

SHARE BUY-BACKS GIVE CORPORATES LONG-AWAITED EQUITY BOOST

After many years of lobbying and consultation, it looks as if UK law is about to allow companies to buy back their own shares and hold them 'in treasury', able to be reissued to investors – or option holders – at a later date.

A consultation paper on share buy-backs was issued by the DTI in May 1998 and, a year later, the DTI decided to deregulate in this area of company law. A DTI consultation paper on treasury shares was issued in September 2001 and responses were summarised in a paper published in May 2002. Draft regulations were proposed in February 2003 and the government expects these regulations to be brought into force later this year, on the same day that various consequential tax law changes are enacted by this summer's Finance Bill.

Until now, companies had to cancel any shares they bought back, and could not reissue them except through the usual new issue procedures. The introduction of treasury shares means that companies will be able to actively manage their capital base efficiently and cheaply.

As Sheelagh Killen, technical editor at the Association of Corporate Treasurers, says in a recent article in *The Treasurer*, treasury shares "should allow companies to run, on average, with a higher level of debt/equity gearing and a consequently lower cost of capital".

The responses the DTI received

to its September 2001 consultation paper were more mixed with regard to the financial benefits of the proposal, however. A couple of respondents were unsure there would be any cost benefit, though the DTI says that one respondent – the Association of Corporate Treasurers – insisted that the benefits to be derived from this "cost-effective tool for active capital management were expected to be considerable".

The proposal is that a company will be able to seek shareholders' permission to hold up to 10% of nominal capital as treasury shares (the relatively small proportion is one reason why some may consider that the treasury shares proposal will be of limited value, compared with the size of some recent rights issues). Such permission would have to set out the maximum number of shares involved, the prices at which share buy-backs can take place and a time limit on such authorisation.

Holding in treasury

Shares held in treasury will not have any voting rights, nor are they entitled to dividends or any assets on a winding up. (Clearly, they are entitled to bonus shares in the event of a scrip issue, to keep everything pro rata.)

Killen points out that current US practice is to disregard treasury shares when calculating earnings per share. They must be recorded clearly in the share register as being owned by the company – in other words, they may not be held by a nominee company – with

appropriate disclosure in the annual report, and regulatory disclosure of purchases and sales.

The new rules will only apply to companies whose shares are listed on a stock market or are traded on AIM. If a company holds treasury shares and is, for example, taken over or taken private, the treasury shares must be cancelled forthwith.

Reissuing

Any shares bought back may be reissued at any time (subject to a number of Listing Rules restrictions) and must be paid for out of distributable reserves. So if, for example, a company wishes to buy back ordinary shares funded by the issue of preference shares, the ordinary shares must be cancelled and not held in treasury.

If shares are subsequently resold to investors, then the premium paid over par value can be treated as a realised gain, with any excess over that treated as an unrealised profit. Below is an example from Killen's article:

- A corporate treasury buys £1 shares at £1.20.
- They are later resold at £1.50.
- Realised profits = 20p per share.
- Unrealised profits = 30p per share (recorded in the share premium account, according to the draft regulations).

There is no regulation prohibiting the sale of treasury shares at a price below their par value (cf: an issue of new shares). With the following exception, shares cannot be sold for anything other than cash: one of the most important aspects of reissuing treasury shares is that they can be used to cover certain employee or director share, or share options schemes (see Options 1, page 48), regardless if they are bought for cash.

Institutional investors and their representative bodies, such as the Association of British Insurers and

the National Association of Pension Funds, have been concerned about how treasury shares might affect their pre-emption rights. These rights are still intact and apply to the reissue of treasury shares, except that companies can seek shareholder approval to dispense with that right (as, indeed, they commonly do at present) at the same time as seeking permission to hold shares in treasury. The ABI, NAPF and ACT are expected to work together to prepare some best practice guidelines.

Accounting

Killen explains that, as there is no UK accounting treatment for treasury shares yet, companies will likely look to the international standard, IAS 32: *Financial instruments: Disclosure and presentation* and the *Statement of Interpretation* SIC 16. Treasury shares should be deducted from equity, and not reported as an asset. No gain or loss should be recorded in the p&l on the purchase or sale of treasury shares.

Andrew Sawers.

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Useful links

- The new draft regulations are available at www.dti.gov.uk/cld/holdingtreasury.pdf
- The Association of Corporate Treasurers is at www.treasurers.org