

example, cost of sales; selling, general, and administrative; etc.).

Q. Increasing Rate Preferred Stock

Facts: A registrant issues Class A and Class B nonredeemable preferred stock¹ on 1/1/X1. Class A, by its terms, will pay no dividends during the years 20X1 through 20X3. Class B, by its terms, will pay dividends at annual rates of \$2, \$4 and \$6 per share in the years 20X1, 20X2 and 20X3, respectively. Beginning in the year 20X4 and thereafter as long as they remain outstanding, each instrument will pay dividends at an annual rate of \$8 per share. In all periods, the scheduled dividends are cumulative.

At the time of issuance, eight percent per annum was considered to be a market rate for dividend yield on Class A, given its characteristics other than scheduled cash dividend entitlements (voting rights, liquidation preference, etc.), as well as the registrant's financial condition and future economic prospects. Thus, the registrant could have expected to receive proceeds of approximately \$100 per share for Class A if the dividend rate of \$8 per share (the "perpetual dividend") had been in effect at date of issuance. In consideration of the dividend payment terms, however, Class A was issued for proceeds of \$79 3/8 per share. The difference, \$20 5/8, approximated the value of the absence of \$8 per share dividends annually for three years, discounted at 8%.

The issuance price of Class B shares was determined by a similar approach, based on the terms and characteristics of the Class B shares.

Question 1: How should preferred stocks of this general type (referred to as "increasing rate preferred stocks") be reported in the balance sheet?

Interpretive Response: As is normally the case with other types of securities, increasing rate preferred stock should be recorded initially at its fair value on date of issuance. Thereafter, the carrying amount should be increased periodically as discussed in the Interpretive Response to Question 2.

Question 2: Is it acceptable to recognize the dividend costs of increasing rate preferred stocks according to their stated dividend schedules?

Interpretive Response: No. The staff believes that when consideration received for preferred stocks reflects expectations of future dividend streams, as is normally the case with cumulative preferred stocks, any discount due to an absence of dividends (as with Class A) or gradually increasing dividends (as with Class B) for an initial period represents prepaid, unstated dividend cost.² Recognizing the dividend cost of these instruments according to their stated dividend schedules would report Class A as being cost-free, and would report the cost of Class B at less than its effective cost, from the standpoint of common stock interests (i.e., for purposes of computing income applicable to common stock and

earnings per common share) during the years 20X1 through 20X3.

Accordingly, the staff believes that discounts on increasing rate preferred stock should be amortized over the period(s) preceding commencement of the perpetual dividend, by charging imputed dividend cost against retained earnings and increasing the carrying amount of the preferred stock by a corresponding amount. The discount at time of issuance should be computed as the present value of the difference between (a) dividends that will be payable, if any, in the period(s) preceding commencement of the perpetual dividend; and (b) the perpetual dividend amount for a corresponding number of periods; discounted at a market rate for dividend yield on preferred stocks that are comparable (other than with respect to dividend payment schedules) from an investment standpoint. The amortization in each period should be the amount which, together with any stated dividend for the period (ignoring fluctuations in stated dividend amounts that might result from variable rates,³ results in a constant rate of effective cost vis-a-vis the carrying amount of the preferred stock (the market rate that was used to compute the discount).

Simplified (ignoring quarterly calculations) application of this accounting to the Class A preferred stock described in the "Facts" section of this bulletin would produce the following results on a per share basis:

CARRYING AMOUNT OF PREFERRED STOCK

	Beginning of Year (BOY)	Imputed Dividend (8% of Carrying Amount at BOY)	End of year
Year 20X1	\$79.38	6.35	85.73
Year 20X2	85.73	6.86	92.59
Year 20X3	92.59	7.41	100.00

During 20X4 and thereafter, the stated dividend of \$8 measured against the carrying amount of \$100⁴ would reflect dividend cost of 8%, the market rate at time of issuance.

The staff believes that existing authoritative literature, while not explicitly addressing increasing rate

preferred stocks, implicitly calls for the accounting described in this bulletin.

The pervasive, fundamental principle of accrual accounting would, in the staff's view, preclude registrants from recognizing the dividend cost on the basis of whatever cash payment schedule might be arranged.

Furthermore, recognition of the effective cost of unstated rights and privileges is well-established in accounting, and is specifically called for by APB Opinion 21 and Topic 3.C of this codification for unstated interest costs of debt capital and unstated dividend costs of redeemable preferred stock capital,

¹ "Nonredeemable" preferred stock, as used in this SAB, refers to preferred stocks which are not redeemable or are redeemable only at the option of the issuer.

² As described in the "Facts" section of the issue, a registrant would receive less in proceeds for a preferred stock, if the stock were to pay less than its perpetual dividend for some initial period(s), than if it were to pay perpetual dividend from date of issuance. The staff views the discount on

increasing rate preferred stock as equivalent to a prepayment of dividends by the issuer, as though the issuer had concurrently (a) issued the stock with the perpetual dividend being payable from date of issuance, and (b) returned to the investor a portion of the proceeds representing the present value of certain future dividend entitlements which the investor agreed to forgo.

³ See Question 3 regarding variable increasing rate preferred stocks.

⁴ It should be noted that the \$100 per share amount used in this issue is for illustrative purposes, and is not intended to imply that application of this issue will necessarily result in the carrying amount of nonredeemable preferred stock being accreted to its par value, stated value, voluntary redemption value or involuntary liquidation value.