

respectively. The staff believes that the requirement to recognize the effective periodic cost of capital applies also to nonredeemable preferred stocks because, for that purpose, the distinction between debt capital and preferred equity capital (whether redeemable⁵ or nonredeemable) is irrelevant from the standpoint of common stock interests.

Question 3: Would the accounting for discounts on increasing rate preferred stock be affected by variable stated dividend rates?

Interpretive Response: No. If stated dividends on an increasing rate preferred stock are variable, computations of initial discount and subsequent amortization should be based on the value of the applicable index at date of issuance and should not be affected by subsequent changes in the index.

For example, assume that a preferred stock issued 1/1/X1 is scheduled to pay dividends at annual rates, applied to the stock's par value, equal to 20% of the actual (fluctuating) market yield on a particular Treasury security in 20X1 and 20X2, and 90% of the fluctuating market yield in 20X3 and thereafter. The discount would be computed as the present value of a two-year dividend stream equal to 70% (90% less 20%) of the 1/1/X1 Treasury security yield, annually, on the stock's par value. The discount would be amortized in years 20X1 and 20X2 so that, together with 20% of the 1/1/X1 Treasury yield on the stock's par value, a constant rate of cost vis-a-vis the stock's carrying amount would result. Changes in the Treasury security yield during 20X1 and 20X2 would, of course, cause the rate of total reported preferred dividend cost (amortization of discount plus cash dividends) in those years to be more or less than the rate indicated by discount amortization plus 20% of the 1/1/X1 Treasury security yield. However, the fluctuations would be due solely to the impact of changes in the index on the stated dividends for those periods.

Question 4: Will the staff expect retroactive changes by registrants to comply with the accounting described in this bulletin?

Interpretive Response: All registrants will be expected to follow the accounting described in this bulletin for

increasing rate preferred stocks issued after December 4, 1986.⁶ Registrants that have not followed this accounting for increasing rate preferred stocks issued before that date were encouraged to retroactively change their accounting for those preferred stocks in the financial statements next filed with the Commission. The staff did not object if registrants did not make retroactive changes for those preferred stocks, provided that all presentations of and discussions regarding income applicable to common stock and earnings per share in future filings and shareholders' reports are accompanied by equally prominent supplemental disclosures (on the face of the income statement, in presentations of selected financial data, in MD&A, etc.) of the impact of not changing their accounting and an explanation of such impact (e.g., that dividend cost has been recognized on a cash basis).

R. Deleted by SAB 103

S. Quasi-Reorganization

Facts: As a consequence of significant operating losses and/or recent write-downs of property, plant and equipment, a company's financial statements reflect an accumulated deficit. The company desires to eliminate the deficit by reclassifying amounts from paid-in-capital. In addition, the company anticipates adopting a discretionary change in accounting principles¹ that will be recorded as a cumulative-effect type of accounting change. The recording of the cumulative effect will have the result of increasing the company's retained earnings.

Question 1: May the company reclassify its capital accounts to eliminate the accumulated deficit without satisfying all of the conditions enumerated in Section 210² of the Codification of Financial Reporting Policies for a quasi-reorganization?

Interpretive Response: No. The staff believes a deficit reclassification of any nature is considered to be a quasi-reorganization. As such, a company may not reclassify or eliminate a deficit in retained earnings unless all requisite

conditions set forth in Section 210³ for a quasi-reorganization are satisfied.⁴

Question 2: Must the company implement the discretionary change in accounting principle simultaneously with the quasi-reorganization or may it adopt the change after the quasi-reorganization has been effected?

Interpretive Response: The staff has taken the position that the company should adopt the anticipated accounting change prior to or as an integral part of the quasi-reorganization. Any such accounting change should be effected by following GAAP with respect to the change.⁵

Chapter 7A of ARB 43 indicates that, following a quasi-reorganization, a "company's accounting should be substantially similar to that appropriate for a new company." The staff believes that implicit in this "fresh-start" concept is the need for the company's accounting principles in place at the time of the quasi-reorganization to be those planned to be used following the reorganization to avoid a misstatement of earnings and retained earnings after the reorganization.⁶ Chapter 7A of ARB 43 states, in part, " * * * in general, assets should be carried forward as of the date of the readjustment at fair and

³ Section 210 (ASR 25) indicates the following conditions under which a quasi-reorganization can be effected without the creation of a new corporate entity and without the intervention of formal court proceedings:

1. Earned surplus, as of the date selected, is exhausted;
2. Upon consummation of the quasi-reorganization, no deficit exists in any surplus account;
3. The entire procedure is made known to all persons entitled to vote on matters of general corporate policy and the appropriate consents to the particular transactions are obtained in advance in accordance with the applicable laws and charter provisions;
4. The procedure accomplishes, with respect to the accounts, substantially what might be accomplished in a reorganization by legal proceedings—namely, the restatement of assets in terms of present considerations as well as appropriate modifications of capital and capital surplus, in order to obviate, so far as possible, the necessity of future reorganization of like nature.

⁴ In addition, ARB 43, Chapter 7A, outlines procedures that must be followed in connection with and after a quasi-reorganization.

⁵ Opinion 20 provides accounting principles to be followed when adopting accounting changes. In addition, many newly-issued accounting pronouncements provide specific guidance to be followed when adopting the accounting specified in such pronouncements.

⁶ Certain newly-issued accounting standards do not require adoption until some future date. The staff believes, however, that if the registrant intends or is required to adopt those standards within 12 months following the quasi-reorganization, the registrant should adopt those standards prior to or as an integral part of the quasi-reorganization. Further, registrants should consider early adoption of standards with effective dates more than 12 months subsequent to a quasi-reorganization.

⁵ Application of the interest method with respect to redeemable preferred stocks pursuant to Topic 3.C results in accounting consistent with the provisions of this bulletin irrespective of whether the redeemable preferred stocks have constant or increasing stated dividend rates. The interest method, as described in APB Opinion 21, produces a constant effective periodic rate of cost that is comprised of amortization of discount as well as the stated cost of each period.

⁶ The staff first publicly expressed its view as to the appropriate accounting at the December 3–4, 1986 meeting of the EITF.

¹ Discretionary accounting changes require the filing of a preferability letter by the registrant's independent accountant pursuant to Item 601 of Regulation S-K and Rule 10-01(b)(6) of Regulation S-X, respectively.

² ASR 25.