BUYING BACK SHARES

FROM 1 DECEMBER, UK COMPANIES WILL BE ALLOWED TO HOLD TREASURY SHARES, SOMETHING THEIR US AND EUROPEAN COMPETITORS HAVE BEEN DOING FOR YEARS, SAYS **PETER ELWIN** OF CAZENOVE.

From 1 December 2003, listed UK companies will be able to buy back their own shares and hold them 'in treasury' rather than cancelling them. The transaction will reduce distributable reserves, but when the shares are re-issued the reduction will be reversed. The re-issue of treasury shares will be subject to restrictions, as we will outline below.

CURRENT UK PRACTICE. Under the Companies Act 1985, companies are permitted to purchase their own shares, but these shares must immediately be cancelled – they cannot be held and subsequently sold on – and the repurchase must be funded out of distributable reserves or by issuing new shares.

THE NEW REGULATIONS. The new regulations[1] will enable listed companies (including those traded on AIM or European markets) to buy their own shares and hold them as 'treasury shares' indefinitely. Shares can be sold, transferred under an employee share scheme or cancelled at the company's discretion.

They can be acquired as part of a normal share buyback programme, but the UK Listing Authority has said that companies should indicate the purpose of the buyback when seeking shareholders' permission.

If a company holding treasury shares subsequently delists, the treasury shares would immediately have to be cancelled.

Treasurers should note that there are a number of important restrictions relating to treasury shares:

- they cannot exceed 10% of the nominal value of the shares (or class of shares) in issue;
- they do not carry normal shareholders' rights (e.g. to vote or attend meetings);
- they are not entitled to dividends or other distributions (including on a winding up); and
- they are not entitled to participate in rights issues but they are entitled to any bonus shares – these will simply increase the treasury share holding.

TAX CONSIDERATIONS. The aim of the tax rules is to treat a treasury share transaction in exactly the same way as a buyback

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and cancellation, followed by a subsequent issue of new shares. Thus, the company will pay stamp duty as usual when shares are acquired (whether for holding or cancellation), the shares will be treated as cancelled for tax purposes, and there will be no CGT consequences when they are resold.

ACCOUNTING FOR TREASURY SHARES. UK Generally Accepted Accounting Principles (GAAP) are being altered to allow for the introduction of treasury shares.

Under the proposed rules, treasury shares should be deducted from shareholders' funds (effectively shown as negative equity). They will not be shown as an asset.

Transactions in treasury shares will not have any impact on the profit and loss account, or on the statement of total recognised gains and losses. Instead, consideration paid or net proceeds received will be shown in the reconciliation of movements in shareholders' funds.

This proposed treatment is the same as that currently required under International Accounting Standards (IAS) and US GAAP, and thus will not be affected when UK companies are required to adopt IAS in 2005.

THE IMPACT ON DISTRIBUTABLE RESERVES. Under the new rules, distributable reserves must be reduced by the cost of the treasury shares purchased – potentially restricting the company's ability to pay dividends in the future.

However, when they are subsequently resold, the proceeds of sale can be credited to distributable reserves. As might be

Treasury shares: action points

- Consider internal organisational issues: should the treasury function control treasury share dealing? Designate staff as dealers and update internal policies.
- Discuss the dealing process with the company's broker.
- Ensure that the legal framework is in place: discuss with lawyers; check Articles; get authority from members.

Example

Efficient PLC purchases two million 10p shares on the market for £3.50 each, with the intention of holding them as treasury shares. They are subsequently resold for £4.50. The accounting entries will be as follows:

Purchase
Cost of purchase = 2m x £3.50 = £7m (reduction in cash).
Distributable profits are reduced by a corresponding £7m.

Sale
Proceeds received = 2m x £4.50 = £9m (cash increases).
The original £7m removed from distributable reserves can be returned but the remaining surplus (£2m) is undistributable and is shown within the share premium account.
The impact of these transactions is summarised below. This example does not attempt to illustrate the variety of alternative presentations that can be used by companies – in common with IAS, neither the regulations nor UK GAAP prescribe a particular method.

	BEFORE	BUYBACK	AFTER	RESALE	AFTER
	£m	£m	£m	£m	£m
Share capital	20	–	20	–	20
Share premium	380	–	380	2.0	382
Distributable reserves	**1,500**	**-7.0**	**1,493**	**7.0**	**1,500**
Shareholders' funds	**1,900**	**-7.0**	**1,893**	**9.0**	**1,902**

By way of comparison, if the shares had been cancelled and then new shares issued subsequently, distributable profits would have remained at £1,493m.

expected, the amount that can be credited to distributable reserves is restricted to the amount originally deducted. Any excess 'profit' on resale must be credited to the share premium account and thus remains undistributable.

If the transaction had been done by way of a buyback and subsequent new issue, distributable reserves would remain depleted.

POINTS TO CONSIDER WHEN SELLING TREASURY SHARES. Four particular points will need to be considered when re-issuing treasury shares, as follows:

- Unlike new shares, treasury shares can only be sold for cash (including foreign currency) unless they are being transferred as part of an employee share scheme. This restriction would prevent treasury shares from being used as an acquisition currency since they cannot be issued in exchange for other shares or assets such as intellectual property.
- Pre-emption rights will apply unless they have been waived by the shareholders. It is likely that the Pre-emption Group guidelines will also apply to treasury shares, restricting any single non-rights issue to no more than 5% of the company's issued share capital (and no more than 7.5% for such issues in a three-year period). A final decision has not yet been made.
- Companies will be unable to sell treasury shares during close periods, or whilst they are the subject of a takeover bid.
- Treasury shares can be sold for less than their nominal value (unlike new shares) enabling companies to raise cash even when the share price is severely depressed without the need for a capital restructuring first.

REAPING THE BENEFITS. Treasury shares will enable UK companies to actively managing their weighted cost of capital since share buyback programmes can be reversed easily – for example, if investors become less tolerant of gearing or the company's capital requirements change.

Secondly, companies will be able to cover employee stock option plans, convertibles and warrants without issuing new shares, avoiding the dilution of existing equity holdings.

Thirdly, cash can be raised quickly and easily by placing treasury shares.

CONCLUSION. The treasury share regulations will align UK law more closely with the law in other countries and will add welcome flexibility to UK companies' ability to manage their finances.

However, the restrictions in the regulations mean that companies will still favour 'B' share issues and other forms of restructurings if they wish to return significant amounts of capital.

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Notes

[1] *Companies (Acquisition of Own Shares) (Treasury Shares) Regulations 2003 (http://www.legislation.hmso.gov.uk/si/si2003/20031116.htm)*

A follow-up article on the practical considerations for treasurers in using treasury shares will appear in the October edition of The Treasurer.