases and get the following conclusions.

The essence of bottom-up holdings is that the promoters of publicly traded companies bear the bottom-line losses or bottom-line profits from the stocks purchased by the publicly traded company's employees. Each accounting reporting period, the publicly traded company should compare the promised price at the granting date of the bottom-up holding increase initiative with the stock price on the balance sheet date. When the promised price is higher than the balance sheet date stock price, the difference is recognized as an amount to be credited or recorded in the accounting books, with the debit as 'management expenses' (current profit and loss) and the credit as 'capital reserves – other capital reserves' (owner's equity). When the promised price is lower than the balance sheet date stock price, the difference is written back within the promised period, with the debit to 'capital reserves – other capital reserves' (owner's equity) and the credit to 'management expenses' (current profit and loss).

Based on the research in this article, we also draw the following implications: firstly, our accounting treatment should be based on the economic essence of the company's business, rather than on appearances; Secondly, the formulation of accounting rules originated from economic businesses, but lags economic businesses. Therefore, it is necessary to strengthen the application of accounting theory and practice to reduce the worldly distance between accounting rules and actual economic businesses.

4.3. Limitations and future research

Firstly, this article only uses a qualitative analytical methods, utilizing a case study approach to elucidate the accounting treatment of share-based payments involving bottom-up shareholding increases. This approach, while informative, lacks further confirming the research conclusions through empirical research methods. Secondly, the phenomenon of bottom-up shareholding increases represents a distinct occurrence within the Chinese market context, one that has not been documented or analyzed in international research literature. In other words, there has been no relevant international research. We have not focused on critiquing and evaluating the 'Application Case of Share-based Payment Standards – Big Shareholder Backdoor Equity Incentive Plan' released by the Chinese Ministry of Finance.

Recognizing these limitations, there is a clear path forward for enhancing the understanding and analysis of bottom-up shareholding increases. Future research will aim to gather a comprehensive inventory of real-world cases where bottom-up shareholding increases have occurred within China. By employing empirical research methodologies across a broad dataset, the goal is to deepen the investigation into this phenomenon. This approach will not only validate the initial qualitative insights with quantitative evidence but also contribute to a more nuanced understanding of the implications and mechanics of bottom-up shareholding increases in the context of global accounting standards and practices.

Note

1. http://kjs.mof.gov.cn/zt/kjzss/srzzzq/gfzfyyal/202105/t20210518_3704076.htm.
<http://kjs.mof.gov.cn/zt/kjzss/srzzzq/gfzfyyal/202105/P020210518378130607194.pdf>.

Authors contributions

Lixia Wang: Conception and design; The final approval of the version to be published.

Vigdis W Boasson: Revising it critically for intellectual content.

Guoqing Xu: Analysis and interpretation of the example; The drafting of the paper.

All authors agree to be accountable for all aspects of the work.

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Guoqing Xu, Postgraduate in Shanghai University. His research is bottom-up shareholding increase and equity incentive.

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