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Elements of a Systematic Pattern of Treasury Share Acquisitions: A White Paper Discussion

American Institute of Certified Public Accountants (AICPA)

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Background and Purpose of this Paper

Authoritative guidance on systematic plans of treasury share acquisitions is limited. Other than paragraph 47d of Accounting Principles Board Opinion No. 16, *Business Combinations* ("APB 16"), as interpreted by AICPA Interpretation 20 of APB 16, guidance for treasury share acquisitions is contained in Accounting Series Release No. 146 issued in August 1973 ("ASR 146") and Accounting Series Release No. 146A issued in April 1974 ("ASR 146A"). In addition, practice has been guided by information contained in a question and answer memorandum (Q&A;) documenting discussions between the AICPA SEC Regulations Committee and certain members of the U.S. Securities and Exchange Commission staff (the "SEC staff") concerning implementation of the ASRs. The Q&A; memorandum was later separately published in the November 1974 *Journal of Accountancy,* but should be read together with the ASRs. In contrast to ASRs, however, it should be recognized that the views expressed in the Journal of Accountancy article do not constitute an official policy of the Commission. The above referenced material is hereafter collectively referred to as the "Guidance."

Based on information contained in the above Guidance, treasury shares are not considered tainted if they are (1) acquired for certain specific purposes permitted under APB 16[1], provided (2) a "systematic pattern" of acquisitions was established at least two years[2] before the business combination was initiated, and (3) there is a reasonable expectation that the shares will be reissued for the purpose for which they were acquired.[3]

Guidance regarding the "systematic pattern" criterion of APB 16 is particularly limited, with practice having evolved largely from the interpretive Q&A; referred to above. The SEC staff has expressed concern that practice may not be applying the criterion rigorously. For example, a company may have been acquiring treasury shares over a period of time under only a very broad corporate authorization defining an aggregate number of shares. Further, their intended objective may have been to offset the dilution associated with issuance of stock options. The shares may have been acquired following no apparent pattern other than to not exceed the overall Board authorized aggregate limit. Accordingly, the company may have exercised discretion to purchase shares when the stock price was low, when it had excess cash, when a specific immediate use for the shares was identified, or in similar circumstances. That approach resulted in shares being acquired in varying amounts and at varying times throughout the years. The SEC staff believes that the treasury share repurchases in the above example would be tainted because they were not made pursuant to specified criteria under an established systematic pattern that was in operation at the time of the repurchases. Therefore, the actual repurchases cannot be objectively compared to a plan as stipulated by ASR 146.

The purpose of this white paper is to identify the common elements of a "systematic pattern" that would be expected to be part of a repurchase plan in order to satisfy the broad requirements of the Guidance. This paper assumes that both the "purpose" and "reasonable expectation of reissuance" requirements of the systematic plan are met and, therefore, focuses only on the systematic pattern requirement.

The Elements of a Systematic Plan

In general, a systematic pattern of acquisitions is evidenced by the orderly and regular acquisition of shares over time pursuant to specified criteria. Depending on the criteria specified, the number of shares purchased might not be equal each period. A systematic pattern requires that a formal plan be in place and that actual acquisitions can be objectively compared to the original plan. Although systematic plans may be structured in a variety of ways, all such plans must contain certain required elements. Those required elements are:

- Corporate or board authorization specifying the purpose of the plan and a target *aggregate* level of purchases.
- Reasonably objective criteria specifying the level at which *periodic* purchases will be made, specifying both the criteria for determining the **number** of share repurchases and the **time period** to which those criteria will be applied.

In their simplest form, the objective criteria would specify a defined number of shares per a defined period (for example, 5,000 shares to be purchased each month). Some companies may wish to further refine those objective criteria to account for factors such as cash availability or stock price limitations. Regardless of whether the criteria are simple or complex, they must be sufficiently specific to allow for an objective comparison of actual purchases against the plan.

Following is a more detailed discussion of the required elements of a systematic plan.

Requirement #1: Corporate or Board Authorization

The corporate or board authorization provides the broad authority and overall direction for the repurchase plan including the purpose for which the shares are being acquired. For example, in order for the shares to be considered untainted, the repurchases must be for one or more of the specific purposes provided for in APB 16. Accordingly, the corporate or board authorization should contain wording describing one or more of those specific purposes such as "the shares will be acquired to fulfill the Company's requirements to issue common stock upon exercise of employee stock options under its existing stock option plan."

The corporate or board authorization should establish an overall aggregate limit for the share repurchases. While this authorization may be expressed as a specified number (e.g., "up to 5 million shares"), it also would be acceptable to express the limit in such terms as "a number sufficient to meet employee stock option exercise requirements for the next two years" provided a reasonable estimate of the amount can be contemporaneously derived and documented from the description.

Some companies may wish to purchase shares both for the specific purposes for which a systematic pattern is used, as well as for general capital management purposes (untainted and tainted purposes respectively). For example, the Board may authorize the company to acquire a stated number of shares for "exercise of options *and* other corporate purposes." In that situation, the board of directors or other responsible parties must state at the outset that the acquisition of shares is for stock options (or other allowable purposes under the Guidance) as well as other corporate purposes, *and* contemporaneous detailed records must be maintained regarding the division of actual repurchases between the two categories. With the issuance of Staff Accounting Bulletin No. 96, (SAB 96) an open authorization at the time a pooling is consummated that is unclear as to the amount of shares that have been authorized for repurchase that would be considered tainted when purchased likely would result in *all* of the remaining shares under authorization being considered tainted treasury shares. Therefore, while the authorization itself ordinarily need not specify the number of shares authorized for the systematic plan versus general corporate purposes, it is imperative that any open authorization at the time a pooling is consummated clearly distinguish between the two types of purchases. If not, it may be necessary to modify the authorization prior to the date of consummation to indicate that all future purchases are for purposes which either result in the purchase of untainted shares or tainted shares, to the extent available in the 90% test (see Emerging Issues Task Force Issue No. 87-16).

The corporate or board authorization need not set forth the specific objective systematic criteria to be followed in making the actual purchases – those criteria generally are determined by management within the overall authorization guidelines set by the corporation/board. It is important that management's detailed plan and internal calculations be documented and consistent with the board authorization.

An example of a board authorization and detailed management plan that would be acceptable under a systematic plan follows.

The board authorizes the repurchase of 5 million shares for issuances under the company's employee stock option plan. The company's press release is consistent with the stated purpose and amounts under the board authorization. Management contemporaneously documents a specific plan pursuant to that authorization. The plan requires management to (a) estimate the number of shares to be issued during the next twenty four months for option exercises and (b) repurchase evenly each month the number of shares necessary to meet the expected need in excess of treasury stock inventory on hand. The documented plan provides that each month the number of shares to be repurchased is adjusted as factors change. The estimate of the number of shares to be issued is based on the company's stock price at the beginning of the month and the expiration of stock options over the subsequent twenty four months. All options that are (a) in-the-money at the beginning of the month and (b) expire by their terms within twenty four months are included in the estimated number of shares to be issued. From this number, the shares repurchased under the plan and not yet reissued are subtracted. If the net number is negative, no shares are repurchased; if positive, the net number is then divided by 24 to obtain the required monthly repurchase amount. The plan specifies that in the event the company is precluded from purchasing shares due to legal constraints (e.g., black out periods and market anti-manipulation rules), it will repurchase any cumulative deficit beginning on the first day subsequent to the lapse of such constraints and continuing each day until the deficit is eliminated. Repurchases each day subsequent to the lapse of the legal constraint will be at the maximum amount permitted under applicable securities law.

Requirement #2: Objective Criteria

Management's formal reacquisition plan must be sufficiently explicit so that the pattern of reacquisitions may be objectively compared to the plan. The objective criteria set forth by management should provide for two factors—(1) an objective means to determine the **number** of shares to be acquired each period and (2) a **period** of time to which the objective criteria are to be applied.

With respect to the first factor, the number of shares can be set either as a *fixed* number per period (e.g. 5,000 shares per quarter, or 5,000 shares per month) or, alternatively, can be expressed as a *variable* number calculated using specified criteria (e.g., ¼ of 1% of shares traded per month, or the number of shares that can be purchased with $200,000 per month). The example to question 9 of the *Journal of Accountancy* Q&A; also indicates the company's objective criteria can be expressed as a range (for example, the company will purchase between 3,000 to 5,000 shares each month). The more objectively determinable the upper and lower boundaries of the range, the more likely the range will be supportable under a systematic pattern. In addition, the width of the range should be reasonable, not excessively broad, and based on factors that can be expressed objectively.

The objective criteria also should specify the time period during which that number of shares will be purchased (e.g., daily, monthly, quarterly). For example, the criteria might specify that 5,000 shares will be purchased each month or each quarter, or that ¼ of 1% of the shares traded daily, monthly, or quarterly will be purchased. The specified time period should not exceed a quarter—since a longer time period would not contain sufficient frequency to establish a systematic pattern. For example, while objective criteria calling for purchases of 5,000 shares per *month* or 5,000 shares per *quarter* would meet the requirements of a systematic plan, a plan to purchase 50,000 shares per *year* or *six months* would not.

The SEC staff has indicated that it generally would not object to a quarterly time period for repurchases, even if the timing for when these repurchases would be made throughout the quarter was not specified. The SEC staff has also indicated, however, that it would object to abusive patterns within an overall quarterly time period approach. For example, the SEC staff would probably not object to the following patterns within an overall policy to repurchase 10,000 shares per quarter:

January	2,000	July	7,000
February	3,000	August	—
March	5,000	September	3,000
April	1,000	October	4,000
May	6,000	November	4,000
June	3,000	December	2,000

Conversely, if the 10,000 shares were repurchased on January 2, June 30, July 1, and December 31 of each year, the SEC staff would view the pattern as tantamount to a semi-annual plan, not a quarterly plan, and would object to it qualifying as a systematic pattern.

The criteria must provide sufficient specificity to allow for an objective comparison of the pattern of actual purchases against the criteria of the plan. If the criteria are too broad, such that the repurchases cannot be objectively compared against the systematic pattern of reacquisitions, the treasury shares acquired would be considered tainted for pooling purposes.

The following are other examples of systematic plans that would allow for an objective assessment of actual repurchases:

- The company will purchase 5,000 shares per month, based on cash availability[4] as determined at the beginning of the month. If the cash availability criteria are not met, no shares will be purchased that month.
- The company will purchase 9,000 shares during the quarter, but only when the stock price on the first trading day of the quarter is below $40 per share. When the stock price is $40 or greater on the first trading day of the quarter, the company will not purchase any shares that quarter.
- The company will purchase 5,000 shares each month based on a sliding scale of stock prices. If the stock price is less than $40 per share on the last trading day of the prior month, 5,000 shares will be purchased the following month. If the stock price is between $40 and $45, 2,500 shares will be purchased. If the stock price is above $45, no shares will be purchased.
- The company will purchase $500,000 worth of shares per quarter, not to exceed 20,000 shares in any quarter.
- The company will purchase shares equal to ½ of 1% of the trading activity for a quarter, subject to cash availability, but limited to no more than 7,500 shares per month. The company's objective is to repurchase on a weekly (or alternatively, daily) basis ½ of 1% of the prior week's (or day's) trading activity subject to cash availability and subject to the 7,500 share maximum.
- A company that has thinly traded shares may specify that it will purchase 1 million shares each year in unsolicited blocks of 100,000 or less, but in no case more than 300,000 per quarter, and in no case more than the amount of shares reasonably expected to be reissued under the stock option plan in the next 12 months which, at the time the plan is adopted, is reasonably expected to approximate 1 million shares. The Company anticipates achieving its repurchase goals under this policy.

The following are examples of plans that would not allow for objective assessment of actual repurchases:

Assume that the company is authorized to repurchase up to 12,000,000 shares in 19X1 for expected stock option exercises.

- The company's detailed plan allows for the repurchase of not more than 5,000,000 shares and not less than 2,000,000 shares per quarter. In this case, the range of repurchases on a quarterly basis would be considered too broad and provide too much discretion to be considered an objectively determinable systematic plan.
- The company's detailed plan allows for the repurchase of up to 3,000,000 shares per quarter, to be determined on the basis of a combination of factors, including the company's stock price, cash availability, overall market environment and availability of other investment opportunities. The plan would be disqualified because it allows for purchases within a broad range (i.e., from 0 to 3,000,000 shares) based on factors that influence management's determination of share repurchase volume, without objectively specifying how changes in each factor would be determined and how such changes would affect repurchase volume.
- The company's detailed plan specifies that the company will repurchase unsolicited blocks of shares of not less than 100,000 shares and not greater than 500,000 shares. In addition, however, the plan also allows management to not accept an unsolicited offer if based upon the facts and circumstances, management believes that acceptance is not in the best interest of the company. Management has rejected a small number of unsolicited offers on the basis that they did not believe the stock price was attractive, or they had concerns regarding impact on certain financial measures used by analysts and regulators, or they strategically felt at the time that there were better uses of the required proceeds. This plan would not be considered systematic due to the degree of management discretion.
- The company's detailed plan specifies that the company will repurchase 50,000 shares per month when its stock price exceeds $50 per share, 500,000 shares per month when its stock price is between $40 and $50 per share, and 1,000,000 shares per month when its stock price is less than $40 per share. All share prices are determined based on the closing price on the last day of the prior month. Share repurchases are capped at the overall limit of 12,000,000 shares. While not specified in the plan, management has adjusted the stock price ranges on a periodic basis to manage stock repurchase volumes. In this instance, the plan does not specify when and how changes to the stock price ranges will be identified. Therefore, such changes would be viewed as changes to the systematic pattern that would necessitate re-seasoning the plan.

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1. Such purposes include acquisitions to satisfy exercise of stock options, issuances under stock compensation arrangements, conversion of convertible securities, recurring stock dividends, and similar purposes, provided the shares are acquired under a systematic pattern. ASR 146 and ASR 146A also describe purposes for which shares can be acquired without meeting the systematic pattern requirements and not be considered tainted. This paper focuses on purchases of shares under a systematic pattern.
2. Unless the reacquisition plan was established concurrently with the adoption of a new stock option or stock compensation plan.

3. The SEC staff believes that the number of shares acquired generally should not exceed expected issuances under stock option plans, warrants or convertible securities over the two years following the date of acquisition. As to stock purchase or bonus plans or stock dividends, the number of shares acquired generally should not exceed anticipated requirements within the next year.
4. As with the other criteria, it is important that the "cash availability" limitation be objectively defined so that actual acquisitions can be objectively compared to the plan. For example, available excess cash may be defined as current cash balances less a specified percentage of projected future net cash requirements over a set future period (e.g., current cash less 125% of projected net cash requirements for the next 12 months). In order to use projected future net cash requirements as a factor, the company also would need to have an objective source from which to regularly and consistently obtain that amount such as regular budgets and forecasts, debt covenant calculations, etc.
