as regards policyholders shall remain unchanged following such restatement. The following components of unassigned funds (surplus) shall be considered in determining the amount available for restatement:

a. Net Income
b. Effect of Exchange Rate Fluctuations
c. Dividends to Stockholders
d. Change in Accounting Principles
e. Correction of an Error
f. Stock Issuance Expenses

6. The assets and liabilities of the reporting entity shall continue to be carried at historical cost or other value required under statutory accounting principles. No adjustments to assets or liabilities shall be made to reflect the effect of a quasi-reorganization.

7. The impact of the restatement shall be disclosed in the notes to financial statements as long as financial statements for the period of the reorganization are presented. The effective date of the reorganization shall be disclosed for a period of ten years following the reorganization.

DISCUSSION

8. Current statutory accounting guidance does not address quasi-reorganizations. Quasi-reorganization is a concept in GAAP that is intended to apply in very limited situations. The effect in GAAP accounting for a quasi-reorganization is to eliminate negative retained earnings by capitalizing negative retained earnings to paid-in capital; and, to adjust net assets downward, but not upward, to fair value (i.e., individual assets may be written up or liabilities reduced as appropriate, but only to the extent that the aggregate net adjustment does not increase net assets). Quasi-reorganizations are initiated for various purposes, including to facilitate the payment of dividends by a reporting entity that is currently profitable but has negative retained earnings prior to the quasi-reorganization.

9. The conclusion permits the restatement of gross paid in and contributed surplus and unassigned funds (surplus) under a quasi-reorganization in certain limited circumstances. The conclusion also requires that total surplus as regards policyholders remain unchanged following such restatement and that the assets and liabilities of the reporting entity be carried at historical cost or other value required under statutory accounting principles and not revalued pursuant to a quasi-reorganization. This conclusion allows regulatory flexibility in instances where there has been a change in the ultimate ownership, the business plan of the reporting entity has substantively changed the operations and business mix of the reporting entity and the situation or circumstances that gave rise to the negative unassigned funds (surplus) will not be part of the ongoing operations, or the reporting entity is a shell company with no existing operations or outstanding policies. This conclusion is consistent with the regulatory need for consistent data on a year-to-year basis in order to monitor performance of insurance enterprises on a continuing basis. The conclusion is also consistent with the requirement to retain the historical basis of reporting following a business combination as discussed in *Issue Paper No. 68—Business Combinations and Goodwill*.

10. This issue paper adopts Chapter 7, Section A of ARB 43 with a modification to permit restatement of gross paid in and contributed surplus and unassigned funds (surplus) only in certain limited circumstances. In addition, this issue paper requires that the assets and liabilities of the reporting entity continue to be carried at historical cost or other value required under statutory accounting principles and

11. The statutory accounting principles outlined in the conclusion above are consistent with the conservatism concept in the Statement of Concepts, as follows:

> Conservatism
>
> Conservative valuation procedures provide protection to policyholders against adverse fluctuations in financial condition or operating results. Statutory accounting should be reasonably conservative over the span of economic cycles and in recognition of the primary responsibility to regulate for financial solvency. Valuation procedures should, to the extent possible, prevent sharp fluctuations in surplus.
>
> Consistency
>
> The regulators' need for meaningful, comparable financial information to determine an insurer's financial condition requires consistency in the development and application of statutory accounting principles. Because the marketplace, the economic and business environment, and insurance industry products and practices are constantly changing, regulatory concerns are also changing. An effective statutory accounting model must be responsive to these changes and address emerging accounting issues. Precedent or historically accepted practice alone should not be sufficient justifications for continuing to follow a particular accounting principle or practice which may not coincide with the objectives of regulators.

Drafting Notes/Comments
None

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
None

Generally Accepted Accounting Principles
12. ARB 43 provides the following guidance (only the pertinent excerpts are included below):

> Chapter 7: CAPITAL ACCOUNTS
> Section A -- Quasi-Reorganization or Corporate Readjustment
>
> (Amplification of Institute Rule No. 2 of 1934)
>
> 1. A rule was adopted by the Institute in 1934 which read as follows:
>
> "Capital surplus, however created, should not be used to relieve the income account of the current or future years of charges which would otherwise fall to be made thereagainst. This rule might be subject to the exception that where, upon reorganization, a reorganized company would be relieved of charges which would require to be made against income if the existing corporation were continued, it might be regarded as permissible to accomplish the same result without reorganization provided the facts were as fully revealed to and the action as formally approved by the shareholders as in reorganization."[1]
>
> [1] See chapter 1A, paragraph 2.
>
> 2. Readjustments of the kind mentioned in the exception to the rule fall in the category of what are called quasi-reorganizations. This section does not deal with the general question of quasi-reorganizations, but only with cases in which the exception permitted under the rule of 1934 is availed of by a corporation. Hereinafter such cases are referred

to as readjustments. The problems which arise fall into two groups: (a) what may be permitted in a readjustment and (b) what may be permitted thereafter.

Procedure in Readjustment

3. If a corporation elects to restate its assets, capital stock, and surplus through a readjustment and thus avail itself of permission to relieve its future income account or earned surplus account of charges which would otherwise be made thereagainst, it should make a clear report to its shareholders of the restatements proposed to be made, and obtain their formal consent. It should present a fair balance sheet as at the date of the readjustment, in which the

11. Capital surplus originating in such a readjustment is restricted in the same manner as that of a new corporation; charges against it should be only those which may properly be made against the initial surplus of a new corporation.

12. It is recognized that charges against capital surplus may take place in other types of readjustments to which the foregoing provisions would have no application. Such cases would include readjustments for the purpose of correcting erroneous credits made to capital surplus in the past. In this statement the committee has dealt only with that type of readjustment in which either the current income or earned surplus account or the income account of future years is relieved of charges which would otherwise be made thereagainst.

13. ARB 46 provides the following guidance (only the pertinent excerpts are included below):

1. Paragraph 10 of Chapter 7(a), Quasi-Reorganization or Corporate Readjustment, of Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins, reads as follows:

> After such a readjustment earned surplus previously accumulated cannot properly be carried forward under that title. A new earned surplus account should be established, dated to show that it runs from the effective date of the readjustment, and this dating should be disclosed in financial statements until such time as the effective date is no longer deemed to possess any special significance.

2. The committee believes that the dating of earned surplus following a quasi-reorganization would rarely, if ever, be of significance after a period of ten years. It also believes that there may be exceptional circumstances in which the discontinuance of the dating of earned surplus could be justified at the conclusion of a period less than ten years.

OTHER SOURCES OF INFORMATION

14. Securities and Exchange Commission *Codification of Financial Reporting Policies*, Section 210 provides the following guidance (only the pertinent excerpts are included below):

210 Quasi-Reorganization ASR 25:
Inquiry has been made from time to time as to 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 the creation of new corporate entity and without the intervention of formal court proceedings, is enabled to eliminate a deficit whether resulting from operations or the 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 has been the Commission’s view for some time that a quasi-reorganization may not be considered to have been effected unless at least all of the following conditions exist:

(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 law 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 conditions as well as appropriate modifications of capital and capital surplus, in order to obviate so far as possible the necessity of future reorganizations of like nature.

It is implicit in such a procedure that reductions in the carrying value of assets at the effective date may not be made beyond a point which gives appropriate recognition to conditions which appear to have resulted in relatively permanent reductions in asset values; as for example, complete or partial obsolescence, lessened utility value, reduction in investment value due to changed economic conditions, or, in the case of current assets, declines in indicated realization value. It is also 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 or principal purpose of the quasi-reorganization is the elimination of a deficit in earned surplus resulting from operating losses.
In the case of the quasi-reorganization of a parent company, it is an implicit result of such procedure that the effective date should be recognized as having the significance of a date of acquisition of control of subsidiaries. Likewise, in consolidated statements, earned surplus of subsidiaries at the effective date should be excluded from earned surplus on the consolidated balance sheet.

15. The Securities and Exchange Commission Staff Accounting Bulletins--Codification provides the following guidance (only the pertinent excerpts are included below):

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 principles[1] 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.

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[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, 17 CFR §§229.601 and 210.10-01(b)(^), respectively.

Question 1:

May the company reclassify its capital accounts to eliminate the accumulated deficit without satisfying all of the conditions enumerated in Section 210[2] of the Codification of Financial Reporting Policies for a quasi-reorganization?

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[2] Accounting Series Release No. 25 (May 29, 1941).

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 210[3] for a quasi-reorganization are satisfied.[4]

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[3] Section 210 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 conditions as well as appropriate modifications of capital and capital

surplus, in order to obviate so far as possible the necessity of future reorganizations of like nature.

[4] In addition, Accounting Research Bulletin (ARB) No. 43, Chapter 7A, outlines procedures that must be followed in connection with and after a quasi-reorganization.

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 generally accepted accounting principles with respect to the change.[5]

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[5] Accounting Principles Board Opinion No. 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.

Chapter 7A of Accounting Research Bulletin (ARB) No. 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 No. 43 states, in part, "... in general, assets should be carried forward as of the date of the readjustment at fair and not unduly conservative amounts, determined with due regard for the accounting to be employed by the Company thereafter (emphasis added)."

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[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.

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.[7]

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[7] 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.

Generally Accepted Accounting Principles

- *Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins, Chapter 7, Section A, Quasi-reorganization or Corporate Readjustment*
- *Accounting Research Bulletin No. 46, Discontinuance of Dating Earned Surplus*

State Regulations

- No additional guidance obtained from state statutes or regulations.

Other Sources of Information

- Securities and Exchange Commission Codification of Financial Reporting Policies, Section 210
- Securities and Exchange Commission Staff Accounting Bulletins - Codification, Topic 5, S

