HOLDING YOUR OWN IN SHARES

THE DEPARTMENT OF TRADE & INDUSTRY'S FINAL DRAFT OF PROPOSED REGULATIONS IS GOOD NEWS FOR UK TREASURERS, AS IT MEANS AT LONG LAST TREASURY SHARES WILL BE AVAILABLE IN THE UK. **SHEELAGH KILLEN** PROVIDES AN INTRODUCTION.

The Department of Trade & Industry (DTI) has recently issued the final draft of proposed regulations that will introduce treasury shares into UK treasury practice during 2003. Treasury shares have been permitted in other jurisdictions such as Japan, Germany and the US for some time, but many UK treasuries will be exploring the opportunities offered by this tool for the first time. Therefore, Treasury Essentials this month offers students of The Association of Corporate Treasurers (ACT) a brief beginner's guide to treasury shares.

WHAT ARE TREASURY SHARES?

Treasury shares are shares in a company which are acquired by that company and held by them. These shares can then either be 're-issued' (that is, sold for cash) into the market by the company at some future date or, alternatively, cancelled.

WHY ARE TREASURY SHARES IMPORTANT TO TREASURERS?

A company's cost of capital is determined by the implied cost of its issued equity, its cost of debt and the ratio of debt to equity within the company's capital base (known as 'gearing'). As the post-tax cost of debt is generally cheaper than that of equity, companies may seek ways of reducing their cost of capital by raising greater levels of debt relative to equity.

In some instances, the optimum method to achieve this may include the buy-back of the company's shares. This is particularly attractive where management believes that the company's shares are presently undervalued by the market.

Currently, under English Law, once a share re-purchase has been effected, the shares acquired by the company must be cancelled. This means that once equity has been reduced in this way, the move cannot be reversed, except through a formal new issue. The availability of treasury shares (which permit treasurers to buy shares and re-issue them quickly and cost-effectively) will give companies additional flexibility in the management of their capital base.

This should allow companies to run, on average, with a higher level of debt/equity gearing and a consequently lower cost of capital. For this reason, the ACT has been supportive of the proposals to introduce treasury shares in the UK and has been instrumental in the DTI's consultation process.

A secondary application for treasury shares is to assist in the operation of company share schemes. For example, before treasury shares were introduced, some companies established offshore trusts funded by the company in order to acquire shares for distribution to staff under employee shares schemes. Now companies which are permitted to hold treasury shares will be able to acquire shares for later distribution, as treasury shares will either be transferable to an employee share scheme or available to satisfy employee share options. The shares, however, will not be relevant to employee share incentive plans (SIPs) where employees have a beneficial interest in shares from the start of the scheme. This is because treasury shares will not rank for dividends (see below).

WHAT WAS A KEY ISSUE FOR DEBATE BEFORE UK TREASURY SHARES COULD BE INTRODUCED?

One of the key aspects that had to be considered in relation to the re-issuance of shares was the question of pre-emption rights. These rights provide that existing shareholders should be offered 'first refusal' of any new shares issued in a company before these can be sold to third parties. This prevents the holding of the current shareholders becoming diluted against their will. For example, if four shareholders currently hold 250 shares in a company with 1,000 shares, each owns 25% of the total value of the company. If 250 new shares are issued to a third party (at a fair price in relation to the rest of the company), each of the original shareholders still owns 250 shares, but this holding now represents just 20% of the total company value. There is no immediate economic loss to that shareholder as he or she now owns 20% of a more valuable company (because of the inflow of funds from the new issue). However, their exposure to the performance of the company will change going forward as they will be entitled to a smaller share of the total gains or losses which the company makes.

Equity investors were keen that shareholders pre-emption rights should not be significantly compromised by the use of treasury

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shares. Therefore, professional bodies representing investors, particularly in the institutional sector, have been very active in the UK consultation process for treasury shares. For example, the Association of British Insurers (ABI) and the National Association of Pension Funds (NAPF) have worked closely with the ACT in developing the concept of treasury shares and will be joining with the ACT in issuing best practice guidance on their use. Under the latest draft UK regulations for treasury shares, pre-emption rights for shareholders will be preserved, subject to the existing shareholder discretions to vary these by special resolution.

WHAT ARE THE PROPOSED NEW RULES FOR UK TREASURY SHARES?

The draft DTI regulations will allow companies to hold up to 10% of their nominal share capital (or up to 10% of any one class of shares) as treasury shares, subject to gaining the approval of their shareholders. This approval will set out the maximum number of shares which can be acquired, the range of permissible prices to be paid for shares and the period for which authorisation is given. Treasury shares can be then be re-issued without advance permission of shareholders, except at particularly sensitive times such as those indicated by the regulatory guidance, including the Model Code[1] and the Alternative Investment Market (AIM) rules[2]. As mentioned above, pre-emption rights will remain in place but can be varied in accordance with a company's articles or by special resolution of the shareholders.

According to the present draft proposals, only 'qualifying shares' are within the scope of the new treasury shares regime. In general, this means the shares of companies included in the UK official list, the AIM and EU-listed companies. Therefore, only these listed companies can take advantage of the new rules.

The detail of the regulations specify that unless treasury shares are purchased for immediate cancellation, any purchase must be paid for out of distributable profits (rather than by issuing new shares). It should also be noted that any proceeds on the subsequent sale of treasury shares which equate to the premium over par already paid by the company on acquiring these shares may be treated as realised profits (as the purchase was originally funded from distributable reserves). The excess of sale proceeds of treasury shares over the purchase price is regarded as unrealised profit for the purposes of company law. For example, if a treasury buys £1 shares at £1.20 each and sells them at £1.50, on disposal, 20p of the proceeds will be realised profits and the remaining 30p unrealised.

Treasury shares cannot be held by nominees and must be recorded in the share register. Details of purchases should be disclosed in the company's annual report and regulatory disclosure rules will also apply to purchases and sales by a company's treasury. No dividends will be payable on treasury shares and they will not hold entitlement to a share of assets on a winding up. The shares will carry no voting rights, although they will be eligible for bonus shares in a scrip issue. In countries such as the US, where treasury shares are used, it is accepted practice to ignore treasury shares when computing earnings per share.

Corresponding changes to the Companies Act and the UK Listing Rules will be made to accommodate the new regime. The Finance Bill 2003 will also contain related amendments to tax legislation.

WHAT WILL BE THE ACCOUNTING FOR TREASURY SHARES?

As treasury shares have not previously existed in the UK, no specific UK GAAP guidance on this topic has yet been published by the Accounting Standards Board. However, as UK GAAP is converging with International Financial Reporting Standards, it is presumed that the accounting for treasury shares will follow the model developed in IAS 32: *Financial Instruments: Disclosure and Presentation* and the related *Statement of Interpretation SIC 16*. SIC 16 states that: "Treasury shares should be presented in the balance sheet as a deduction from equity, and the acquisition of treasury shares should be presented in the financial statements as a change in equity. Treasury shares may not be reported as an asset. Additionally, no gain or loss should be recognised in the income statement on the sale, issuance, or cancellation of treasury shares, and consideration received should be presented in the financial statements as a change in equity." The ACT supported this treatment in its response to the DTI consultation.

WHERE CAN I FIND OUT MORE ABOUT TREASURY SHARES?

Copies of the new draft regulations can be downloaded via the DTI website at www.dti.gov.uk/cld/holdingtreasury.pdf. The ACT's contributions to the treasury shares consultation can be accessed at www.treasurers.org/treasury_resources/technical-papers.cfm. More information on pre-emption rights and purchase of own shares can be found in the UK Country Guide in *The Treasurer's Handbook 2003*, p506.

There will be further coverage of treasury shares in *The Treasurer* over the coming months and the ACT is looking at organising a member event on this topic shortly.

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Notes

[1] *Can be downloaded in pdf format at www.fsa.gov.uk/pubs/ukla/chapt16-3.pdf*

[2] *Can be downloaded in pdf format at www.londonstockexchange.com/aim/rules.asp*