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Legal Developments

Business Combinations and Treasury Stock Acquisitions: The Current Position of the SEC

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The various aspects of accounting for business combinations as either purchases or poolings-of-interests have been discussed and debated for quite some time. One interesting area which has recently been resolved after almost four years of new rulings, opinions and hearings involves treasury stock acquisitions and their effect on the pooling-of-interests method of accounting.

The Problem

The Accounting Principles Board (APB) of the American Institute of Certified Public Accountants (AICPA) issued its Opinion No. 16 on Business Combinations[1] setting up the criteria for treating a business combination as a purchase or pooling-of-interests in 1970. A general provision was that if cash or other assets were given or liabilities incurred to obtain another business, such a combination must be treated as a purchase. A pooling-of-interests could occur if stock was exchanged. The APB realized that this rule had an obvious loophole: to circumvent the use-of-cash provisions, an acquiring company could simply use its cash (or other assets or incur liabilities) to buy shares of its own stock and then use this treasury stock to effect the business combination. Technically, the combination could be treated as a pooling-of-interests because only stock was used. (A pooling-of-interests might be desired because of the existence of non-depreciable goodwill, because the pooled earnings would increase the earnings-per-share, because a smaller asset basis would give a higher rate of return on assets, etc.)

APB Opinion No. 16 and Accounting Interpretation No. 20

To avoid this obvious problem, the APB Opinion required that "none of the combining companies changes the equity interest of the voting common stock in contemplation of effecting the combination either within two years before the plan of combination is initiated or between the dates the combination is initiated and consummated . . ."[2] However, companies could buy treasury stock of voting common stock if it was for "purposes other than business combinations."[3] Examples of other purposes would be new pension and profit sharing plans and "systematic reacquisitions" such as under existing pension plans, stock dividends (provided stock dividends have been given in the past in a systematic manner), etc.

In addition to a "systematic pattern," stock reacquisitions must be examined as to both the purpose for which shares were acquired and subject to the "reasonable expectation" rule. In other words, purchases of treasury stock must be for a specific purpose other than a combination and there must be a reasonable expectation that the reacquired shares will be used for the purpose designated. If these tests were not met, the resulting treasury stock was "tainted" and any business combination within two years of the reacquisition had to be treated as a purchase, unless the "tainted" shares were not material (defined as equal to or less than 10% of the total shares used to effect the combination).

An Accounting Interpretation was later issued by the AICPA which attempted to clarify the "other business purpose" test. After giving rather vague guidelines the Interpretation concludes that:

> In the absence of persuasive evidence to the contrary, however, it should be presumed that all acquisitions of treasury stock during the two years preceding the date a plan of combination is initiated (or from October 31, 1970 to the date of initiation if that period is less than two years) and between initiation and consummation were made in contemplation of effecting business combinations to be accounted for as a pooling of interests. Thus, lacking such evidence, this combination would be accounted for by the purchase method regardless of whether treasury stock or unissued shares or both are issued in the combination.[4]

The Interpretation also examined the methods by which "tainted" shares could be "cured." Any treasury shares held two years or more prior to a business combination were automatically "cured" — i.e., no longer "tainted," meaning the pooling-of-interest method could be used. Another "cure" was to sell a number of shares (either treasury shares or new issues) equal to the "tainted" shares prior to the consummation of the business combination. The Interpretation did not mention the "systematic pattern" test nor was the reacquisition of treasury shares subsequent to the combination discussed.

ASR No. 146.

In response to APB No. 16 and Accounting Interpretation No. 20, the Securities and Exchange Commission (SEC) issued Accounting Series Release (ASR) No. 146 on August 24, 1973. ASR No. 146 established guidelines and rules which were much more strict than those of the

AICPA. The SEC examined the criteria for avoiding "tainted" stock: Purpose, Systematic Pattern, and Reasonable Expectation.

Under the Purpose test, the SEC upheld the AICPA's Accounting Interpretation of Opinion No. 16 in its presumption of stock reacquisitions being for the purpose of effecting a business combination unless persuasive evidence to the contrary existed. The SEC went further to say that the "intended subsequent distribution of common shares rather than . . . the business reasons for acquiring treasury shares"[5] would be an appropriate approach for determining the purpose of the reacquisition. For example, a firm might buy treasury shares because the market price is low but that reason does not overcome the presumption that the purchase was made to effect a business combination and such shares would therefore be "tainted." However, shares reacquired to fulfill a contractual obligation, declare stock dividends, meet stock option requirements, etc. *unrelated to the business combination* would overcome the presumption of "tainted" stock.

The Systematic Pattern test could be met by the reacquisition of shares based on a specified number of shares or on such criteria as market price, cash availability, etc. However, these reacquisitions must be pursuant to a formal reacquisition plan unrelated to a business combination. Unanticipated interruptions in the carrying out of a reacquisition plan caused by legal constraints would not invalidate an otherwise systematic pattern.

The SEC's rules on the Reasonable Expectation test caused the most furor:

> The determination of whether there is reasonable expectation that shares will be issued for the stated purposes of acquiring the shares is a matter of judgment. Generally, there would appear to be such reasonable expectation where the following circumstances exist at the time a reacquisition plan is adopted or shares are reacquired:
>
> 1. As to stock option plans, warrants or convertible securities, the quoted price of the common shares is not less than 75 percent of the exercise or conversion price.
>
> 2. As to stock purchase or bonus plans or stock dividends, either (a) shares are reacquired to fulfill existing commitments or dividends declared or (b) based on a pattern of issuing shares for such purposes in the prior two years, the shares are reacquired to fulfill anticipated requirements in the succeeding year.

Since the market prices of stocks are currently so very low, the "75% of exercise price" rule applied to an increasing number of businesses. Due to the number of objections from registrants and accountants, the SEC agreed to suspend the effective date (on October 5, 1973) of ASR 146 and consider comments on the release.

Two other sections of ASR 146 deserve comment. The SEC noted that Accounting Interpretation No. 20 made no reference to the Systematic Pattern test and that many accountants assumed that this was no longer a test (as it had been under APB Opinion No. 16). ASR No. 146 reiterated that the Systematic Pattern test is certainly a criteria and had not been superceded.

Secondly, the SEC noted that APB Opinion No. 16 did not address itself to the question of treasury stock reacquisitions subsequent to the consummation of a business combination. The SEC ruled that "in specific fact situations, subsequent reacquisitions may be so closely related to the prior combination plan that they should be considered part of the combination plan"[6] meaning that the subsequent reacquisition could result in "tainted" shares and invalidate a pooling-of-interests treatment.

The ASR concluded by stating that the accounting for business combinations prior to the release would not have to be revised.

ASR No. 146A

After the SEC agreed to suspend ASR No. 146, it issued ASR No. 146A on April 11, 1974.[7] In essence, ASR No. 146A reaffirmed the SEC's position taken in ASR 146 with five modifications:

(1) The requirements of ASR No. 146 apply only to business combinations after April 11, 1974;

(2) The SEC recognized that for the purpose test, unusual circumstances may arise where reacquisition of shares can occur without "tainting" the stock. Examples were acquiring treasury stock to buy stock of a deceased shareholder pursuant to a legal agreement; settling claims relating to the original issuance of the stock; repossessing stock pledged as collateral on loans; and repurchasing stock from employees under a prior contractual agreement;

(3) The 75 percent reasonable expectation test is to be taken as a guideline, not as a rule. For example, if the market price represented volatility of the market price (rather than a trend) and if the remaining conversion period was long, the 75 percent rule would not apply;

(4) The 10 percent limitation of "tainted" shares, expressed in APB Opinion No. 16 as the materiality factor, would still apply; and

(5) No hard and fast rules for reacquisitions subsequent to the consummation of a business combination would be set, but each case would be considered individually.

Conclusion

Subsequent to the issuance of ASR No. 146A, members of the SEC staff and AICPA representatives met to discuss implementation and interpretation matters relating to the two SEC releases.[8] More than half the questions involved the Systematic Pattern Test and the rest of the questions were rather equally distributed among effective dates (only reacquisitions of business combinations after April 11, 1974, are subject to the rules of ASR Nos. 146 and 146A. Prior to that date, reacquisitions and combinations are subject to the rules of APB Opinion No. 16 and Accounting Interpretation No. 20.), issuance of shares after April 11, 1974, and the Purpose and Reasonable Expectation tests. The entire memorandum (although not an official position of the Commission) will be published in the *Journal of Accountancy*.[9]

In conclusion, if a client is contemplating a business combination and prefers the pooling-of-interests method of accounting, the CPA must establish whether, under ASR Nos. 146 and 146A, "tainted" treasury stock exists and determine how the "tainted" shares can be cured. This can be done several ways, including the Purpose, Systematic Pattern, and Reasonable Expectation tests. If this fails, a cure can be effected through time (two years) or by the reissuance of stock prior to the consummation of the business combination. In any case, the accountant must study the applicable rules very carefully.

Footnotes

[1] *Accounting Principles Board Opinion No. 16 - Business Combinations* (American Institute of Certified Public Accountants, New York, N.Y., August 1970).

[2] *op. cit.*, paragraph 47-C.

[3] *op. cit.*, paragraph 47-D.

[4] AICPA Accounting Interpretation No. 20 (September, 1971).

(Continued on page 25)