SULLIVAN & CROMWELL

NEW YORK TELEPHONE (212) 952-8100
TELEX 62694 (INTERNATIONAL), 127816 (DOMESTIC)
CABLE ADDRESS LADYCOURT, NEW YORK

48 Wall Street, New York 10005

250 PARK AVENUE, NEW YORK 10017
17, AVENUE MATIGNON, 75008 PARIS
21 IRONMONGER LANE, LONDON EC2V 8JB

November 15, 1973

The Chief Accountant,
Securities and Exchange Commission,
Washington, D.C. 20549.

Re: Accounting Series Release No. 146,
Securities Act Release No. 5429 --
Effect of Treasury Stock Transactions
on Accounting for Business Combinations

Dear Sir:

This letter is in response to the Commission's invitation for comments on its proposed Accounting Series Release No. 146 ("ASR 146"), relating to the effect of treasury stock transactions on accounting for business combinations.

As the Commission observes in ASR 146, the conditions set forth in paragraphs 47-c and 47-d of Accounting Principles Board Opinion No. 16 ("APB 16"), relating to the reacquisition of certain shares in connection with poolings of interest, have been subject to varied interpretations in practice. We commend the Commission for undertaking clarification in this area, but we believe that in several respects ASR 146 goes beyond desirable clarification and imposes substantive accounting requirements that could lead to severe hardship and unexpected results.

Of primary concern is the statement that ASR 146 is to be applied to all business combinations after the date

of the release, even though the shares used in these combinations may have been reacquired within the past two years in accordance with authoritative accounting pronouncements at the time. We believe this could lead to severe hardships, including unforeseen risks of liability, if issuers, having relied in good faith upon the advice of independent accountants and having taken action with significant economic and financial consequences, may now be denied poolings of interest accounting because share reacquisitions are now proscribed by ASR 146. This is a particularly acute problem in terms of ASR 146's requirement for a "systematic pattern" of reacquisition, and its criteria in determining whether there is a "reasonable expectation" that reacquired shares will be issued for the purposes stated. We urge that ASR 146 be adopted without any retroactive effect and that it be applied prospectively only.

Second, we are also concerned with the penultimate paragraph of ASR 146 which states that "significant reacquisitions [of shares] closely following a combination which otherwise qualifies as a pooling of interests may invalidate the applicability of that method". As the Commission notes, there is no discussion of this point in APB 16, nor is there any in Accounting Interpretation No. 20 of the American Institute of Certified Public Accountants ("AICPA 20"). If this statement in ASR 146 is intended as a warning to alert issuers and accountants <u>prior to a combination</u> as to the possible relevance of events occurring subsequent to the combination, we believe it serves a useful purpose. If, on the other hand, this paragraph has broader significance and may be a basis for a "second look" at the appropriateness of pooling of interests accounting at some unspecified later time, we believe it raises serious potential difficulties. Quite obviously, clear cases of fraud will invalidate a pooling, and this point needs

no elaboration in a release of the Commission. In other cases, however, a decision of an issuer and its independent accountants, arrived at in good faith on the basis of the relevant facts then existing, should not be subject to reexamination as a result of purchases within some unspecified post-combination period. This conclusion seems appropriate in light of the substantial significant economic and financial consequences of reacquisition programs and their potential effect on business combinations. A contrary view would seem to us to overlook the substantial potential liabilities and litigation risks which otherwise would be present, especially if the Commission has reviewed a proxy statement or registration statement in connection with the combination prior to its consummation. Moreover, it is not clear from ASR 146 whether a problem on reexamination can be cured by a sale of the post-combination reacquired shares. Accordingly, if this paragraph is retained, we urge that the Commission make it clear it is intended merely as a caveat as to the relevance of an issuer's intent at the time of combination on the accounting determinations then made. As discussed more fully below, this is an instance where we believe it of great importance that the intent and facts existing at the time a course of action is taken be given dispositive weight.

In addition to the foregoing comments, we have certain additional comments on the proposed release.

"Systematic Pattern" and "Reasonable Expectations"

We do not believe it is necessary to require that treasury shares acquired within the restricted period for recurring distributions be considered "tainted" unless they are both acquired in a "systematic pattern" and there is a

"reasonable expectation" that the shares will be issued for the stated purposes. Rather, a good faith determination by an issuer that there is a reasonable expectation that shares proposed to be reacquired will be used as stated seems to us to be the more appropriate test. At the very least, we suggest this be the case when the determination is concurred in at the time by the issuer's independent accountants.

The fact that ASR 146 permits a newly-adopted stock option or compensation plan to be "funded" without regard to the "systematic pattern" requirement illustrates, in our view, that the requirement may not be necessary for the intended purposes of the release.

The requirement of a systematic pattern may make it impossible for an issuer that has not previously declared stock dividends to commence a program of purchasing shares for that purpose and still retain its flexibility to pool. Furthermore, employee participation under stock option, bonus or purchase plans is not necessarily predictible, and an issuer may not find it desirable for sound economic reasons to purchase shares on a systematic basis. Similarly, there may be no present commitments, and anticipated future requirements are subject to change irrespective of potential poolings. Moreover, with respect to the price of the shares not being less than 75% of the exercise or conversion price of options, warrants or convertible securities, the standards in ASR 146 appear to give no consideration to anti-dilution adjustments, variable conversion or exercise prices or market fluctuations over the period in question.

The foregoing suggests to us that the requirement of a "systematic pattern" may appropriately be eliminated from ASR 146. We believe that a good faith determination by a Board of Directors that there is a reasonable expectation that reacquired shares will be used for stated purposes unrelated

to a business combination is the proper and more equitable test to apply. For example, what if a systematic pattern is no longer economically sound, but still desirable in light of commitments - can the issuer suspend purchases for an indefinite period and renew them when market or earnings conditions improve? It seems to us that given the risks of liability if the Board of Directors proceeds otherwise than in accordance with sound business judgment and the best interests of shareholders, and given the resulting economic and financial commitments, the requirement of a "systematic pattern" can result in a Board being forced to continue a program against its best judgment in order to preserve its right to pool, and can prejudice those companies wishing to initiate valid programs involving treasury shares, or wishing to consummate an acquisition, feasible only as a pooling, which was not foreseeable when their share acquisition programs were initiated.

With respect to the requirement that there be a "reasonable expectation", we believe that this test should be applied at the time of the Board's decision to acquire shares or to institute a program for such acquisition, without regard to subsequent events which cannot be foreseen or allowed for. For example, ASR 146 indicates in connection with "purchases" and contingent share agreements that shares acquired and reserved for these purposes at the date of a pooling would not be "tainted" when, based on <u>current</u> negotiations, <u>presently existing</u> earnings levels or the market price of shares, <u>etc</u>., there is a reasonable expectation that the shares will be issued for the stated purposes. What happens if shares acquired for a "purchase" cannot be delivered because the transaction has been terminated prior to consummation because of market conditions or adverse earnings? Similarly, what if shares acquired pursuant to a contingent share agreement are not issued because subsequent events reveal facts which make such issuances

unnecessary under the governing documents or in fact require a return of escrowed shares to the issuer? Moreover, there could be difficult liability questions presented if the agreement for a business combination required that the transaction be accounted for as a pooling, but after the execution of the agreement and after the creation of financial commitments, facts arose with respect to a "purchase" or contingent share arrangement of the type mentioned above, which made the pooling impossible under ASR 146.

Accordingly, we urge that the Commission consider revising ASR 146 to make clear that subsequent facts and developments in the foregoing context will not preclude a pooling of interests if "reasonable expectations" existed when the action was taken.

"Immateriality"

Finally, we note that ASR 146 contains no provision corresponding to the statement in AICPA 20 that an immaterial amount of possibly "tainted" shares will not preclude a pooling. We urge that an express statement as to immateriality comparable to that contained in AICPA 20 be added so as to avoid unnecessary hardship where a technical, but clearly immaterial, problem may arise.

The Financial Accounting Standards Board has recently added to its technical agenda a complete reconsideration of APB 16 and the question of "good will" arising in business combinations. In light of this development, we suggest that the Commission add a statement to ASR 146 comparable to its statement in the recent Accounting Series Release on improved disclosure of leases, to the effect that the Commission by ASR 146 does not intend to prejudge issues before the FASB, and will reconsider the requirements of ASR 146 as a consequence of action by the FASB.

If additional comments are thought to be desirable, we would be pleased to communicate with the Commission and its Staff. In such event, would you kindly contact Ricardo A. Mestres, Jr. or Joseph McLaughlin of this office.

Very truly yours,

SULLIVAN & CROMWELL