

Statutory Issue Paper No. 84

Quasi-Reorganizations

STATUS

Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 72

Type of Issue:

Common Area

SUMMARY OF ISSUE

1. Readjustments of additional paid in capital as if a reporting entity were reorganized but without the occurrence of a formal reorganization are considered to be quasi-reorganizations. Generally, quasi-reorganizations result in the elimination of a deficit retained earnings and establishment of a new basis for assets and liabilities. Current statutory accounting guidance does not address quasi-reorganizations.
2. GAAP addresses accounting for quasi-reorganizations in *Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins* (ARB 43) and in *Accounting Research Bulletin No. 46, Discontinuance of Dating Earned Surplus* (ARB 46). Guidance is also provided in the Securities and Exchange Commission *Codification of Financial Reporting Policies*, Section 210 and in the Staff Accounting Bulletins--Codification.
3. The purpose of this issue paper is to establish statutory accounting principles for quasi-reorganizations that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. Restatement of gross paid in and contributed surplus and unassigned funds (surplus) under a quasi-reorganization shall be permitted only if the criteria in both subparagraphs 4 a and 4 b and either subparagraph 4 c or 4 d are met:
 - a. Such restatement is approved in writing by the domiciliary Commissioner;
 - b. An 80% or greater change in the ultimate ownership of the reporting entity has occurred within six months prior to approval of such restatement;
 - c. A new business plan has been adopted that results in a substantive change in 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;
 - d. The reporting entity is a shell company with no existing operations, inforce policies or outstanding claims.
5. As defined in *Issue Paper No. 72—Statutory Surplus*, unassigned funds (surplus) represents the undistributed and unappropriated amount of surplus at the balance sheet date. In no instance shall restatement result in the unassigned funds (surplus) account being greater than zero or the gross paid in and contributed surplus account being less than zero immediately following the restatement. Total surplus

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 that no changes to total surplus as regards policyholders are to be made to reflect the effect of a quasi-reorganization. This issue paper adopts ARB 46 with modification to require disclosure of the impact of the restatement in the notes to financial statements as long as financial statements for the period of reorganization are presented.

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 adjustment of carrying amounts is reasonably complete, in order that there may be no continuation of the circumstances which justify charges to capital surplus.

4. A write-down of assets below amounts which are likely to be realized thereafter, though it may result in conservatism in the balance sheet at the readjustment date, may also result in overstatement of earnings or of earned surplus when the assets are subsequently realized. Therefore, in general, assets should be carried forward as of the date of readjustment at fair and not unduly conservative amounts, determined with due regard for the accounting to be employed by the company thereafter. If the fair value of any asset is not readily determinable a conservative estimate may be made, but in that case the amount should be described as an estimate and any material difference arising through realization or otherwise and not attributable to events occurring or circumstances arising after that date should not be carried to income or earned surplus.

5. Similarly, if potential losses or charges are known to have arisen prior to the date of readjustment but the amounts thereof are then indeterminate, provision may properly be made to cover the maximum probable losses or charges. If the amounts provided are subsequently found to have been excessive or insufficient, the difference should not be carried to earned surplus nor used to offset losses or gains originating after the readjustment, but should be carried to capital surplus.

6. When the amounts to be written off in a readjustment have been determined, they should be charged first against earned surplus to the full extent of such surplus; any balance may then be charged against capital surplus. A company which has subsidiaries should apply this rule in such a way that no consolidated earned surplus survives a readjustment in which any part of losses has been charged to capital surplus.

7. If the earned surplus of any subsidiaries cannot be applied against the losses before resort is had to capital surplus, the parent company's interest in such earned surplus should be regarded as capitalized by the readjustment just as surplus at the date of acquisition is capitalized, so far as the parent is concerned.

8. The effective date of the readjustment, from which the income of the company is thereafter determined, should be as near as practicable to the date on which formal consent of the stockholders is given, and should ordinarily not be prior to the close of the last completed fiscal year.

Procedure after Readjustment

9. When the readjustment has been completed, the company's accounting should be substantially similar to that appropriate for a new company.

10. 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.

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 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.

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 210² of the Codification of Financial Reporting Policies for a quasi-reorganization?

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 210³ for a quasi-reorganization are satisfied.⁴

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

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).”

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

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.

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. (Added by SAB No. 78, 8/25/88.)

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 210.⁸ Assume a company has adopted Statement of Financial Accounting Standards (“SFAS”) No. 96, 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 as 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?

⁸ Supra Note 3.

Interpretive Response:

The staff believes SFAS No. 96 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 210,⁹ 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.”¹⁰

⁹ Section 210 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.]

¹⁰ Special Report: A Guide to Implementation of Statement 96 on Accounting for Income Taxes; Financial Accounting Standards Board (March 1989); question 26, page 36 and 37, states in part: “ARB No. 43, Chapter 7, “Capital Accounts,” states that after a quasireorganization, 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 for financial reporting 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.”

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.¹¹ 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 54 of SFAS No. 96 for the tax benefits of tax carryforward items.¹² 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.

¹¹ SFAS No. 96 (December 1987); paragraph 54, states: “Some quasi reorganization involve only the elimination of a deficit in retained earnings by a concurrent reduction in contributed capital. For that type of reorganization, subsequent recognition of the tax benefit of a prior operating loss or tax credit carryforward for financial reporting is reported as required by paragraph 52 and then reclassified from retained earnings to contributed capital.” [Emphasis added.] Also, Supra Note 10.

¹² The first sentence of paragraph 54 of SFAS No. 96 states: “The tax benefit of an operating loss or tax credit carryforward for financial reporting as of the date of a quasi-reorganization as defined and contemplated (involving write-offs directly to contributed capital) in ARB No. 43, Chapter 7, “Capital Accounts,” is reported as a direct addition to contributed capital if the tax benefits are recognized in subsequent years”.

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 APB Opinion No. 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.]¹³

¹³ Accounting Principles Board Opinion No. 20 (July 1971); paragraph 16.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- *Issue Paper No. 68—Business Combinations and Goodwill*
- *Issue Paper No. 72—Statutory Surplus*

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