

not unduly conservative amounts, **determined with due regard for the accounting to be employed by the Company thereafter.**" (emphasis added)

In addition, the staff believes that adopting a discretionary change in accounting principle that will be reflected in the financial statements within 12 months following the consummation of a quasi-reorganization leads to a presumption that the accounting change was contemplated at the time of the quasi-reorganization.<sup>7</sup>

**Question 3:** In connection with a quasi-reorganization, may there be a write-up of net assets?

**Interpretive Response:** No. The staff believes that increases in the recorded values of specific assets (or reductions in liabilities) to fair value are appropriate providing such adjustments are factually supportable, however, the amount of such increases are limited to offsetting adjustments to reflect decreases in other assets (or increases in liabilities) to reflect their new fair value. In other words, a quasi-reorganization should not result in a write-up of net assets of the registrant.

**Question 4:** The interpretive response to question 1 indicates that the staff believes that a deficit reclassification of any nature is considered to be a quasi-reorganization, and accordingly, must satisfy all the conditions of Section 210.<sup>8</sup> Assume a company has satisfied all the requisite conditions of Section 210, and has eliminated a deficit in retained earnings by a concurrent reduction in paid-in capital, but did not need to restate assets and liabilities by a charge to capital because assets and liabilities were already stated at fair values. How should the company reflect the tax benefits of operating loss or tax credit carryforwards for financial reporting purposes that existed as of the date of the quasi-reorganization when such tax benefits are subsequently recognized for financial reporting purposes?

**Interpretive Response:** The staff believes Statement 109 requires that any subsequently recognized tax benefits of operating loss or tax credit carryforwards that existed as of the date of a quasi-reorganization be reported as a direct addition to paid-in capital. The staff believes that this position is consistent with the "new company" or "fresh-start" concept embodied in

Section 210,<sup>9</sup> and in existing accounting literature regarding quasi-reorganizations, and with the FASB staff's justification for such a position when they stated that a "new enterprise would not have tax benefits attributable to operating losses or tax credits that arose prior to its organization date."<sup>10</sup>

The FASB recognized that a practice existed of recording deficit elimination type quasi-reorganizations without evaluating the concurrent need to restate assets and liabilities to fair values, and provided guidance on accounting for the tax benefits of carryforward items subsequent to such an event.<sup>11</sup> This practice and accounting is not permitted by Section 210, and accordingly, is not appropriate for registrants. The staff believes that all registrants that comply with the requirements of Section 210 in effecting a quasi-reorganization should apply the accounting required by the first sentence of paragraph 39 of Statement 109 for the tax benefits of tax

<sup>9</sup> Section 210 (ASR 25) discusses the "conditions under which a quasi-reorganization has come to be applied in accounting to the corporate procedures in the course of which a company, without creation of new corporate entity and without intervention of formal court proceedings, is enabled to eliminate a deficit whether resulting from operations or recognition of other losses or both and to establish a new earned surplus account for the accumulation of earnings subsequent to the date selected as the effective date of the quasi-reorganization." It further indicates that "it is implicit in a procedure of this kind that it is not to be employed recurrently, **but only under circumstances which would justify an actual reorganization or formation of a new corporation**, particularly if the sole purpose of the quasi-reorganization is the elimination of a deficit in earned surplus resulting from operating losses." (emphasis added)

<sup>10</sup> FASB Special Report: A Guide to Implementation of Statement 109 on Accounting for Income Taxes: Questions and Answers answer 9 states in part: "ARB 43, Chapter 7, 'Capital Accounts,' states that after a quasi-reorganization, the enterprise's accounting should be substantially similar to that appropriate for a new enterprise. As such, any subsequently recognized tax benefit of an operating loss or tax credit carryforward that existed at the date of a quasi-reorganization should not be included in the determination of income of the "new" enterprise, regardless of whether losses that gave rise to an operating loss carryforward were charged to income prior to the quasi-reorganization or directly to contributed capital as part of the quasi-reorganization. A new enterprise would not have tax benefits attributable to operating losses or tax credits that arose prior to its organization date."

<sup>11</sup> Statement 109, paragraph 39, states, in part: "The only exception is for enterprises that have previously both adopted Statement 96 and effected a quasi reorganization that involves only the elimination of a deficit in retained earnings by a concurrent reduction in contributed capital prior to adopting this Statement. For those enterprises, subsequent recognition of the tax benefit of prior deductible temporary differences and carryforwards is included in income and reported as required by paragraph 37 \* \* \* and then reclassified from retained earnings to contributed capital." Also, see Footnote 10.

carryforward items.<sup>12</sup> Therefore, even though the only effect of a quasi-reorganization is the elimination of a deficit in retained earnings because assets and liabilities are already stated at fair values and the revaluation of assets and liabilities is unnecessary (or a write-up of net assets is prohibited as indicated in the interpretive response to question 3 above), subsequently recognized tax benefits of operating loss or tax credit carryforward items should be recorded as a direct addition to paid-in capital.

**Question 5:** If a company had previously recorded a quasi-reorganization that only resulted in the elimination of a deficit in retained earnings, may the company reverse such entry and "undo" its quasi-reorganization?

**Interpretive Response:** No. The staff believes Opinion 20 would preclude such a change in accounting. It states: "a method of accounting that was previously adopted for a type of transaction or event which is being terminated **or which was a single, nonrecurring event in the past should not be changed.**" (emphasis added)<sup>13</sup>

#### *T. Accounting for Expenses or Liabilities Paid by Principal Stockholder(s)*

**Facts:** Company X was a defendant in litigation for which the company had not recorded a liability in accordance with Statement 5. A principal stockholder of the company transfers a portion of his shares to the plaintiff to settle such litigation. If the company had settled the litigation directly, the company would have recorded the settlement as an expense.

**Question:** Must the settlement be reflected as an expense in the company's financial statements, and if so, how?

**Interpretive Response:** Yes. The value of the shares transferred should be reflected as an expense in the company's financial statements with a corresponding credit to contributed (paid-in) capital.

The staff believes that such a transaction is similar to those described in AICPA Interpretation 1 to Opinion 25 in which a principal stockholder<sup>1</sup>

<sup>12</sup> The first sentence of paragraph 39 of Statement 109 states: "[t]he tax benefit of deductible temporary differences and carryforwards as of the date of a quasi reorganization as defined and contemplated in ARB 43, Chapter 7, ordinarily are reported as a direct addition to contributed capital if the tax benefits are recognized in subsequent years."

<sup>13</sup> Opinion 20, paragraph 16.

<sup>1</sup> Statement 57, paragraph 24e, defines principal owners as "owners of record or known beneficial owners of more than 10 percent of the voting interests of the enterprise."

<sup>7</sup> Certain accounting changes require restatement of prior financial statements. The staff believes that if a quasi-reorganization had been recorded in a restated period, the effects of the accounting change on quasi-reorganization adjustments should also be restated to properly reflect the quasi-reorganization in the restated financial statements.

<sup>8</sup> See footnote 3.