

Financial reporting developments

*A comprehensive guide*

# Bankruptcies, liquidations and quasi-reorganizations

March 2024

# To our clients and other friends

This publication is designed to assist professionals in understanding the financial reporting issues associated with bankruptcies, liquidations and quasi-reorganizations. This publication includes excerpts from and references to the Accounting Standards Codification issued by the Financial Accounting Standards Board (FASB), interpretive guidance and examples.

This publication was updated to reflect the latest guidance and views on the accounting considerations for entities in bankruptcy, liquidation and quasi-reorganization and standard-setting developments. See Appendix A for more detail on the updates provided.

We are available to answer your questions and discuss any concerns you may have.

*Ernst + Young LLP*

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**Notice to readers:**

This publication includes excerpts from and references to the Financial Accounting Standards Board (FASB or Board) Accounting Standards Codification (Codification or ASC). The Codification uses a hierarchy that includes Topics, Subtopics, Sections and Paragraphs. Each Topic includes an Overall Subtopic that generally includes pervasive guidance for the Topic and additional Subtopics, as needed, with incremental or unique guidance. Each Subtopic includes Sections that in turn include numbered Paragraphs. Thus, a Codification reference includes the Topic (XXX), Subtopic (YY), Section (ZZ) and Paragraph (PP).

Throughout this publication references to guidance in the Codification are shown using these reference numbers. References are also made to certain pre-Codification standards (and specific sections or paragraphs of pre-Codification standards) in situations in which the content being discussed is excluded from the Codification.

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# 1 Introduction to bankruptcies

Bankruptcy is a legal procedure for dealing with the debt problems of individuals and businesses. This procedure is covered under Title 11 of the United States Code (the Bankruptcy Code or the Code). The Bankruptcy Code is a federal statute, enacted on 1 October 1979, as Title 11 of the United States Code by the Bankruptcy Reform Act of 1978. Under the jurisdiction of the US District Court, the Bankruptcy Court (the court) generally is responsible for cases filed under the Bankruptcy Code.

## 1.1 Types of bankruptcies (updated April 2023)

The six basic types of bankruptcies under the Bankruptcy Code are traditionally given the names of the chapters that describe them. These types of bankruptcies are listed below with a brief description of who can avail themselves of the respective chapters:

| Type       | Applicability        | Description   |
|------------|----------------------|---|
| Chapter 7  | Entities/Individuals | Chapter 7 provides for an orderly liquidation of all the assets and distributions to creditors. An independent trustee is appointed or elected and is charged with the responsibility to sell or dispose of the assets of the entity/estate, pursue any transfers that are avoidable, make distributions to administrative claimholders and creditors and dissolve the entity/estate. Under Chapter 7, the entity generally discontinues operations and allows the trustee to divide the assets according to each creditor's priority and standing. Chapter 7 is the most common form of bankruptcy.                        |
| Chapter 9  | Municipalities       | Chapter 9 is available should any municipality choose to avail itself of its provisions. Section 101 of the Bankruptcy Code defines municipality as a political subdivision or public agency or instrumentality of a state.   |
| Chapter 11 | Entities/Individuals | Chapter 11 is typically used to reorganize a business, although individuals also may file a petition under Chapter 11. Upon the filing of a voluntary petition for relief under Chapter 11, the entity automatically assumes an additional identity as the "debtor-in-possession." The term refers to a debtor (entity) that keeps possession and control of its assets while undergoing a reorganization under Chapter 11, without the appointment of a trustee. Generally, the entity, as "debtor-in-possession," operates the business and performs many of the functions that a trustee performs in other bankruptcies. |
| Chapter 12 | Farmers/fishermen    | Chapter 12 is reserved for farmers or fishermen and addresses the specific needs of "family farmers" or "family fishermen" with "regular annual income." Chapter 12 allows farmers or fishermen to reorganize and retain all or part of their property, subject to total debt limitations. In addition, the individual or the individual and spouse must have earned more than 50 percent of their gross income from their farming or commercial fishing operations. Farmers who are not eligible for relief, or who elect not to seek relief under Chapter 12, may file under another chapter.                             |

| Type       | Applicability                          | Description   |
|------------|--|---|
| Chapter 13 | Individuals/Qualifying entities        | Chapter 13 bankruptcy is available to individuals with regular income who wish to adjust their debts as part of a plan approved by the court and creditors. These cases are administered by a standing panel of Chapter 13 trustees. Qualifying small businesses may also file under Chapter 13. Chapter 13 may be used only by individually owned entities. If the debt exceeds certain limits, the individual or qualifying entity must file under another chapter. |
| Chapter 15 | Ancillary and other cross-border cases | Chapter 15 provides an effective mechanism for dealing with cases of cross-border insolvency. See section 1.4, <i>Cross-border bankruptcies</i> , for more information.   |

Effective February 2020, the Small Business Reorganization Act of 2019 created a new Subchapter V under Chapter 11 of the Bankruptcy Code. In order to qualify for Subchapter V, the debtor must be engaged in commercial or business activities with noncontingent debts of \$2,725,625 or less. However, the Coronavirus Aid, Relief, and Economic Security (CARES) Act temporarily increased this debt limit to \$7,500,000 through 27 March 2022, at which point it reverted to the original amount. In June 2022 the Bankruptcy Threshold Adjustment and Technical Corrections Act was enacted to reinstate the debt limit of \$7,500,000 retroactively to 27 March 2022 and will remain in effect through 21 June 2024. In addition to the benefits that come along with Chapter 11 protection, Subchapter V bankruptcy cases are intended to provide relaxed plan confirmation requirements, accelerated deadlines, reduced expenses and less administrative burden throughout the process.

The vast majority of cases are filed under the three main chapters of the Bankruptcy Code, which are Chapter 7, Chapter 11 and Chapter 13. The primary function of a Chapter 7 bankruptcy proceeding is to liquidate the entity's nonexempt assets and distribute the proceeds to the entity's creditors. The primary function of a Chapter 11 and a Chapter 13 bankruptcy proceeding is to reorganize the entity's financial affairs through a court-approved plan. An entity can file for bankruptcy on a voluntary basis or the creditors can commence an involuntary bankruptcy under Chapters 7, 11 or 13 if certain criteria are met.

In bankruptcy, no payments can be made to an unsecured creditor unless the secured class of creditors (often banks and other financial institutions) have been paid in full or otherwise settled on a prorated basis with other creditors as determined by the courts. After the secured creditors are paid, administrative creditors<sup>1</sup> are next in line to receive payment. Unsecured creditors have the third priority after administrative creditors and usually are a compromised class. Lastly, the shareholders of the entity have the last claim on the assets of the entity and may not receive any payment if the secured and unsecured creditors' claims are not fully paid.

Through bankruptcy, most of an entity's debts are eliminated, thereby providing the entity a fresh start. Although each type of bankruptcy differs from the others in significant ways, there are important elements that are common to all bankruptcies, such as automatic stays and discharges. A Chapter 11 filing allows the entity to continue its operations while in bankruptcy and allows it to liquidate through the Chapter 11 process.

This publication addresses Chapters 7 and 11 filings. In addition, this publication also addresses the accounting for entities that are in the process of liquidation, whether through a bankruptcy proceeding or other forms of liquidation. An entity in liquidation is no longer a going concern and instead follows liquidation basis accounting. Entities that are liquidating under Chapter 7 apply Accounting Standards Codification (ASC) 205-30, as discussed in section 6, *Liquidation basis of accounting*. Upon filing for a Chapter 11 bankruptcy reorganization, an entity would be in the scope of ASC 852-10 (see sections 3 through 5 for more guidance).

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<sup>1</sup> Administrative creditors hold claims for services provided to the entity during the postpetition period of the proceedings.

Although global enterprises often will avail themselves of bankruptcy protection in non-US jurisdictions, the focus of this publication is on filings under the United States Bankruptcy Code. In the event that an entity or a subsidiary files for bankruptcy protection in a non-US jurisdiction, those local laws prevail. Depending on the jurisdiction, management may not be able to continue to operate the subsidiary as it may do in the US pursuant to a Chapter 11 bankruptcy filing. As such, there may be different accounting and financial reporting considerations between a Chapter 11 filing in the US and a bankruptcy filing in a non-US jurisdiction.

## 1.2 Overview of Chapter 11 bankruptcy

A Chapter 11 bankruptcy filing is a form of bankruptcy reorganization available to any business, though it is most often used by corporate entities. It has no limits on the amount of debt to be restructured and is the most common choice for large businesses seeking to restructure debt. The entity usually remains in possession of its assets and operates the business under the supervision of the court and for the benefit of creditors (i.e., the debtor-in-possession (DIP) is a fiduciary for the creditors). In order to operate as a DIP, the entity generally must obtain financing. DIP financing provides liquidity while the entity attempts to reorganize itself. Without such financing, particularly in a lengthy bankruptcy proceeding, the entity likely would consider (or be forced to consider) liquidation.

An entity normally enters reorganization under Chapter 11 by filing a petition (either voluntarily or involuntarily) with the court. This filing begins the reorganization proceedings. The goal of the proceedings is to maximize recovery by creditors and shareholders by preserving the viability of the entity. For that purpose, the entity prepares a plan of reorganization (the plan) to be confirmed by the court. The plan, once confirmed, may affect the rights of unsecured creditors, undersecured creditors, secured creditors and shareholders. Before a plan is confirmed by the court, it must comply with general provisions of the Code. Those provisions include that (1) the plan is feasible, (2) the plan is in the best interest of the creditors and (3) if an impaired class does not accept the plan, the plan must be determined to be fair and equitable before it can be confirmed.

The court appoints a US Trustee to facilitate the reorganization process. A creditors' committee generally is appointed by the trustee from among the largest, unsecured creditors who are not insiders. The committee represents all of the creditors in providing oversight for the entity's operations and is a body with whom the entity can negotiate an acceptable plan of reorganization. Creditors are divided by the plan into classes based on the characteristics of their claims, and their voting power is a function of the amount of their claim against the entity. If the entity has insufficient creditor votes to confirm a plan, the entity can attempt to convince the court to "cram down" a plan on its creditors. Such a "cram down" will confirm a plan despite creditor opposition, by meeting certain statutory tests. Absent a "cram down," a Chapter 11 reorganization plan is confirmed only upon the affirmative vote of a super-majority of the creditors as defined in the Code.

In certain circumstances, an entity may negotiate with creditors and shareholders and reach an agreement on the plan prior to filing for bankruptcy protection (i.e., a "prepackaged" bankruptcy). A prepackaged bankruptcy is nonetheless subject to approval by the court.

### 1.2.1 Chapter 11 key players, process and timeline

#### 1.2.1.1 Filing

A Chapter 11 bankruptcy begins with the filing of a petition with the court serving the area where the entity has a domicile or residence. A petition may be a voluntary petition, which is filed by the entity, or it may be an involuntary petition, which is filed by creditors that meet certain requirements. Unless the court orders otherwise, the entity must file with the court:

- ▶ Schedules of assets and liabilities
- ▶ A schedule of current income and expenditures
- ▶ A schedule of executory contracts and unexpired leases
- ▶ A statement of financial affairs

Upon filing a voluntary petition for relief under Chapter 11 or, in an involuntary case, the entry of an order for relief, the entity automatically assumes an additional identity as the “debtor-in-possession.” The term refers to a debtor (entity) that keeps possession and control of its assets while undergoing a reorganization under Chapter 11 without the appointment of a trustee. An entity will remain a debtor-in-possession until the entity’s plan of reorganization is confirmed, the entity’s case is dismissed or converted to Chapter 7 or a Chapter 11 trustee is appointed. The appointment or election of a trustee occurs only in a small number of cases. Generally, the entity, as “debtor-in-possession,” operates the business and performs many of the functions that a trustee would perform.

### **1.2.1.2 Debtor-in-possession**

The Code places the entity in the position of a fiduciary, with the rights and powers of a Chapter 11 trustee, and it requires the entity to perform all functions and duties of a trustee, except the investigative functions. These duties, set forth in the Code and Federal Rules of Bankruptcy Procedure, include accounting for property, examining and objecting to claims and filing informational reports as required by the court and the U.S. trustee or bankruptcy administrator (discussed below), such as monthly operating reports. The entity also has many of the other powers and duties of a trustee, including the right, with the court’s approval, to employ attorneys, accountants, appraisers, auctioneers or other professional persons to assist the entity during its bankruptcy. Other responsibilities include filing tax returns and reports that are either necessary or ordered by the court after confirmation.

### **1.2.1.3 Trustee or bankruptcy administrator**

The U.S. trustee (or bankruptcy administrator) is responsible for monitoring the compliance of the entity with the reporting requirements. The trustee plays a major role in monitoring the progress of a Chapter 11 bankruptcy and supervising its administration. The trustee is responsible for monitoring the entity’s operation of the business. The trustee also monitors applications for compensation and reimbursement by professionals. In addition, the trustee conducts a meeting of the creditors, often referred to as the “Section 341 meeting,” in a Chapter 11 bankruptcy.

The trustee also imposes certain requirements on the entity concerning matters such as reporting its monthly income and operating expenses, establishing new bank accounts and paying current employee withholding and other taxes. Should an entity fail to comply with the reporting requirements of the trustee or orders of the court, or fail to take the appropriate steps to bring the case to confirmation, the trustee may file a motion with the court to have the entity’s Chapter 11 case converted to another chapter of the Code or to have the case dismissed.

In certain jurisdictions, a bankruptcy administrator performs similar functions that the trustee performs. As such, the terms are often used interchangeably.

### **1.2.1.4 Creditors’ committees**

Creditors’ committees can play a major role in Chapter 11 bankruptcies. The committee is appointed by the trustee and ordinarily consists of a limited number of unsecured creditors who hold the largest unsecured claims against the entity. Among other things, the committee:

- ▶ Consults with the entity on administration of the bankruptcy
- ▶ Investigates the entity’s conduct and operation of the business
- ▶ Participates in formulating a plan

Creditors’ committee may hire an attorney or other professionals to assist in the performance of the committee’s duties, with the court’s approval. A creditors’ committee can be an important safeguard to the proper management of the business by the entity.

### 1.2.1.5 **Role of an examiner**

The appointment of an examiner in a Chapter 11 bankruptcy is rare. The role of an examiner is generally more limited than that of a trustee. The examiner is authorized to perform the investigatory functions of the trustee and is required to file a statement of any investigation conducted. If ordered to do so by the court, however, an examiner may carry out any other duties of a trustee that the court orders the entity not to perform.

### 1.2.1.6 **Automatic stay**

The automatic stay provides a period of time in which all judgments, collection activities, foreclosures and repossessions of property are suspended and may not be pursued by the creditors on any debt or claim that arose before the filing of the bankruptcy petition. As with other bankruptcies, a stay of creditor actions against the entity automatically goes into effect when the bankruptcy petition is filed. The stay provides an opportunity for the entity to negotiate with the creditors to try to resolve the difficulties in the entity's financial situation.

Under specific circumstances, the secured creditor can obtain an order from the court granting relief from the automatic stay. For example, when the entity has no equity in the secured property and the property is not necessary for an effective reorganization, the secured creditor can seek an order of the court lifting the stay to permit the creditor to foreclose on the property, sell it and apply the proceeds to the debt.

### 1.2.1.7 **Avoidable transfers**

The entity or the trustee, as the case may be, has what are called "avoiding" powers. These powers may be used to undo a transfer of money or property made during a certain period before the filing of the bankruptcy petition. By avoiding a particular transfer of property, the entity can cancel the transaction and force the return or "disgorgement" of the payments or property, which then are available to pay all creditors. Generally, and subject to various defenses, the power to avoid transfers is effective against transfers made by the entity within 90 days before filing the petition. In addition, under 11 U.S.C. § 544, a trustee is authorized to avoid transfers under applicable state law, which often provides for longer periods. Avoiding powers prevent unfair prepetition payments to one creditor at the expense of all other creditors.

### 1.2.1.8 **Adversary proceedings**

Frequently, the entity will institute a lawsuit, known as an adversary proceeding, to recover money or property. Adversary proceedings may take the form of lien avoidance actions, actions to avoid preferences, actions to avoid fraudulent transfers or actions to avoid postpetition transfers. Creditors may also initiate adversary proceedings by filing complaints to determine the validity or priority of a lien, revoke an order confirming a plan, determine whether a debt may be discharged, obtain an injunction or subordinate a claim of another creditor.

### 1.2.1.9 **Conversion or dismissal**

An entity in Chapter 11 has a one-time absolute right to convert the Chapter 11 case to a case under Chapter 7 unless: (1) the entity is not a debtor-in-possession; (2) the case originally was commenced as an involuntary case under Chapter 11; or (3) the case was converted to a case under Chapter 11 other than at the entity's request. An entity in a Chapter 11 case does not have an absolute right to have the case dismissed upon request.

A party in interest may file a motion to dismiss or convert a Chapter 11 bankruptcy to a Chapter 7 bankruptcy "for cause." Generally, if cause is established after notice and hearing, the court must convert or dismiss the case (whichever is in the best interests of creditors) unless it specifically finds that the requested conversion or dismissal is not in the best interest of creditors. Cause for dismissal or conversion includes an unexcused failure to timely comply with reporting and filing requirements; failure to attend the meeting of creditors or attend an examination without good cause; failure to timely provide information to the trustee; and failure to timely pay postpetition taxes or timely file postpetition returns.

In addition, failure to file a disclosure statement or to file and confirm a plan within the time established by the Bankruptcy Code or order of the court; inability to effectuate a plan; and denial or revocation of confirmation are causes for dismissal or conversion. The inability to consummate a confirmed plan represents “cause” for dismissal under the statute.

### **1.2.1.10 Disclosure statement**

Generally, the entity (or any plan proponent) must file and get court approval of a written disclosure statement before there can be a vote on the plan of reorganization. The disclosure statement must provide “adequate information” concerning the affairs of the entity to enable the holder of a claim or interest to make an informed judgment about the plan. After the disclosure statement is filed, the court must hold a hearing to determine whether the disclosure statement should be approved. Acceptance or rejection of a plan usually cannot be solicited until the court has first approved the written disclosure statement. The disclosure statement includes, but is not limited to, the following:

- ▶ Information about the entity and reasons for the bankruptcy filing
- ▶ A summary of the plan of reorganization
- ▶ The plan for operating the business in the future
- ▶ Information concerning the assets, liabilities and business affairs of the entity
- ▶ Relevant financial statement information for current and prior periods
- ▶ Pro forma financial information based on the reorganization value, showing the expected financial structure of the entity when it emerges from bankruptcy
- ▶ Classification of claims and the specificity of how each class of claims will be treated under the plan

### **1.2.1.11 Acceptance of the plan of reorganization (confirmation date)**

Only the entity may file a plan of reorganization during the first 120-day period after the petition is filed (or after entry of the order for relief, if an involuntary petition was filed). The court may grant extension of this exclusive period for up to 18 months after the petition date. In addition, the entity has 180 days after the petition date or entry of the order for relief to obtain acceptances of its plan. In practice, entities typically seek extensions of both the plan filing and plan acceptance deadlines at the same time so that any order sought from the court allows the entity two months to seek acceptances after filing a plan before any competing plan can be filed.

If the exclusive period expires before the entity has filed and obtained acceptance of a plan, other parties in interest, such as the creditors’ committee or a creditor, may file a plan. Such a plan may compete with a plan filed by another party in interest or by the entity. If a trustee is appointed, the trustee must file a plan, a report explaining why the trustee will not file a plan or a recommendation for conversion or dismissal of the case.

The Bankruptcy Code states that a Chapter 11 plan must designate classes of claims and interests for treatment under the reorganization. Generally, a plan will classify claim holders as secured creditors, unsecured creditors entitled to priority, general unsecured creditors, and equity security holders. The court decides which claims to “allow” (referred to as “allowed claims”). The entity may list a claim when it files for bankruptcy, or the claim may be allowed if a creditor submits proof to the court. The court will determine the amount of allowed claims in some cases. Once the amount is established and approved by the court, the claim becomes an allowed claim. When a claim is not allowed, the creditor holding the claim cannot vote on the reorganization plan, unless the court allows the claim only for voting purposes. An entity may have a claims register that lists the amount of claims filed and the amount allowed. The amount of the allowed claims may differ from the actual settlement amount of these claims.

Under the Bankruptcy Code, an entire class of claims is deemed to accept a plan if the plan is accepted by creditors that hold:

- ▶ At least two-thirds in dollar amount of all allowed claims, and
- ▶ More than one-half in number of the allowed claims in the class

If there are impaired classes of claims, the court cannot confirm a plan unless it has been accepted by at least one class of non-insiders who hold impaired claims (i.e., claims that are not going to be paid completely or in which some legal, equitable or contractual right is altered). Moreover, under the Code, holders of unimpaired claims are deemed to have accepted the plan. Even if not all classes of creditors approve the plan, under certain conditions, the bankruptcy code allows the court the discretion to confirm the plan under what is referred to as a “cram down.”

Any party in interest may file an objection to confirmation of a plan. The Bankruptcy Code requires the court, after notice, to hold a hearing on confirmation of a plan. If no objection to confirmation has been timely filed, the Bankruptcy Code allows the court to determine whether the plan has been proposed in good faith and in compliance with the Code. In order to confirm the plan, the court must find, among other things, that: (1) the plan is feasible; (2) it is proposed in good faith; and (3) the plan and the proponent of the plan are in compliance with the Bankruptcy Code. In order to satisfy the feasibility requirement, the court must find that confirmation of the plan is not likely to be followed by liquidation (unless the plan is a liquidating plan) or the need for further financial reorganization. The confirmation date is the date the court approves the plan.

### 1.2.1.12

#### Discharge

The Bankruptcy Code generally provides that confirmation of a plan of reorganization discharges an entity from any debt that arose before the date of confirmation. After the plan is confirmed, the entity is bound by the provisions of the plan.

### 1.2.1.13

#### Final decree

A final decree closing the case must be entered after the discharge occurs. At that time, the entity has emerged from bankruptcy. The emergence date is also referred to as the effective date.

The following is a summary of the phases and major actions normally taken during reorganization under Chapter 11:

| Phases                  | Actions normally taken   |
|-------------------------|--|
| <b>Filing</b>           | <ul style="list-style-type: none"> <li>▶ A petition for reorganization is filed with the court listing, among other things, all the entity's outstanding obligations</li> <li>▶ Debtor assumes identity as a debtor-in-possession</li> <li>▶ An automatic stay is triggered</li> <li>▶ A trustee or bankruptcy administrator is assigned</li> <li>▶ A meeting of the creditors takes place</li> <li>▶ If needed, a new debtor-in-possession credit facility is arranged</li> </ul> |
| <b>Plan formulation</b> | <ul style="list-style-type: none"> <li>▶ The trustee appoints a creditors' committee</li> <li>▶ The court sets the date by which all creditors must submit their claim and support for such claim. If the entity initially listed the claim, the creditor does not have to provide support unless there is a disagreement over the amount</li> <li>▶ The plan of reorganization is finalized</li> </ul>  |
| <b>Confirmation</b>     | <ul style="list-style-type: none"> <li>▶ The plan of reorganization and disclosure statement is filed with the court</li> <li>▶ The court holds hearing to determine if the disclosure statement should be approved</li> <li>▶ The court solicits a vote on the acceptance or rejection of the plan</li> </ul>   |
| <b>Emergence</b>        | <ul style="list-style-type: none"> <li>▶ The court and creditors approve the plan and the entity emerges from bankruptcy</li> <li>▶ The final decree is entered closing the case</li> </ul>  |

## 1.2.2 Prepackaged and prearranged bankruptcies

A prepackaged or a prearranged bankruptcy is a plan of reorganization that an entity prepares in cooperation with its creditors that will take effect once the entity enters bankruptcy. This plan must be voted on by shareholders and agreed to by its significant creditors before the entity files its petition for bankruptcy and can result in shorter turnaround times. Certain high-interest subordinated debt agreements, for example, require all debt holders to approve any amendments to the debt agreements. However, approval of only two-thirds in amount and of a majority in number of each class of creditors voting is required under a court approved prepackaged or prearranged bankruptcy. If prepackaged or prearranged plans involve an offer to sell securities, they may have to be registered with the SEC before the issuance can take place.

The idea behind a prepackaged bankruptcy plan is to shorten and simplify the bankruptcy process in order to save the entity money in legal and accounting fees, as well as the amount of time spent in bankruptcy protection. The sooner the entity can emerge from bankruptcy, the sooner it can implement its reorganization and return to generating revenues from its core operations.

Some constituents believe entities emerging from a prepackaged or a prearranged Chapter 11 reorganization should be exempt from ASC 852's guidance and should instead consider the debt modification guidance in ASC 470-60, because the restructuring of the debt took place prior to the petition being filed and the filing was merely a formality.

However, the legal requirements of these types of filings, including the court's confirmation of the plan of reorganization, are no different from a standard bankruptcy filing. That is, a plan developed and voted on before the petition is filed must meet the same content and confirmation standards as a plan voted on after the Chapter 11 petition is filed and must still be approved by the court before the entity can emerge from bankruptcy. As such, an entity that has a prepackaged or a prearranged bankruptcy should still apply the guidance in ASC 852.

See section 2.6 of our Financial reporting developments (FRD) publications, *Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)* or *Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)*, as applicable, and section 3.9.15, *Applicability of troubled debt restructuring accounting*, for additional guidance on when ASC 470-60 applies.

## 1.2.3 Section 363 sales

In lieu of a reorganization plan or "cram down," the entity (or appointed Chapter 11 trustee) may utilize the powers bestowed upon it by Section 363 under Chapter 11 of the Code to sell all, or a portion of, the entity's assets to a third party. Under a Section 363 sale, the entity selects the potential purchaser offering the highest purchase price. The initial bidder is known as the "stalking horse" bidder and it presents a fully negotiated asset purchase agreement to the court for its approval. Pursuant to the Section 363 sale process, the entity files bidding procedures and conducts an auction. The bidder that provides the highest purchase price or total consideration is officially approved by the court as the ultimate buyer. A Section 363 sale generally is effected through a newly created "buyer company" that provides the buyer with title to the purchased assets free and clear of any prior liens and claims, as well as any claims or liabilities assumed by the buyer. Claims may remain unpaid by the entity after the sale is completed. Even though an entity has effectively sold all (or a portion) of its assets, it remains under bankruptcy protection (and the provisions of ASC 852 continue to apply) until the court has approved (or "crammed-down") the plan of reorganization. The buyer's accounting in a Section 363 sale would follow ASC 805. See section 3.9.17.3, *Accounting for a Section 363 sale by the acquirer*, for additional guidance.



### 1.3 Overview of Chapter 7 bankruptcy

A Chapter 7 bankruptcy does not involve the filing of a plan of repayment as in a Chapter 11 bankruptcy. Instead, the bankruptcy trustee gathers and sells the entity's nonexempt assets and uses the proceeds of such assets to pay holders of claims (creditors) in accordance with the provisions of the Bankruptcy Code. Part of the entity's property may be subject to liens and mortgages that pledge the property to other creditors. In such instances, those secured creditors would generally receive a return of their collateral. Accordingly, the filing of a petition under Chapter 7 may result in the loss of property. Administrative claims such as salaries, accounting and legal fees are paid first during a Chapter 7 bankruptcy filing and any remaining funds are then distributed to the creditors. Upon total liquidation of the entity's assets and the settlement of claims, the entity receives a discharge from its prepetition debts.

### 1.4 Cross-border bankruptcies

With increasing frequency, a bankruptcy proceeding in one country has a connection to assets or information located in another. Because of the involvement of multiple jurisdictions, unique problems arise. To address some of these issues, the United States enacted Section 304 of the US Bankruptcy Code in 1978. Section 304 was repealed in 2005 and replaced with Chapter 15, titled "Ancillary and Other Cross Border Cases." Chapter 15 increased the range of options available in the United States in support of foreign bankruptcy proceedings.

Chapter 15 of the Code provides solutions to problems that arise in connection with cross-border bankruptcies, allowing US courts to issue subpoenas, orders to turn over assets, stays on pending actions and orders of other types as circumstances dictate. The ancillary proceeding permitted under Chapter 15 is often a more efficient and less costly alternative to initiating an independent bankruptcy proceeding in the US. It also avoids the conflicts that could arise between the jurisdictions involved in two independent bankruptcy proceedings initiated in connection with the same debtor. Chapter 15 also establishes mechanisms for the cooperation between US and foreign courts and representatives regarding proceedings that involve the same debtor.

When determining the appropriate accounting for a Chapter 15 bankruptcy, it is important to understand which type of filing (reorganization or liquidation) is being completed in the foreign country. See section 3.1, *The scope of ASC 852*, for additional discussion.

## 2 Before bankruptcy or liquidation

### 2.1 Introduction

This chapter highlights items to consider when an entity encounters significant financial difficulties before filing for bankruptcy and/or liquidating.

Some of the more common factors causing a business to file for bankruptcy protection are highlighted below:

**External business conditions** – In some instances, a business files for bankruptcy due to external business conditions. These conditions often include an unforeseen spike in the costs involved in running the business, a significant decrease in sales prices, a significant increase in competition, a product recall or a legal issue. Each of these conditions can result in the inability to generate new capital when it is necessary to cover additional costs, leaving the entity with a potentially damaging deficit.

**Internal business conditions** – Internal business conditions can be a contributing factor when an entity decides to file for bankruptcy. A loss of clients, poor location and issues that are related to the entity's credit standing are all examples of issues that could lead to an entity having financial difficulties. A weak, feuding or underperforming management team can also create detrimental internal conditions that result in filing for bankruptcy.

**Tax problems** – Corporate taxes are applied to all companies operating in the United States and vary by the type of entity. Outstanding tax debts that an entity is unable to settle can result in the government causing the entity to cease operations or to file for bankruptcy.

Whether financial difficulty occurs due to ineffective business strategies or due to declines in the overall economy, there are certain accounting items that should be considered as a result of an entity's poor performance. These considerations are discussed below.

### 2.2 Goodwill, intangible assets and long-lived assets

Economic and market conditions may result in a financial decline and poor performance, which usually precede a petition for bankruptcy. As such, an interim test for impairment will most likely be completed because of the existence of interim impairment indicators. The guidance in ASC 350 and ASC 360 should be considered in assessing these types of assets for recoverability.

ASC 350 requires goodwill be tested for impairment on an annual basis and **more frequently** if an event occurs or circumstances change that indicate an impairment has more likely than not occurred. Similarly, ASC 350 requires that indefinite-lived intangible assets be tested for impairment on an annual basis and **more frequently** if events or changes in circumstances indicate that the asset might be impaired. Finally, ASC 360 requires that finite-lived assets, including definite-lived intangible assets, be tested for recoverability **whenever** events or changes in circumstances indicate that the carrying amount may not be recoverable. The impairment assessment should occur not only in connection with the audit of the entity's annual financial statements or, in the case of goodwill and indefinite-lived intangible assets, the annual impairment test date, but also any time that indicators of impairment are present, such as the periods directly preceding a petition for bankruptcy.

## 2.2.1 Goodwill and indefinite-lived intangible assets

ASC 350 includes the following examples of events and circumstances that might indicate that it is more likely than not that the fair value of a reporting unit is less than its carrying amount:

- ▶ Macroeconomic conditions such as a deterioration in general economic conditions, limitations on accessing capital, fluctuations in foreign exchange rates or other developments in equity and credit markets
- ▶ Industry and market considerations such as a deterioration in the environment in which an entity operates, an increased competitive environment, a decline in market-dependent multiples or metrics (considered in both absolute terms and relative to peers), a change in the market for an entity's products or services or a regulatory or political development
- ▶ Cost factors such as increases in raw materials, labor or other costs that have a negative effect on earnings and cash flows
- ▶ Overall financial performance such as negative or declining cash flows or a decline in actual or planned revenue or earnings compared with actual and projected results of relevant prior periods
- ▶ Other relevant entity-specific events such as changes in management, key personnel, strategy, or customers; contemplation of bankruptcy; or litigation
- ▶ Events affecting a reporting unit such as a change in the composition or carrying amount of its net assets, a more-likely-than-not expectation of selling or disposing all, or a portion, of a reporting unit, the testing for recoverability of a significant asset group within a reporting unit, or recognition of a goodwill impairment loss in the financial statements of a subsidiary that is a component of a reporting unit
- ▶ If applicable, a sustained decrease in share price (considered in both absolute terms and relative to peers)

ASC 350 specifically includes the contemplation of bankruptcy as an event or circumstance that might indicate that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. In addition, we would expect that an entity that is experiencing financial difficulties would have triggered most of the factors highlighted above and would therefore be required to perform an interim goodwill impairment test.

If a goodwill impairment charge is not recorded prior to the filing of a bankruptcy petition, appropriate documentation is required to support the assertion that a goodwill impairment charge was not warranted at that time. Appropriate consideration should be given to valuations filed as part of any plan of reorganization. Such valuations should be appropriately reconciled to any valuations used for goodwill impairment testing.

Similar to goodwill, an indefinite-lived intangible asset should be tested for impairment annually or more frequently if events or changes in circumstances indicate that the asset might be impaired. ASC 350 provides the following examples of events and circumstances that might indicate that it is more likely than not that the fair value of an indefinite-lived intangible asset is less than its carrying amount:

- ▶ Cost factors, such as increases in raw materials, labor or other costs that have a negative effect on future expected earnings and cash flows
- ▶ Financial performance, such as negative or declining cash flows, or a decline in actual or planned revenue or earnings compared with actual and projected results of relevant prior periods

- ▶ Legal, regulatory, contractual, competitive, economic, political, business or other factors
- ▶ Other relevant entity-specific events, such as changes in management, key personnel, strategy or customers; contemplation of bankruptcy; or litigation
- ▶ Industry and market considerations, such as a deteriorating operating environment, increased competition, a decline in market-dependent multiples or metrics (both in absolute terms and relative to peers) or a change in the market for an entity's products or services due to obsolescence, demand, competition or other economic factors
- ▶ Macroeconomic conditions, such as a deterioration in general economic conditions, limited access to capital, foreign exchange rate fluctuations or other equity and credit market developments

ASC 350 provides entities the option to first perform a qualitative assessment to determine whether it is more likely than not that goodwill or an indefinite-lived intangible asset is impaired. However, when an entity is experiencing financial difficulties and/or contemplating filing for bankruptcy, we generally believe it would be unlikely that the entity would satisfy the impairment test using only a qualitative assessment. See our FRD, *Intangibles – Goodwill and other*, for further discussion of testing goodwill and indefinite-lived intangible assets for impairment.

Entities that either conclude it is more likely than not that goodwill or an indefinite-lived intangible is impaired or opt out of the qualitative assessment must determine the fair value of the reporting unit. The fair value of the reporting unit is the amount at which the units as a whole could be sold in a current transaction between willing parties. See our FRD, *Fair value measurement*, for further discussion of measuring fair value.

## 2.2.2

### Finite-lived intangible assets and other long-lived assets

Similar to ASC 350, the guidance in ASC 360 requires long-lived assets, including finite-lived intangible assets, to be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable (i.e., information indicates that an impairment might exist). The following are examples from ASC 360 of such events or changes in circumstances:

- ▶ A significant decrease in the market price of a long-lived asset (asset group)
- ▶ A significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or in its physical condition
- ▶ A significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset (asset group), including an adverse action or assessment by a regulator
- ▶ An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset (asset group)
- ▶ A current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset (asset group)
- ▶ A current expectation that, more likely than not, a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life

Deterioration in an entity's operating results may lead to a conclusion that one or more of these events have occurred. However, similar to the discussion above on goodwill and indefinite-lived intangible assets, these events are merely examples of circumstances that would require a recoverability test and should not be considered all inclusive. Other considerations might include a significant drop in the share price of the entity, an impairment of goodwill and other indefinite-lived intangibles under ASC 350 (this would be a particularly relevant indicator when the intangible relates to or is used by an asset group containing other long-lived assets), or the examples in section 2.2.1, *Goodwill and indefinite-lived intangible assets*.

See our FRD, *Impairment or disposal of long-lived assets*, for additional guidance. The accounting requirements vary depending on whether the asset is expected to be held and used, disposed of by sale, or disposed of other than by sale.

## 2.3 Debt

### 2.3.1 Covenant violations

Events leading to a bankruptcy, such as an uncertain economic environment and weakness in operating results, present operating and financing challenges that frequently affect an entity's ability to comply with financial covenants. To avoid bankruptcy, an entity may engage in activities that result in a change in control of the entity that can trigger a covenant violation. When a covenant violation has occurred at the balance sheet date (or prior to the issuance of financial statements), or if it has not occurred but it is probable that a violation will occur in the next year, the classification of debt in the balance sheet as either current or noncurrent should be analyzed under ASC 470. See section 2.7.1.2 of our FRDs, *Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)*, or *Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)*, as applicable, for additional guidance on the classification of debt.

See section 2.4.3.1.2 of our FRDs, *Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)*, or *Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)*, as applicable, for guidance on premiums, discounts and issuance costs for debt that becomes due on demand due to covenant violations.

#### 2.3.1.1 SEC staff views on potential debt covenant violations

The Securities and Exchange Commission (SEC) staff often requests that registrants provide comprehensive disclosures of material debt covenants. In addition, the SEC staff expects expanded disclosures when indicators of increased risk of default are present or management has concluded it is reasonably likely that covenants will not be met in the future.

Failing to comply with material debt covenants can have a significant effect on a registrant's liquidity. Accordingly, the SEC staff has requested that registrants whose risk of noncompliance with debt covenants is reasonably likely improve their related disclosures. The SEC staff has focused on providing users of financial statement information with greater transparency into the nature of, and measurement against, such covenants as well as the potential risks and actual or reasonable effects of noncompliance with such covenants on the registrant's financial condition and liquidity.

Specifically, the SEC staff generally requests the following types of disclosures:

- ▶ Actual quantitative ratios or amounts compared to required minimum/maximum values contained in debt covenants, with explanations of how such ratios or amounts are determined and their relationship to amounts reported under US GAAP

- ▶ Default provisions in debt agreements that would accelerate the repayment of debt if not cured within applicable grace periods or would trigger cross-default provisions in other debt agreements
- ▶ Risk factors associated with technical defaults or breach of financial ratio covenants in credit facilities
- ▶ The nature of financial ratio violations and their impact on the registrant's liquidity
- ▶ The nature of waivers and/or modifications of existing debt covenants to cure or prevent any potential violation(s), including how long such waivers apply and a description of the related covenant
- ▶ The steps that the registrant is taking to avoid any potential breach of covenants
- ▶ The effect of debt covenants on the registrant's ability to issue new debt or equity, such as restrictions on debt incurrence, interest payments, dividend payments and debt ratios
- ▶ Alternate sources of funding and the consequences of accessing them (e.g., costs)

### 2.3.2 Troubled debt restructurings

Entities having financial difficulties often evaluate their liquidity and debt positions, leading to agreements to modify, exchange or extinguish existing debt. If debt is modified or exchanged outside of a prearranged or prepackaged bankruptcy plan, the guidance in ASC 470-60 applies. As such, entities should first evaluate whether the modification or exchange meets certain criteria to be considered a troubled debt restructuring. See section 2.6 of our FRDs, *Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)*, or *Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)*, as applicable, for additional guidance.

Determining the appropriate accounting model is important due to the significant differences in the accounting for these transactions under each of the potentially applicable models. Under ASC 470-60, if an entity's financial difficulties led the creditor to grant the entity a concession it would not otherwise have granted, the transaction is a troubled debt restructuring and should be accounted for by determining a new effective interest rate based on the carrying amount of the original debt and the revised cash flows. If the transaction is not considered a troubled debt restructuring under ASC 470-60, the modification or exchange of debt should be evaluated under ASC 470-50 to determine whether the modification or exchange is considered an extinguishment. Under ASC 470-50, a transaction is considered an extinguishment of the original debt if the terms of the new debt and original debt are substantially different, regardless of the transaction's form. The original and new debt instruments are "substantially different" if the present value of the cash flows under the terms of the new debt instrument is at least 10% more or less than the present value of the remaining cash flows under the terms of the original instrument.

If the original and new debt instruments are substantially different, the new debt should be initially recorded at fair value and the original debt should be derecognized, with the difference recognized as an extinguishment gain or loss. Other modifications or exchanges not considered to be substantially different are accounted for prospectively as yield adjustments. Variable terms of the instruments, embedded conversion options or the involvement of intermediaries may affect the "substantially different" analysis.

The accounting for modifications to or exchanges of line-of-credit or revolving-debt agreements generally depends on whether the borrowing capacity (the product of the remaining term and the maximum available credit) has increased or decreased.

Entities may offer additional securities or other consideration not required under the original terms (a "sweetener") to encourage a creditor to exercise its conversion right in a convertible debt instrument. In these circumstances, this transaction would be an induced conversion. When an induced conversion occurs, expense recognition equal to the fair value of the additional securities or other consideration issued to induce conversion is required.

### 2.3.3 Fair value disclosures

ASC 825 requires entities to provide specific disclosures regarding their financial instruments, including debt issued by the entity. These disclosures include information about the fair value, concentrations of credit risk and market risk of financial instruments. When an entity is in financial difficulty or the economy in which the entity operates significantly changes, the fair value of its debt might differ from the amount recorded in the entity's financial statements. For example, market illiquidity or perceptions of credit risk of the entity might affect the fair value of the debt.

When determining the fair value of the debt issued by an entity that is struggling financially for disclosure purposes, the involvement of valuation professionals is encouraged due to the complexities involved. See our FRD, *Fair value measurement*, for additional guidance on measuring fair value.

## 2.4 Working capital

### 2.4.1 Inventory

As an entity's financial condition (e.g., sales volume, gross margins or operating profits) deteriorates, the cost of inventory may be higher than market prices. Entities having financial difficulties should consider all factors when determining if the carrying amount of inventory is recoverable, including changes in prices subsequent to the end of the reporting period. In accordance with ASC 855, such changes are typically recognized, because they provide additional evidence with respect to conditions that existed at the balance sheet date.

Entities should consider the SEC staff's view on the income statement classification of inventory markdowns associated with a restructuring, as discussed in ASC 420-10-S99-3. The SEC staff recognizes that circumstances may exist in which an entity can assert that inventory markdowns are costs directly attributable to a restructuring (see section 2.9, *Restructurings, disposal or exit activities and discontinued operations*). However, the staff believes that it is difficult to distinguish inventory markdowns attributable to a restructuring from inventory markdowns attributable to external factors that are independent of a restructuring. Further, the staff believes that decisions about the timing, method and pricing of dispositions of inventory generally are considered normal, recurring activities integral to the management of the ongoing business. Accordingly, the SEC staff believes that inventory markdowns should be classified as a component of cost of goods sold.

### 2.4.2 Accounts receivable, contract assets and loans receivable (updated March 2024)

An entity contemplating a bankruptcy filing may have trouble collecting receivables and loans from customers as those customers become aware of the financial difficulties of the entity. Customers often become reluctant to settle outstanding payables to an entity having financial difficulties due to the fear that the entity may not be able to honor its legal obligations – for example, future required service obligations or warranty fulfillment. In addition, an entity that has a concentration of customers within its own industry might experience delayed or nonpayment from those customers as those customers also might be experiencing financial difficulties. Commercial banks, finance companies, credit unions, thrifts, real estate companies, real estate investment trusts (REITs) and insurance companies may experience financial difficulty if their customers are unable to repay loans, which may be a substantial component of their assets. As such, an entity may be required to increase its allowance for credit losses in periods preceding a bankruptcy filing.

ASC 326 includes the guidance for measuring the allowance for credit losses for accounts receivable, contract assets and loans receivable. Depending on the facts and circumstances, an entity also may need to consider ASC 310-10 when accounting for modifications to debtors experiencing financial difficulty and 310-20-35-9 through 310-20-35-14 when accounting for a loan refinancing or restructuring.

ASU 2022-02 amended ASC 310 to eliminate the recognition and measurement guidance for a troubled debt restructuring for creditors that have adopted ASU 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*<sup>2</sup> and requires them to make enhanced disclosures about loan modifications for borrowers experiencing financial difficulty. The amendments are currently effective for all entities. Entities facing financial difficulties may have significant changes in their allowance. Entities should disclose their accounting policy for determining the allowance, and other disclosures required by ASC 310-10 and ASC 326, as applicable. Changes to the policy or to customer payment trends should be disclosed in management's discussion and analysis (MD&A). The SEC staff has commented that registrants should disclose the effects of the changes in estimates of the allowance for each period presented and how the changes are expected to affect future financial results. See section 2.12, *Risks and uncertainties*, for additional guidance on disclosing changes in estimates.

See our FRD, *Credit impairment under ASC 326*, for additional guidance on applying ASC 326. In addition, consideration should be given to collectibility and the effect on revenue recognition policies, as discussed in section 2.10, *Revenue recognition*.

## 2.5 Investments, including equity method investments

If an entity is contemplating bankruptcy because of economic or industry factors and the entity holds investment securities of other entities that are facing similar challenges, those investment securities are assessed for impairment. See our FRD, *Certain investments in debt and equity securities*, for more discussion on the accounting for impairments of debt and equity securities.

See section 6.8 of our FRD, *Equity method investments and joint ventures*, for guidance on the indicators of when to evaluate an equity method investment for other-than-temporary impairment, and the accounting if impairment is indicated.

## 2.6 Income taxes

See section 6 and section 14.3.1 of our FRD, *Income taxes*, for guidance on evaluating deferred tax assets for realizability prior to bankruptcy and an entity's ability and/or intent to continue to indefinitely reinvest foreign earnings prior to bankruptcy, respectively.

## 2.7 Consolidation

Entities experiencing financial difficulties may be forced to change their capital structure to modify their governing documents or contractual arrangements, or to shift their strategic direction. These activities and others may constitute reconsideration events under ASC 810 that require an entity to reconsider whether an entity that it has an interest in is a variable interest entity (VIE). ASC 810-10-35-4 defines events that require the reconsideration of whether an entity is a VIE as follows:

- ▶ The entity's governing documents or contractual arrangements are changed in a manner that changes the characteristics or adequacy of the entity's investment at risk
- ▶ The equity investment or some part thereof is returned to the equity investors, and other interests become exposed to expected losses of the entity
- ▶ The entity undertakes additional activities or acquires additional assets, beyond those that were anticipated at the later of the inception of the entity or the latest reconsideration event, that increase the entity's expected losses

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<sup>2</sup> ASU 2016-13 (codified in ASC 326) is currently effective for all entities.



- ▶ The entity receives an additional equity investment that is at risk, or the entity curtails or modifies its activities in a way that decreases its expected losses
- ▶ Changes in facts and circumstances occur such that the holders of the equity investment at risk, as a group, lose the power from voting rights or similar rights of those investments to direct the activities of the entity that most significantly impact the entity's economic performance

As a result of these events, an entity could go from being a VIE to a voting entity or vice versa. An entity that previously was not subject to the VIE guidance in ASC 810 does not become subject to it simply because of losses that reduce the equity investment, even if those losses are in excess of expected losses or the equity investment is reduced to zero. Additionally, a troubled debt restructuring, as defined in ASC 470-60, does not require reconsideration of whether an entity is a VIE. See our FRD, [Consolidation](#), for additional guidance, including the required disclosures related to VIEs.

### 2.7.1 Decreases in a parent's ownership interest in a subsidiary without loss of control

A parent that is experiencing financial difficulties may raise funds by (1) selling a portion of its stake in the subsidiary or (2) causing the subsidiary to issue more shares. In either case, the carrying amount of the noncontrolling interest generally should be increased to reflect the increase in net assets owned by holders of the noncontrolling interest. Said another way, the amount attributed to the additional noncontrolling interests should equal the percentage of net assets that the holders of these interests own.

Any difference between the consideration received (whether by the parent or the subsidiary) and the adjustment made to the carrying amount of the noncontrolling interest should be recognized directly in equity attributable to the controlling interest (that is, as an adjustment to additional paid-in capital). See section 18.3.2 of our FRD, [Consolidation](#), for additional guidance.

### 2.7.2 Loss of control of a subsidiary or business

A parent that is struggling financially might sell or otherwise lose control of a subsidiary or group of assets that is a business in a transaction that is in the scope of ASC 810. If this is the case, the parent deconsolidates the subsidiary or derecognizes a group of assets that is a business upon loss of control, and generally recognizes a gain or loss. Any remaining noncontrolling ownership interest in the subsidiary (and any consideration received) is measured at its fair value. That ownership interest is subsequently accounted for in accordance with other applicable US GAAP (e.g., ASC 321, ASC 323).

See section 19.4.2.1 of our FRD, [Consolidation](#), for additional guidance, including the accounting for any contingent consideration received.

Due to the complexity of determining the fair value of a noncontrolling interest in an entity that is struggling financially, the involvement of valuation professionals is encouraged. See our FRD, [Fair value measurement](#), for additional guidance on measuring fair value.

Entities would appropriately account for and disclose any contingencies related to deconsolidated subsidiaries in accordance with the applicable US GAAP (e.g., ASC 450).

## 2.8 Derivatives and hedge accounting

An entity experiencing financial difficulties that is hedging forecasted transactions is required to reevaluate those arrangements because the forecasted events or transactions may no longer be attainable or probable. In addition, a deterioration in an entity's credit quality can result in the hedging relationship no longer being deemed "highly effective." In these cases, the entity may no longer qualify for hedge accounting under ASC 815.

Under the cash flow hedge accounting model, certain changes in the fair value of a hedging instrument can be deferred in other comprehensive income (OCI) and reclassified into earnings in the same period or periods in which the hedged forecasted transaction affects earnings. The determination that a derivative is no longer highly effective as a hedge due to financial difficulties and credit degradation does not invalidate hedge accounting until the point of such determination. Accordingly, previous balances deferred in OCI when hedge accounting was effective would be reclassified to earnings when the hedged item affects earnings (that is, not immediately). However, ASC 815 requires that these amounts be immediately reclassified into earnings if it is determined that the forecasted transaction is probable of not occurring. See our FRD, *Derivatives and hedging*, as applicable, for additional guidance.

### 2.8.1 Derivative contracts with counterparties in similar industries

A counterparty to a hedging instrument in the same industry as the entity might be experiencing financial difficulties similar to the entity. If this is the case, ASC 815 states that entities must consider the likelihood of the counterparty's compliance with the contractual terms of the hedging derivative as part of an ongoing assessment of hedge effectiveness. For example, if the chances of the counterparty not defaulting cease to be probable, the entity would be unable to conclude that a cash flow hedging relationship is expected to be highly effective in offsetting cash flows and, consequently, hedge accounting would no longer be applied. This concept applies equally to derivative instruments that are assets or liabilities.

A derivative counterparty does not typically enter into financial distress overnight. Fair value measurements should reflect changes in market participant concerns regarding non-performance risk as they occur. As market perceptions of nonperformance risk increase, such deterioration could call into question the continued application of hedge accounting for those affected derivatives in formal hedging relationships. Severe deterioration in the counterparty's creditworthiness may potentially prevent the hedging relationship from being "highly effective" on an ongoing basis and cause hedge accounting to cease at that point. See section 4.9 of our FRD, *Derivatives and hedging*, as applicable, for additional guidance.

Additional disclosures are required if an entity holds derivative instruments that contain contingent features that would require it to pay the counterparty upon various events related to credit-risk, such as bankruptcy, insolvency, payment default and delinquency of the underlying. See section 8.11.1 of our FRD, *Derivatives and hedging*, as applicable, for additional guidance.

### 2.9 Restructurings, disposal or exit activities and discontinued operations

Entities having financial difficulties that are on the verge of filing for bankruptcy may consider taking strategic actions, such as workforce reductions, consolidation of facilities and other restructurings. In addition, entities may consider eliminating certain operations (either through a sale or through a wind-down). ASC 420 requires that a liability for costs associated with an exit or disposal activity be recognized and initially measured at fair value when incurred. Under ASC 420, an entity's commitment to a plan, in and of itself, does not result in the recognition of a liability.

For employees that are entitled to receive one-time termination benefits (i.e., arrangements that, in substance, are not an ongoing benefit arrangement or deferred compensation contract) regardless of when their service terminates and for employees who will not be retained to render service beyond the minimum retention period, a liability for the termination benefits should be recognized and measured at its fair value at the communication date. The communication date is the date when all communication date requirements have been met in accordance with ASC 420-10-25-4. If employees are required to render service beyond a minimum retention period until they are terminated in order to receive the one-time termination benefits, a liability should be measured initially at the communication date based on its fair value as of the termination date and recognized ratably over the future service period. See our FRD, *Exit or disposal cost obligations*, for additional guidance.

Before the adoption of ASC 842, termination costs for contracts, such as operating leases and other executory contracts, are recognized and measured at fair value in the period in which the liability is incurred (generally, when the entity terminates the contract pursuant to the contractual terms or ceases to use the rights conveyed under the contract) in accordance with ASC 420. After the adoption of ASC 842, termination costs for a lease component of a contract are not accounted for under ASC 420, but instead accounted for under ASC 842. However, any non-lease components are still accounted for in accordance with ASC 420. See our FRD, [\*Exit or disposal cost obligations\*](#), for additional guidance.

Management also should determine if the results of operations of a component of an entity to be disposed of should be classified as discontinued operations in accordance with ASC 205-20. The results of operations of a component of an entity to be disposed of by sale may not be reported as discontinued until the held for sale and strategic shift criterion are met. For disposals other than by sale (for example, abandonment, distribution or exchange for similar productive assets), the results of operations of a component of an entity cannot be reported as a discontinued operation until the period in which the long-lived asset or disposal group is either abandoned, distributed or exchanged, depending on the manner of disposal and whether the strategic shift criteria has also been met. See section 5.2, *Fresh-start disclosures*, for reporting considerations when a component meets the criteria to be classified as a discontinued operation only upon emergence from bankruptcy. See our FRD, [\*Discontinued operations\*](#), for additional guidance.

Entities that have undertaken a restructuring or decided to exit parts or all of certain lines of a business should evaluate the long-lived assets associated with the line of business for impairment in accordance with ASC 360-10. The factors contributing to the decision to restructure are likely consistent with some of the impairment indicators in ASC 360-10 (see section 2.2.2, *Finite-lived intangible assets and other long-lived assets*).

## 2.10 Revenue recognition

With the deterioration of operating results, many entities will face increasing pressure to reach earnings goals and analysts' estimates. These pressures may lead entities to change business practices, which can affect the amount and timing of revenue recognition.

In addition, if industry or entity-specific factors are resulting in delayed or nonpayment from customers, consideration should be given to collectibility and the potential effect on the entity's ability to recognize revenue and to estimates of variable consideration. See sections 3.1.5 and 5.2 of our FRD, [\*Revenue from contracts with customers \(ASC 606\)\*](#), for more guidance.

## 2.11 Going concern

An entity's continuation as a going concern is presumed to be the underlying basis for preparation of its financial statements unless its liquidation is imminent. Preparing financial statements under this presumption is referred to as the going concern basis of accounting. Even if liquidation is not imminent, there may be substantial doubt about the entity's ability to continue as a going concern. The going concern assumption is challenged when an entity's ability to remain in business and sustain continued operations would not be possible without substantial disposition of assets outside the ordinary course of business, debt restructuring, revision of its operations or similar actions. When this is the case, but liquidation is not yet imminent, the entity's financial statements should be prepared on a going concern basis, but appropriate disclosure may need to be made. See section 6, *Liquidation basis of accounting*, for guidance on determining when liquidation is imminent.

ASC 205-40 explicitly requires management to evaluate whether there are conditions and events that raise substantial doubt about an entity's ability to continue as a going concern within one year after the financial statements are issued (or available to be issued when applicable).

See section G3, *Going concern*, of the EY Accounting Manual for further information on the going concern presumption and required disclosures.

## 2.12 Risks and uncertainties

The guidance in ASC 275 requires disclosures about the risks and uncertainties existing as of the balance sheet date in the following areas: (1) nature of operations, (2) use of estimates in the preparation of the financial statements, (3) certain significant estimates and (4) current vulnerability due to certain concentrations.

Disclosure of certain significant estimates should be made when information that is known to management prior to the issuance of financial statements meets both of the following criteria:

- ▶ It is at least reasonably possible (as defined in ASC 450) that management's estimate of the effect on the financial statements of a condition, situation or set of circumstances existing at the date of the financial statements will change in the near-term as a result of one or more future confirming events.
- ▶ The effect of the change would be material to the financial statements.

The disclosure should indicate the nature of the uncertainty and an indication that it is at least reasonably possible that a change in the estimate will occur in the near-term. Disclosure of the factors that cause the estimate to be sensitive to change also is encouraged.

Disclosures about vulnerability from concentrations should be made when all three of the following conditions are met:

- ▶ The concentration of risk exists at the date of the financial statements.
- ▶ The concentration makes the enterprise vulnerable to the risk of a near-term severe impact.
- ▶ It is at least reasonably possible that the events that could cause the severe impact will occur in the near-term.

Entities should consider whether they have concentrations in volume of business transacted with a particular customer, supplier or lender; revenue from particular products or services; available sources of supply materials, labor, or services; or market or geographical areas in which it conducts its operations that might meet the three criteria above.

## 2.13 Foreign currency translation adjustments

Entities that are on the verge of filing for bankruptcy may consider selling all or a part of an investment in or within a foreign entity (as defined in ASC 830, for example, a subsidiary, division, branch, joint venture or equity method investment). That is, a foreign entity as defined by ASC 830 may differ from a legal entity. See section 1.2.2 and section 4.4.3 of our FRD, *Foreign currency matters*, for additional discussion on the definition of a foreign entity under ASC 830 and how to treat any cumulative translation adjustment in this scenario, respectively.

## 2.14 Share-based payments

Before bankruptcy or liquidation, the entity continues to account for share-based payments, including modifications or cancellations, in accordance with ASC 718. When determining the fair value of an entity's equity or liability-classified awards, the entity should consider the factors that are causing its operating results to deteriorate. Due to the complexities, the involvement of valuation professionals is encouraged. Entities should also consider the effect of deteriorating operating results on the probability of achieving any performance conditions. See our FRD, *Share-based payment*, for further discussion on these topics.

## 2.15 Loss contingencies

An entity might be experiencing financial difficulties or be contemplating bankruptcy in response to a loss contingency (e.g., environmental-remediation liabilities; injury or damage caused by products sold; self-insurance liabilities; risk of loss or damage caused by fire, explosion or other hazards). The entity should follow the applicable US GAAP (e.g., ASC 450) when recording and disclosing loss contingencies. If other parties are co-defendants in the matter giving rise to the loss contingency and those other parties also are experiencing financial difficulties, the entity should evaluate whether the amount recognized continues to be appropriate. That is, consideration should be given to primary or secondary obligations, as well as whether the entity's best estimate of the probable loss increased as a result of a change in the credit risk of the other parties involved.

## 2.16 Leases (updated March 2024)

An entity that is experiencing financial difficulties may terminate or modify existing leases (e.g., to reduce total leased premises or negotiate a lower lease payment). If a lease is terminated or modified, the entity must carefully consider the specific provisions of the lease in assessing the appropriate accounting. Lease termination and modifications should be accounted for in accordance with ASC 842.

In addition, a lessor might be experiencing financial difficulties because it is experiencing delayed or nonpayment from its lessees who are experiencing financial difficulties. Lessors follow the guidance on credit losses (i.e., ASC 326) to consider possible impairments of net investments in sales-type leases and direct financing leases (see section 2.4.2, *Accounts receivable, contract assets and loans receivable*, for more guidance).

Lessors must evaluate the collectibility of lease payments (and any residual value guarantee) for operating leases. If a lessor determines that it is no longer probable that it will collect operating lease payments and any residual value guarantee from an affected lessee, the lessor's lease income is limited to the lesser of (1) the income that would have been recognized if collection were probable, including income from variable lease payments, and (2) the lease payments, including variable lease payments, that have been collected from the lessee. Lease income is reversed if the lease payments, including variable lease payments, that have been collected from the lessee are less than the lease income recognized to date.

See our FRD, [\*\*\*Lease accounting: Accounting Standards Codification 842, Leases\*\*\*](#) for additional guidance.

# 3 During Chapter 11 bankruptcy

Entities that file for bankruptcy protection may continue to report financial results. ASC 852 provides guidance on financial reporting by entities that have filed petitions with the court and expect to reorganize as going concerns under Chapter 11.

## 3.1 The scope of ASC 852

### Excerpt from Accounting Standards Codification

#### Reorganizations – Overall

##### *Scope and Scope Exceptions*

##### **852-10-15-1**

This Subtopic provides guidance on financial reporting by entities that have filed petitions with the **Bankruptcy Court** and expect to reorganize as going concerns under Chapter 11 of title 11 of the United States Code. The guidance in this Subtopic applies to all entities except governmental organizations.

##### **852-10-15-2**

The guidance in this Subtopic applies to the following transactions and activities:

- a. Reorganizations by entities that expect to reorganize as a going concern under **Chapter 11**
- b. Reorganizations by entities upon emergence from Chapter 11 under confirmed plans.

##### **852-10-15-3**

The guidance in this Subtopic does not apply to the following transactions and activities:

- a. Debt restructurings outside of Chapter 11
- b. Reorganization activities consisting of liquidation or adoption of plans of liquidation under the **Bankruptcy Code**.

The guidance in ASC 852 applies to an entity operating under Chapter 11 with the expectation of reorganizing as a going concern and to an entity emerging from Chapter 11 pursuant to a court-confirmed plan.

Generally, ASC 852 does not apply to entities that liquidate or adopt plans of liquidation under the Code and entities that restructure debt outside of a Chapter 11 bankruptcy filing. Therefore, an entity issuing US GAAP financial statements either during or upon completion of a non-judicial reorganization does not apply ASC 852, even if the non-judicial reorganization plan meets all the requirements of the Code (including issuance of a disclosure statement). However, we believe that an entity that is restructuring under a judiciary bankruptcy process in another jurisdiction that is similar in all substantive respects to Chapter 11 may apply ASC 852 (including when the entity files for Chapter 15 in the US).

ASC 852 does not apply to government organizations. However, we believe a not-for-profit organization (one not owned by a government unit) would be covered by the guidance in ASC 852 when it issues US GAAP financial statements during a Chapter 11 bankruptcy proceeding.

### 3.1.1 Plans of liquidation

ASC 852 explicitly excludes from its scope entities that adopt a plan of liquidation under the Code (generally by filing under the Code's Chapter 7 proceedings). The determination of when a liquidation basis of accounting is appropriate and how to apply such basis is discussed in ASC 205-30 (see section 6, *Liquidation basis of accounting*).

## 3.2 Financial reporting under ASC 852

### Excerpt from Accounting Standards Codification

#### Reorganizations – Overall

#### *Other Presentation Matters*

#### **852-10-45-1**

Entering a **reorganization proceeding**, although a significant event, does not ordinarily affect or change the application of generally accepted accounting principles (GAAP) followed by the entity in the preparation of its financial statements. However, the needs of financial statement users change, and thus changes in the reporting practices previously followed by the entity are necessary.

#### **852-10-45-2**

For the purpose of presenting an entity's financial evolution during a **Chapter 11** reorganization (see paragraph 852-10-10-1), the financial statements for periods including and after filing the Chapter 11 **petition** shall distinguish transactions and events that are directly associated with the reorganization from the ongoing operations of the business.

Despite a Chapter 11 bankruptcy filing, an entity that expects to continue as a going concern applies US GAAP for financial reporting purposes. However, the needs of the financial statement users are different as a result of the entity's operating in bankruptcy, and the reorganizations guidance provides incremental accounting and reporting guidance to address those needs. The financial statements of an entity in bankruptcy reflect the evolution of the proceedings and distinguish those transactions and events directly associated with the reorganization from the ongoing operations of the business.

The provisions of ASC 852 are applicable to financial reporting for periods after which an entity has filed for bankruptcy protection under Chapter 11 of the Code. That is, if an entity with a 31 December 20X8 year-end files for bankruptcy protection on 1 February 20X9, then the entity should not apply the provisions of ASC 852 when preparing its financial statements as of 31 December 20X8, although as discussed below, disclosure of such a bankruptcy filing would be required in the subsequent event disclosures.

It is important to understand the legal entities and subsidiaries that are included in a Chapter 11 filing. In some cases, only certain subsidiaries, but not the parent, are included in a Chapter 11 filing. In other cases, some subsidiaries are excluded from a parent's Chapter 11 filing. The specific provisions of ASC 852 apply only to bankrupt entities.

**Illustration 3-1: Financial reporting when only the subsidiary or parent is in bankruptcy**

Parent Z is a calendar year-end entity with three wholly owned subsidiaries A, B and C. Parent Z and Subsidiary B file for Chapter 11 bankruptcy on 20 November 20X8. Subsidiaries A and C are not part of the bankruptcy filing.

**Analysis**

Parent Z's 31 December 20X8 financial statements would reflect the application of ASC 852 only for Parent Z and possibly for Subsidiary B, if Subsidiary B continues to be consolidated. If Parent Z controls Subsidiaries A and C during bankruptcy, it would continue to consolidate those subsidiaries in its consolidated financial statements, and the accounting would remain unchanged.

While ASC 852 provides guidance for accounting and financial reporting while an entity is in bankruptcy, other US GAAP continues to apply to the extent that it does not conflict with the guidance in ASC 852. However, instances in which a parent and/or certain subsidiaries file for bankruptcy protection while other subsidiaries do not, may have implications on accounting and financial reporting (i.e., control over a subsidiary after the subsidiary has filed for bankruptcy protection and whether intercompany balances are subject to compromise by the court). See section 3.9.13, *Consolidation*, for further discussion.

An entity that files for bankruptcy protection may no longer be able to prepare financial statements in a timely manner. See section 7, *SEC filing issues for bankruptcy and liquidation*, for additional guidance. As such, the effects of events subsequent to the balance sheet date, including the filing for bankruptcy protection, should be considered.

### 3.2.1 Bankruptcy filing after the balance sheet date

We generally do not believe that the subsequent filing for bankruptcy protection after the balance sheet date is an event that, in and of itself, individually requires recognition in the current period financial statements, though subsequent events disclosure is required in accordance with ASC 855. However, a bankruptcy filing subsequent to the balance sheet date but prior to the issuance of the financial statements may confirm facts and circumstances that existed as of the balance sheet date. The evaluation of subsequent events requires consideration of facts and circumstances, and is an area of professional judgment, in particular with respect to estimates at the balance sheet date. See section 2, *Before bankruptcy or liquidation*, for further discussion.

## 3.3 Liabilities under ASC 852

**Excerpt from Accounting Standards Codification****Reorganizations – Overall****Other Presentation Matters****852-10-45-4**

The balance sheet of an entity in Chapter 11 shall distinguish **prepetition liabilities** subject to compromise from those that are not (such as fully secured liabilities that are expected not to be compromised) and **postpetition liabilities**. Liabilities that may be affected by the plan shall be reported at the amounts expected to be allowed, even if they may be settled for lesser amounts. If there is uncertainty about whether a **secured claim** is undersecured, or will be impaired under the **plan of reorganization**, the entire amount of the **claim** shall be included with prepetition claims subject to compromise; such a claim shall not be reclassified unless it is subsequently determined that the claim is not subject to compromise.



**852-10-45-5**

Prepetition liabilities, including claims that become known after a petition is filed, shall be reported on the basis of the expected amount of the **allowed claims** in accordance with Subtopic 450-20, as opposed to the amounts for which those allowed claims may be settled. Once these claims satisfy the accrual provisions of that Subtopic, they shall be recorded in the accounts in accordance with this paragraph. Paragraph 852-10-50-2 notes that claims not subject to reasonable estimation are required to be disclosed in the notes to financial statements.

**852-10-45-7**

Paragraph 852-10-45-4 addresses the separation of liabilities subject to compromise from those that are not. Circumstances arising during reorganization proceedings may require a change in the classification of liabilities between those subject to compromise and those not subject to compromise. Liabilities not subject to compromise shall be further segregated into current and noncurrent classifications if the entity presents a classified balance sheet.

**852-10-45-8**

Section 470-10-45 requires current liabilities classification in a classified balance sheet for long-term liabilities that, by their terms, are due on demand or will be due on demand within one year, or the operating cycle, if longer. This classification requirement also applies to long-term liabilities that are or will be callable by the creditor because of a violation of a provision of the debt agreement. The **automatic stay provisions** of Chapter 11 make it unnecessary to reclassify prepetition long-term liabilities even though prepetition creditors might demand payment or there is a violation of a covenant in the debt agreement.

When an entity files for bankruptcy, all liabilities incurred prior to that date (including those that become known after a petition is filed) are referred to as prepetition liabilities. Liabilities incurred after the filing are referred to as postpetition liabilities. An entity often will submit a list of known liabilities, or claims, in the bankruptcy filing. In addition, creditors may submit a claim to the court by providing proof of a liability. Based on the information provided, the court then decides whether to “allow” the claims (which include both prepetition and postpetition liabilities), and the amount of the claim to allow. This process can take a long period of time. The amount of the allowed claim may differ from the actual settlement amount. The court ultimately determines the settlement amount by evaluating the total of all allowed claims as compared to the reorganization value of the entity.

In the periods before claims for liabilities have been allowed by the court, they are accounted for in accordance with ASC 450. That is, the claim is recognized once it is probable and the amount is reasonably estimable. The claim is therefore measured at the expected (i.e., probable) amount of the claim. In this case, the measured amount is based on the best estimate of the probable amount of the claim that will be allowed by the court, rather than an amount expected to be paid at the end of the bankruptcy proceedings. As the bankruptcy proceeds, more information regarding the amount of an individual claim allowed by the court will likely become available. Once the court has allowed a claim, the allowed amount becomes the amount recorded in the financial statements, regardless of the expected settlement amount.

Consistent with the application of the ASC 450, an entity should disclose any claims that are not subject to reasonable estimation at each balance sheet date. The SEC staff has asked registrants to disclose significant estimates related to the recorded amount for claims and estimated postpetition liabilities. Disclosures about significant estimates should comply with ASC 275. See section 2.12, *Risks and uncertainties*, for additional guidance.

**Illustration 3-2: Recognition and measurement of a prepetition liability**

A calendar year-end entity files for Chapter 11 bankruptcy protection on 15 September 20X8. An unsecured creditor has a \$100 claim related to a prepetition trade payable owed to it from the entity. When preparing its quarterly financial statements as of 30 September 20X8, the entity expects that the court will allow the unsecured creditor claim for \$100.

**Analysis**

Given these facts, the entity will continue to measure the claim at \$100 for financial reporting purposes as of 30 September 20X8, as that amount represents the best estimate of the probable amount of the allowed claim. The amount of the liability is \$100 even though ultimately the bankruptcy proceeding may result in that creditor receiving a lesser amount through the bankruptcy settlement.

**Illustration 3-3: Recognition and measurement of an allowed claim**

Assume the same facts as Illustration 3-2, except that on 15 December 20X8, the court allows the unsecured creditor's claim for \$95. The entity estimates that the ultimate amount that would be received by the creditor through the bankruptcy settlement is \$80.

**Analysis**

Given these facts, the entity will measure the claim at \$95 for financial reporting purposes as of 31 December 20X8, as that is the amount of the allowed claim. The entity's estimate of the ultimate amount that would be received by the creditor through the bankruptcy settlement does not affect the amount of the claim recorded for financial reporting purposes. Rather, and as noted above, the recorded amount is based on the amount of the claim allowed by the court.

The balance sheet of an entity in bankruptcy should classify liabilities as:

- ▶ *Liabilities not subject to compromise* – Includes (1) liabilities that are fully secured and not expected to be compromised and (2) liabilities incurred subsequent to the filing of the petition that are not associated with the pre-bankruptcy events (i.e., postpetition liabilities). There is no change in the manner in which liabilities not subject to compromise are presented in the financial statements before and during bankruptcy. That is, liabilities not subject to compromise should be further segregated between current and noncurrent in a classified balance sheet based on the contractual terms of the obligation. Trade payables incurred subsequent to filing for bankruptcy are typically classified as current, because they likely will be paid from existing resources.
- ▶ *Liabilities subject to compromise* – Includes liabilities incurred before the entity filed for Chapter 11, or that became known after the petition was filed. The liabilities are subject to compromise because they are either undersecured or unsecured and will likely not be repaid at their full amount. Generally, most of an entity's liabilities are subject to compromise in a bankruptcy filing and may include (but are not limited to) trade payables, debt and other obligations. The entire amount of undersecured claims or those claims that will be impaired under the plan of reorganization should be included in liabilities subject to compromise. Liabilities subject to compromise need not be further segregated between current and noncurrent in a classified balance sheet. In practice, liabilities subject to compromise are presented in the balance sheet after current liabilities not subject to compromise and either before or after noncurrent liabilities not subject to compromise.

The following is an illustration of a balance sheet of an entity in bankruptcy:

| <b>Illustration 3-4: Balance sheet during bankruptcy</b> |                         |
|--|-------------------------|
| <b>BAS Corporation (Debtor-in-possession)</b>            |                         |
| <b>Consolidated Balance Sheet</b>                        |                         |
| <b>As of 31 December 20X0</b>                            |                         |
| <b>(in millions, except share data)</b>                  |                         |
| <b>Assets</b>  |                         |
| <b>Current Assets</b>                                    |                         |
| Cash and cash equivalents                                | \$ 600                  |
| Accounts receivable, net                                 | 1,000                   |
| Inventories  | 2,000                   |
| Other current assets                                     | <u>700</u>              |
| <b>Total current assets</b>                              | <b>4,300</b>            |
| Property and equipment, net                              | 2,500                   |
| Intangible assets, net                                   | 1,500                   |
| Goodwill   | 4,000                   |
| Other assets and deferred charges                        | <u>500</u>              |
| <b>Total assets</b>                                      | <b><u>\$ 12,800</u></b> |
| <b>Liabilities and shareholders' deficit</b>             |                         |
| <b>Current Liabilities</b>                               |                         |
| Accounts payable   | \$ 500                  |
| Notes payable  | 1,600                   |
| Other notes payable (Debtor-in-possession financing)     | 550                     |
| Accrued payroll and other liabilities                    | <u>800</u>              |
| <b>Total current liabilities</b>                         | <b>3,450</b>            |
| Long-term debt   | 2,000                   |
| Other long-term liabilities                              | <u>1,300</u>            |
| <b>Total liabilities not subject to compromise</b>       | <b><u>6,750</u></b>     |
| Liabilities subject to compromise                        | <u>7,300</u>            |
| <b>Total liabilities</b>                                 | <b><u>14,050</u></b>    |
| Common stock   | 600                     |
| Additional paid-in capital                               | 2,150                   |
| Accumulated deficit                                      | <u>(4,000)</u>          |
| <b>Total liabilities and shareholders' deficit</b>       | <b><u>\$ 12,800</u></b> |

Liabilities incurred in the normal course of business (e.g., payroll liabilities and certain trade payables) may be subject to bankruptcy proceedings and subject to compromise if incurred prior to the filing for bankruptcy protection.

The classification of liabilities (i.e., liabilities subject to compromise and not subject to compromise, both current and noncurrent liabilities) should be evaluated at each reporting period and should be revised to reflect current expectations and the decisions of the court as the bankruptcy proceeds.

Many liabilities that previously were considered current, including trade payables, likely will be unsecured or undersecured at the time bankruptcy protection is sought. The reporting entity should classify these liabilities consistent with other claims as either subject to compromise or not subject to compromise, based on the status of such claims in the proceedings.

### **3.3.1 Preferential payments**

An entity may have paid creditors, including vendors, prior to its filing for bankruptcy. Subsequent to the bankruptcy filing, the court may determine that payments made prior to bankruptcy are “preference payments” and may require that the creditor return the payment to the entity. In such circumstances, we generally believe that the expectation of the return of a preference payment to the bankrupt entity (recognition of a receivable), and establishment of the related liability subject to compromise, should be recorded in the financial statements when the court approves the return of a preferential payment.

### **3.3.2 Liabilities subject to compromise when an entity is discontinuing an operation**

As noted earlier, the guidance in ASC 852 requires segregation of liabilities subject to compromise in the entity’s balance sheet. The underlying premise in ASC 852 is that the financial statements for periods including and after the filing of a Chapter 11 petition should distinguish transactions and events that are directly associated with the reorganization from the ongoing operations of the business. Similarly, the presentation of discontinued operations for components disposed of or classified as held for sale under the requirements of ASC 360 and ASC 205 is intended to separate, for users of the financial statements, the results of operations of the ongoing business from the results of the discontinued component of the entity.

Although amounts of unsecured liabilities may have been appropriately grouped with other liabilities as held for sale prior to the filing of a Chapter 11 petition, the filing itself and the resulting legal implications may change the characteristics of those obligations from liabilities associated with discontinued operations to general unsecured obligations. That is, the liabilities should be reclassified to liabilities subject to compromise unless the buyer of the component agrees to assume the entity’s obligation for the specific prepetition liability. In such rare cases, the liability would continue to be presented as a liability held for sale. We believe that amounts should not be reclassified into liabilities held for sale unless such liabilities become not subject to compromise and the entity has the ability to transfer the liability in a sale transaction.

### **3.3.3 Accounting for debt while in bankruptcy**

ASC 852 provides prescriptive guidance for accounting for outstanding debt not subject to compromise during bankruptcy. Likewise, the guidance is clear for outstanding debt subject to compromise once that debt becomes an allowed claim. However, judgment may be required to determine when outstanding debt becomes an allowed claim. Consequently, applying ASC 852’s guidance for accounting for outstanding debt during the period between a formal bankruptcy protection filing and the moment that the debt becomes an allowed claim also requires judgment.

### 3.3.3.1 The period between filing for bankruptcy protection and determination that debt becomes an allowed claim

#### Excerpt from Accounting Standards Codification

##### Reorganizations – Overall

##### *Other Presentation Matters*

##### *852-10-45-6*

Debt discounts or premiums as well as debt issue costs shall be viewed as valuations of the related debt. When the debt has become an allowed claim and the allowed claim differs from the net carrying amount of the debt, the recorded amount shall be adjusted to the amount of the allowed claim (thereby adjusting existing discounts or premiums, and deferred issue costs to the extent necessary to report the debt at this allowed amount). The gain or loss resulting from the entries to record the adjustment shall be classified as reorganization items, as discussed in paragraph 852-10-45-9.

Premiums and discounts as well as debt issuance cost on debts that are not subject to compromise, such as fully secured claims, shall not be adjusted.

There is no guidance in ASC 852 on how an entity should account for debt that is subject to compromise prior to the debt becoming an allowed claim. We are aware that there is diversity in practice, and entities typically follow one of the following policies (the application of which should be disclosed and consistently applied):

- ▶ Account for debt using the guidance provided in ASC 852 for debt that has become an allowed claim. This method analogizes to the guidance in ASC 450. Under this approach, as discussed in section 3.3, an entity in bankruptcy that has debt that the court has not yet allowed as a claim recognizes the liability at the amount it expects the court to allow (not the expected settlement amount). Once the court allows the debt as a claim, the liability is recognized at the amount allowed by the court.
- ▶ Account for debt under other relevant US GAAP (that is, continue amortizing associated issuance costs and premiums or discounts in accordance with the guidance in ASC 835-30).

For debt not subject to compromise, the guidance in ASC 852 indicates that the debt discounts, debt premiums and debt issuance costs should not be adjusted (see section 3.3, *Liabilities under ASC 852*, for further discussion of liabilities not subject to compromise).

### 3.3.3.2 Upon determining a debt is an allowed claim

After debt subject to compromise has become an allowed claim, ASC 852 states that the carrying amount of the debt (inclusive of the premium or discount and issuance costs) should be adjusted to the probable amount of the allowed claim for the debt. The resulting gain or loss is classified as a reorganization item.

### 3.3.3.3 Guarantees issued by a parent for the indebtedness of a bankrupt subsidiary

If a parent has lost control of (and deconsolidated) a bankrupt subsidiary, we believe that the parent should follow the guidance in ASC 460 to account for any guarantees that it issued related to the indebtedness of the bankruptcy subsidiary. That is, the parent should recognize a liability because of its ongoing obligation to stand ready to perform over the term of the guarantee, even if it is not probable that the specified default event(s) (that would cause payments under the contingent obligation) will occur at the former subsidiary. The parent that is a registrant should disclose a guarantee of indebtedness of a deconsolidated bankrupt subsidiary in the liquidity section of its MD&A and should disclose risks related to the guarantee in its risk factors.

If the parent has not lost control of the bankrupt subsidiary, we believe the recognition of a guarantee liability would not be appropriate. See section 3.9.13, *Consolidation*, for guidance on determining whether a parent loses control of a subsidiary in bankruptcy.

### 3.3.4 The decision to offset assets and liabilities in the balance sheet

An entity should continue to apply its previous accounting policy election for offsetting assets and liabilities in the financial statements (when such right exists) even after it files for bankruptcy. Offsetting is a policy election that should be consistently applied. To determine if a right of setoff exists, an entity should follow the guidance in ASC 210-20-45-1 and ASC 815-10-45 (when applicable). A right of offset is present when all of the following criteria are met:

- ▶ Each of the two parties owes the other determinable amounts. In making this evaluation, generally an entity considers the court's determination of allowed claims. That is, the court determines the amounts that are owed to the entity.
- ▶ The reporting party has the right to set off the amount owed with the amount owed by the other party.
- ▶ The reporting party intends to set off.
- ▶ The right of setoff is enforceable at law.

In the event an entity holds a receivable from a counterparty, the mere existence of an allowed claim from that same counterparty (e.g., for an account payable) would not, in and of itself, be sufficient for the entity to establish the right of offset for the allowed claim and the receivable balance.

## 3.4 Reorganization items under ASC 852

### Excerpt from Accounting Standards Codification

#### Reorganizations – Overall

#### *Other Presentation Matters*

#### **852-10-45-9**

The statement of operations shall portray the results of operations of the reporting entity while it is in Chapter 11. Revenues, expenses (including professional fees), realized gains and losses, and provisions for losses resulting from the reorganization and restructuring of the business shall be reported separately as **reorganization items**, except for those required to be reported as discontinued operations in conformity with Subtopic 205-20.

#### **852-10-45-10**

It is not appropriate to defer professional fees and similar types of expenditures until the plan is confirmed and then reduce gain from debt discharge to the extent of the previously deferred expenses. It is also not appropriate to accrue professional fees and similar types of expenditures upon the filing of the Chapter 11 petition. Rather, because professional fees and similar types of expenditures directly relating to the Chapter 11 proceeding do not result in assets or liabilities, they shall be expensed as incurred and reported as reorganization items.

Reorganization items are segregated from items related to normal business operations. Entities operating in Chapter 11 should separately account for, present and disclose reorganization items. The determination of whether an item is reorganization related is judgmental. Generally, only costs that are incremental and directly related to the entity's bankruptcy should be presented as reorganization items.

Reorganization items may include:

- ▶ Interest income earned that would not have been earned without the bankruptcy, that is, derived from having excess cash over normal invested capital

- ▶ Expenses related to the reorganization and restructuring including professional fees and similar expenditures directly related to the Chapter 11 proceeding are charged to expense as incurred (see section 3.9.16, *Contingent or “success” fees*, for additional guidance on certain fee arrangements)
- ▶ Gains or losses and certain other adjustments, including gains or losses resulting from adjusting debt from the carrying amount to the amount of the allowed claim (see section 3.3.3, *Accounting for debt while in bankruptcy*)

Reorganization items generally do **not** include:

- ▶ Revenue (while ASC 852-10-45-9 identifies revenue as an item that could be presented as a reorganization item, we generally would not expect revenue to be presented as such, except for adjustments to deferred revenue balances (see section 4.4.5, *Contract liabilities (deferred revenue)*)
- ▶ Recurring internal costs of normal operations
- ▶ Tax effects from reorganization items
- ▶ Interest income related to normal invested capital
- ▶ Certain impairment and restructuring charges (see section 3.9.1, *Goodwill and indefinite-lived intangible asset impairment*, section 3.9.3, *Long-lived asset impairment*, and section 3.9.14, *Restructuring charges, including one-time termination benefits*)
- ▶ Interest expense

The following is an example of a statement of operations of an entity in bankruptcy:

| <b>Illustration 3-5: Statement of operations of an entity in bankruptcy</b> |                   |
|---|-------------------|
| <b>BAS Corporation (Debtor-in-possession)</b>                               |                   |
| <b>Consolidated Statement of Operations</b>                                 |                   |
| <b>Year Ended 31 December 20X0</b>  |                   |
| Net revenues  | \$ 30,000         |
| Cost of sales   | <u>25,000</u>     |
| Gross margin  | 5,000             |
| <br>  |                   |
| Selling, general and administrative expenses                                | 6,500             |
| Restructuring and impairment charges  | 550               |
| Other expenses  | <u>400</u>        |
| Loss before interest, reorganization items and income taxes                 | (2,450)           |
| Interest expense, net (contractual interest, \$425)                         | 155               |
| Reorganization items, net   | 400               |
| Benefit from income taxes   | <u>(25)</u>       |
| Net loss  | <u>\$ (2,980)</u> |

### 3.4.1

## Reorganization items related to discontinued operations

During bankruptcy, the expenses and realized gains and losses resulting from the reorganization and restructuring of the business are presented as reorganization items within income from continuing operations, unless those items are required to be reported as discontinued operations in conformity with the guidance in ASC 205-20. That is, reorganization items associated with a component that is to be disposed of and reported as discontinued operations under the guidance in ASC 205-20 should be presented in the discontinued operations line item in the statement of operations. See our FRD, *Discontinued operations*, for further discussion.

### 3.4.2 Reorganization costs incurred prior to filing for bankruptcy

Given that an entity is only in the scope of ASC 852 after it has filed for bankruptcy protection under Chapter 11, we believe that costs incurred prior to a bankruptcy protection filing should be excluded from costs classified as reorganization items.

### 3.4.3 DIP financing fees

We believe there are two acceptable methods of accounting for professional fees (e.g., legal fees, lender fees) an entity incurs in conjunction with obtaining DIP financing during bankruptcy. One approach is to expense the fees as incurred as reorganization items in the statement of operations, which is similar to the treatment of other professional fees incurred in bankruptcy.

Another approach is to defer and amortize the DIP financing fees over the expected term of the DIP financing arrangement. Under this approach, the DIP financing fees are considered an additional cost of borrowing and are treated similar to other financing costs incurred for debt outside of bankruptcy. The amortization of DIP financing fees is included in interest expense and is therefore presented outside of reorganization items. Because the period of time during which the entity operates in bankruptcy is often uncertain, entities should update the expected term of the DIP financing arrangement at each reporting date.

## 3.5 Interest expense under ASC 852

### Excerpt from Accounting Standards Codification

#### Reorganizations – Overall

#### *Other Presentation Matters*

#### **852-10-45-11**

Interest expense shall be reported only to the extent that it will be paid during the proceeding or that it is probable that it will be an allowed priority, secured, or unsecured claim. Interest expense is not a reorganization item.

Provisions of the Code often relieve an entity from its obligation to pay interest that would have accrued on pre-confirmation debt during the bankruptcy proceedings. Only interest that actually will be paid during the proceeding or that is probable (as defined in the loss contingency guidance of ASC 450) of being an allowed priority, secured or unsecured claim, should be accrued in the financial statements. However, these amounts should not be presented as reorganization items (see section 3.4, *Reorganization items under ASC 852*). The difference between the amount expected to be paid and the amount that the entity was otherwise obligated to pay should be disclosed (see section 5.1, *Disclosures during the reorganization period*).

Interest expense related debtor-in-possession financing should be accounted for under other relevant GAAP.

## 3.6 Interest income under ASC 852

### Excerpt from Accounting Standards Codification

#### Reorganizations – Overall

#### *Other Presentation Matters*

#### **852-10-45-12**

Interest income earned by an entity in Chapter 11 that it would not have earned but for the proceeding, normally all interest income, shall be reported as a reorganization item.



**Excerpt from SOP 90-7 (nonauthoritative)**

52. An entity in reorganization typically accumulates cash during the proceeding because it is not paying its obligations currently. The cash ultimately is distributed to creditors or others in conformity with the plan. The amount of cash accumulated does not reflect the entity's prepetition activities, and it is not expected that such an accumulation would recur in the reorganized entity. The interest income earned during the proceeding on cash accumulated during the proceeding, therefore, is a reorganization item. To the extent that management can reasonably estimate that portion of interest income applicable to normal invested working capital, it should be reported as an operating item in the ordinary manner.

An entity operating in bankruptcy may have more cash on hand because of the various protections provided in bankruptcy (e.g., the automatic stay provisions discussed in ASC 852-10-45-8). Some of the interest earned on this invested cash may be distributed to creditors, rather than benefiting the ongoing operations of the entity. Management often can reasonably estimate the interest income applicable to normal invested working capital, which is therefore expected to be a recurring part of the ongoing operations of the entity. This portion of interest income should be reported as an operating item (i.e., not as a reorganization item). In such instances, we believe the entity should disclose the method used to estimate such interest income applicable to normally invested working capital.

However, consistent with ASC 852-10-45-12, we generally expect interest income derived from an excess over normal invested capital to be reported as a reorganization item.

**3.7****Statement of cash flows under ASC 852****Excerpt from Accounting Standards Codification****Reorganizations – Overall*****Other Presentation Matters******852-10-45-13***

Reorganization items shall be presented separately within the operating, investing, and financing categories of the statement of cash flows. This presentation can be better accomplished by the use of the direct method of presenting the statement. Paragraph 230-10-45-25 lists the operating items that shall be reported separately when the direct method is used. That paragraph encourages further breakdown of those operating items if the entity considers such a breakdown meaningful and feasible. Further identification of cash flows from reorganization items should be provided to the extent feasible. For example, interest received might be segregated between estimated normal recurring interest received and interest received on cash accumulated because of the reorganization. If the indirect method is used, details of operating cash receipts and payments resulting from the reorganization shall be disclosed in a supplementary schedule or in the notes to financial statements. (See paragraph 852-10-50-6A.)

**3.7.1****Classification of reorganization items**

Entities that present a statement of cash flows using the indirect method (the vast majority of entities) inherently include reorganization items in net income. Consequently, cash flows resulting from reorganization items included in net income should be disclosed in a supplementary schedule or in the notes to the financial statements, while those relating to financing or investing would be presented on the face of the statement of cash flows.

### 3.7.2 Fees paid for DIP financing

Consistent with ASC 230-10-45-15, cash outflows for financing activities include, but are not limited to, (1) repayments of amounts borrowed, (2) other principal payments to creditors who have extended long-term credit and (3) payments for debt issue costs.

We believe that fees paid for debtor-in-possession financing would be presented in the financing section of the statement of cash flows. The SEC staff has also commented on this presentation and has historically expected classification in the financing section as well.

### 3.8 Presentation of condensed combined financial statements of entities in reorganization under ASC 852

#### Excerpt from Accounting Standards Codification

##### Reorganizations – Overall

##### *Other Presentation Matters*

##### **852-10-45-14**

Consolidated financial statements that include one or more entities in reorganization proceedings and one or more entities not in reorganization proceedings shall include condensed combined financial statements of the entities in reorganization proceedings. The combined financial statements shall be prepared on the same basis as the consolidated financial statements.

##### **852-10-45-15**

In addition to making the required paragraph 852-10-50-4 disclosures, the propriety of the carrying amounts of intra-entity receivables from entities in Chapter 11 shall be evaluated.

##### Reorganizations – Overall

##### *Disclosure*

##### **852-10-50-4**

Intra-entity receivables and payables of entities in reorganization proceedings shall be disclosed in the condensed combined financial statements referred to in paragraph 852-10-45-14.

Some but not all of the entities in a group (that is, the parent and the subsidiaries) may be reorganizing in a Chapter 11 bankruptcy. If that is the case, the parent is required to include in its consolidated financial statements a set of condensed combined financial statements for only those entities that are reorganizing in Chapter 11 bankruptcy and that continue to be consolidated. Also see section 3.9.13, *Consolidation*, for guidance on when to consolidate or deconsolidate subsidiaries in bankruptcy. Consistent with ASC 852-10-45-15, prior to preparing the condensed combined financial statement disclosure, an entity should ensure that it has considered all relevant aspects of US GAAP, including impairment and collectibility of intra-entity balances to or from the entities in bankruptcy. ASC 852-10-50-4 also requires disclosure in the condensed combined financial statements of intra-entity balances of entities currently in bankruptcy.

We generally find that condensed combined financial statements are presented in audited footnotes to the consolidated financial statements.

Only the entities that filed for bankruptcy apply the measurement and classification provisions of ASC 852 in the consolidated financial statements (see section 3.1, *The scope of ASC 852*).

**Illustration 3-6: Condensed combined financial statements**

Company XYZ has four subsidiaries – Subs A, B, C and D. On 1 July 20X0, Subs A and B file for Chapter 11 bankruptcy protection. Subs C and D were not part of the bankruptcy proceedings. Company XYZ maintained control of Subs A and B after the bankruptcy filing.

**Analysis**

Company XYZ would continue to consolidate Subs A, B, C and D in its 31 December 20X0 consolidated financial statements. Subs A and B would apply ASC 852. ASC 852 would not be applied to the financial statements of Company XYZ (the parent entity), or Subs C and D in the consolidated financial statements.

In addition, Company XYZ would present condensed combined financial information in its footnotes for Subs A and B. Company XYZ (the parent entity), Subs C and D would not be included in the condensed combined financial information.

**3.8.1 Intercompany balances (updated March 2024)**

Accounting for intercompany balances requires special consideration when one entity in the group files for Chapter 11 bankruptcy protection and is no longer controlled by its former parent, as discussed in section 3.9.13, *Consolidation*.

*Payable to a former parent*

If a bankrupt entity has an intercompany payable to its former parent (or entities formerly under common control), we believe the bankrupt entity should recognize a liability (as if the amount was owed to a third party) as one that is subject to compromise. That is, the amount would no longer be designated as an intercompany payable. Such a liability would then be settled in accordance with the reorganization plan approved by the court. See section 3.3, *Liabilities under ASC 852*, for guidance on the measurement of liabilities subject to compromise.

*Receivable from a former parent*

If a bankrupt entity has an intercompany receivable from its former parent (or entities formerly under common control), we believe the bankrupt entity should recognize a receivable as if the amount is owed from a third party. That is, the amount would no longer be designated as an intercompany receivable. The bankrupt entity would then account for the receivable (e.g., consider collectibility and impairment) in accordance with the guidance in ASC 326. Evaluating the collectibility of these receivables will require the use of professional judgment.

**3.9 Other considerations**

Throughout the bankruptcy proceeding, other US GAAP continues to be applicable for financial reporting unless it conflicts with specific guidance in ASC 852. In many cases, the factors influencing the decision to file for bankruptcy protection influenced the accounting and financial reporting prior to seeking bankruptcy protection (see section 2, *Before bankruptcy or liquidation*). We expect these factors to continue to affect the entity's accounting during the bankruptcy period. For example, entities should consider the guidance in section 2.4, *Working capital*, and section 2.5, *Investments, including equity method investments*.

An entity is not assured of emerging from the Chapter 11 proceeding and qualifying for fresh-start accounting (see section 4.1, *Applicability of fresh-start accounting*); therefore, it should not assume emergence or application of fresh-start accounting prior to qualifying for such emergence or fresh-start accounting.

The following sections discuss accounting considerations in areas outside of ASC 852 that are commonly encountered during bankruptcy.

### 3.9.1 Goodwill and indefinite-lived intangible asset impairment (updated March 2024)

During bankruptcy, an entity continues to apply the provisions of ASC 350. That is, an entity continues to perform an annual goodwill and indefinite-lived intangible asset impairment analysis and, to the extent necessary, interim impairment tests. As the bankruptcy proceeds, additional events may occur that continue to require interim impairment tests of goodwill and indefinite-lived intangible assets, consistent with ASC 350. See section 3 of our FRD, *Intangibles – Goodwill and other*, for further discussion of the frequency of goodwill and indefinite-lived intangible asset impairment analysis, as well as the measurement of goodwill and indefinite-lived intangible asset impairment, including when to include a foreign currency translation adjustment in the impairment test.

### 3.9.2 Classification of assets as held for sale, held for use (updated March 2024)

During bankruptcy, an entity continues to apply the classification provisions of ASC 360. The classification of assets as held for sale prior to bankruptcy should be reconsidered. After filing for bankruptcy, management may no longer have the requisite authority to sell assets, including those previously considered held for sale, as we generally believe the appropriate level of authority needed to commit the entity to the plan of disposal would be that of the bankruptcy court or the creditors, as applicable. In addition, a court-appointed sale may be contingent upon emergence from bankruptcy or it may no longer be probable that the sale will be completed within one year. As a result, as the entity progresses through the bankruptcy proceeding, management should continue to assess the appropriate classification of assets as held for sale or held for use. See section 3.3.2, *Liabilities subject to compromise when an entity is discontinuing an operation*, and section 2.2 of our FRD, *Discontinued operations*, for additional guidance.

Similarly, the measurement provisions of ASC 360 continue to apply; that is, depreciation should be recorded unless an asset is classified as held for sale. See our FRD, *Impairment or disposal of long-lived assets*, for further discussion of the classification of assets as held for sale, held for use, or to be disposed of other than by sale.

See section 4.4.12, *Discontinued operations upon emergence in fresh-start accounting*, for reporting considerations when a component meets the criteria to be classified as a discontinued operation upon emergence from bankruptcy.

### 3.9.3 Long-lived asset impairment

During bankruptcy, an entity continues to apply the provisions of ASC 360-10-35, relating to the existence of impairment indicators, the assessment of asset recoverability, and the measurement of any impairment loss with respect to long-lived assets. Management's assumptions in testing long-lived assets for impairment under ASC 360 should be consistent with the plan of reorganization. For instance, when the plan contemplates selling long-lived assets, that strategy also should be considered as part of the ASC 360 impairment analysis. See our FRD, *Impairment or disposal of long-lived assets*, for further discussion of indicators of impairment, the recoverability test and measurement of impairment losses for long-lived assets.

### 3.9.4 Income taxes

During bankruptcy, income taxes should continue to be accounted for in accordance with ASC 740. Issues that are especially challenging in practice include evaluating the realizability of deferred tax assets, the entity's ability to assert the intent and ability to indefinitely reinvest undistributed earnings in the foreign subsidiaries and corporate joint ventures and estimating the annual effective tax rate in interim reporting.

- ▶ See section 6 of our FRD, *Income taxes*, for discussion of valuation allowances.
- ▶ See section 14 of our FRD, *Income taxes*, for additional guidance on indefinitely reinvested undistributed earnings.
- ▶ See section 20 of our FRD, *Income taxes*, for discussion of interim reporting of income taxes.

### 3.9.5 Derivatives and hedge accounting

During bankruptcy, an entity continues to apply the provisions of ASC 815. To assess the effect of bankruptcy on derivative instruments, each derivative contract should be carefully evaluated based on the contract's own unique terms to determine the appropriate accounting treatment.

An entity in bankruptcy must first assess whether a derivative contract continues to be an active derivative contract. Depending on the terms of the contract, a derivative may contractually terminate upon credit deterioration or bankruptcy filing. In such instances, hedge accounting is no longer applied and a receivable from or payable to the counterparty is recognized when the derivative is terminated. The payable to the counterparty may be a liability subject to compromise (see section 3.3, *Liabilities under ASC 852*). In other cases, the contract may provide that the receivable from the counterparty converts to zero, thus eliminating any asset of the entity.

If the derivative has not been terminated and continues to be an active derivative contract (i.e., its value changes with changes in an underlying), the derivative continues to be accounted for under US GAAP at fair value. The bankruptcy could result in any hedging relationships no longer being deemed highly effective as discussed in section 2.8, *Derivatives and hedge accounting*. In such circumstances, the entity should cease hedge accounting in accordance with ASC 815. If master netting agreements exist, the entity may evaluate its net exposure to the individual counterparties. As a result, for a given counterparty, the entity likely would have a single asset (receivable) or a single liability (payable) position. See section 4.9.5 of our FRD, *Derivatives and hedging*, as applicable, for further information on considerations when a party to the instrument is in distress.

#### 3.9.5.1 Amounts included in accumulated other comprehensive income

An entity may have balances in accumulated other comprehensive income (AOCI) as a result of the historical accounting for cash flow hedges under ASC 815. Consistent with the application of ASC 815-30-40-4, an entity should carefully consider the probability of the originally hedged forecasted transaction occurring in consideration of the bankruptcy filing. As a result, based on the facts and circumstances and the court proceedings to date, an entity may determine that the originally hedged forecasted transaction is probable of not occurring and would reclassify the amounts from AOCI to profit or loss. See section 6.7 of our FRD, *Derivatives and hedging*, as applicable, for guidance on discontinuing a cash flow hedge.

### 3.9.6 Liabilities previously recorded at fair value, including derivatives

During bankruptcy, an entity continues to apply the provisions of ASC 820 to liabilities not subject to compromise that were recorded at fair value prior to filing for bankruptcy. Such liabilities may include derivatives and financial liabilities for which the entity previously elected the fair value option under ASC 825. Under ASC 820, the fair value measurement of a liability includes consideration of the issuing entity's credit risk. Prior to filing for bankruptcy protection and the application of ASC 852, the increased credit risk of the entity may cause the liability to be significantly discounted (recorded below the contractual obligation). See section 9.2.1 of our FRD, *Fair value measurement*, for further guidance on an entity's own credit risk.

Subsequent to filing for bankruptcy protection, the fair value measurement provisions of ASC 820 no longer are applicable to prepetition liabilities subject to compromise. As such, those liabilities should be measured at the expected amount of the allowed claim. Consistent with ASC 852-10-45-5, the guidance in ASC 450 is applied when determining the expected (i.e., probable) amount of the allowed claim. That is, the appropriate accounting guidance for such prepetition liabilities, post-bankruptcy filing, should be ASC 450 rather than ASC 820.

We believe the initial recognition of the difference between the fair value and the expected amount of the allowed claim should be reported as a reorganization item on the statement of operations. This approach is consistent with the presentation in ASC 852-10-45-6 for measurement adjustments to debt premiums/discounts for the expected amount of the allowed claim. See section 3.3, *Liabilities under ASC 852*, for additional discussion on the measurement and presentation of prepetition liabilities.

### 3.9.7 Modification or extinguishment of debt

Bankruptcy proceedings may affect the terms of outstanding debt instruments, including commercial paper, corporate bond and convertible debt. The terms of each instrument and the modifications of the terms by the court are carefully considered to determine the appropriate accounting treatment.

Often, debt instruments are modified or extinguished when an entity emerges from bankruptcy protection. In these cases, the modifications would be accounted for upon emergence, either under fresh-start accounting (see section 4.2, *Method for applying fresh-starting accounting*) or based on the guidance when an entity does not qualify for fresh-start accounting (see section 4.5, *Entities that do not meet the criteria for fresh-start accounting*).

If, however, debt instruments are modified or extinguished before an entity emerges from bankruptcy, the entity applies ASC 405, ASC 470-50 or other US GAAP, as appropriate. As discussed in section 3.9.15, *Applicability of troubled debt restructuring accounting*, ASC 470-60 generally does not apply to entities that, in connection with bankruptcy proceedings, enter into debt restructurings that result in a general restatement of the entities' liabilities. Gains or losses resulting from such modifications or extinguishments are classified as reorganization items in the statement of operations, as discussed in section 3.4, *Reorganization items under ASC 852*.

See sections 2.5.1, 2.6.1 and 2.6.2 of our FRDs, *Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)*, or *Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)*, as applicable, for a discussion of the accounting for extinguishments, troubled debt restructurings and modifications of debt instruments, respectively.

### 3.9.8 Equity instruments

Bankruptcy proceedings may affect equity instruments, including common stock, preferred stock, redeemable preferred stock, convertible preferred stock and warrants. For those instruments, or portions of instruments classified as liabilities (e.g., mandatorily redeemable preferred stock, which is a liability under ASC 480), the guidance in ASC 852 relating to the measurement of prepetition claims is applicable. See section 3.3, *Liabilities under ASC 852*, for additional discussion on the measurement and presentation of prepetition liabilities.

The terms of each equity instrument and the modifications of the terms by the court should be considered carefully to determine the appropriate accounting treatment. Oftentimes, pre-existing equity instruments are extinguished upon emergence from bankruptcy protection if the reorganization value is not sufficient to satisfy the outstanding creditors. In this scenario, the emergence from bankruptcy will establish new equity instruments. If, however, equity instruments are legally modified or extinguished prior to emergence, an entity should follow other US GAAP (i.e., accounting requirements outside of ASC 852) to determine the appropriate accounting treatment. See section 3.6 and section 4.4.6 of our FRD, *Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)*, or sections 3.6 and 4.4.5 of our FRD, *Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)*, as applicable, for modifications of stock instruments (e.g., preferred shares) and modification of equity contracts (e.g., warrants), respectively.

### 3.9.9 Leases (updated March 2024)

During bankruptcy, an entity continues to apply ASC 842. Terminations and modifications of lease terms, which are common in bankruptcy, should be accounted for under the lease guidance. An entity that is party to leases must carefully consider the specific provisions of each lease in assessing the appropriate accounting in bankruptcy. For example, certain covenants in the lease may be violated upon the filing of bankruptcy protection. Leases and the laws that govern them vary, and parties to leases may have significantly different rights and obligations under ostensibly similar arrangements. In addition, a security interest in property subject to a lease may differ among leases and jurisdictions.

Lessees must monitor leases for significant events that could trigger a change in the lease term or whether the lessee is reasonably certain to exercise a purchase option. When there is a change in the lease term or a change in whether a lessee is reasonably certain to exercise a purchase option, a lessee is required to reassess lease classification and remeasure the lease liability using revised inputs at the reassessment date. A lessee should carefully evaluate whether there are events associated with a bankruptcy filing (including events prior to a bankruptcy court approving any changes to a lease) that qualify as reassessment events. Refer to section 2.3.6.1, *Reassessment of the lease term and purchase options – lessees*, of our FRD, ***Lease accounting: Accounting Standards Codification 842, Leases***.

Generally, unpaid prepetition lease payments (i.e., lease payments that were due prior to filing for bankruptcy) are claims subject to compromise. In bankruptcy, leases can be affirmed (i.e., assumed without modification), renegotiated (i.e., assumed as modified) or rejected.<sup>3</sup>

If a lease is affirmed in bankruptcy, the lease contract continues and the accounting for the lease is unchanged. If lease terms are renegotiated in bankruptcy, the entity should carefully consider the modifications in lease terms and the effect on the accounting for those leases. See our FRD, ***Lease accounting: Accounting Standards Codification 842, Leases***, for additional guidance.

When a lease is rejected in bankruptcy, the leased property is typically returned to the lessor who may have a claim, as an unsecured creditor, against the entity for the contractual amount due upon rejection (i.e., lease termination payment). The terms of the lease dictate whether termination occurs upon rejection by the court or upon return of the leased item. A lease termination payment is subject to approval by the court, and the provisions of ASC 852 are applied to any claims that may result from rejecting a lease. That is, any amounts due upon termination (e.g., early termination penalties due under the contract) likely qualify as an allowed claim and, consistent with the guidance in ASC 852, should be recorded at the expected (i.e., probable) amount of the allowed claim. We believe that any amounts associated with the termination of a lease would be presented as a reorganization item.

If any obligations are subject to compromise, these liabilities should be segregated on the balance sheet (see section 3.3, *Liabilities under ASC 852*).

Consideration also should be given to the effects of any modifications on the accounting for any related leasehold improvements.

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<sup>3</sup> A rejected lease also is referred to as a repudiated lease.

### 3.9.10 Executory contracts

During bankruptcy, an entity continues to account for executory contracts as prescribed elsewhere in US GAAP. An executory contract is a contract that remains wholly unperformed or for which there remains something to be done by either or both parties to the contract. Executory contracts include numerous forms of arrangements for both buyers and sellers of products and services. One example is a product purchase order in which one party's performance obligations are limited to accepting delivery and making agreed-upon payments. Other examples include, but are not necessarily limited to, employment contracts, service contracts, certain derivative contracts, purchase and sales commitments, insurance contracts, franchise agreements and compensation arrangements. Unless specifically covered by other accounting guidance, executory contracts are generally not recognized for financial reporting until the transaction occurs (e.g., delivery, performance under the contract, transfer of cash).

An executory contract may automatically terminate when either party files for bankruptcy and may give rise to a prepetition claim that should be recorded consistent with other prepetition claims as described in ASC 852-10-45-5. That is, an entity records the probable amount of the allowed claim (see section 3.3, *Liabilities under ASC 852*). We believe that any amounts recorded because of the termination of an executory contract would be presented as a reorganization item.

### 3.9.11 Pension/Other post-employment benefits (OPEB)

ASC 715 provides the accounting for pension and other postretirement benefit arrangements. The entity should consider all facts and circumstances when assessing whether pension and OPEB liabilities should be presented as liabilities subject to compromise during bankruptcy, and if so, determining the expected amount of the allowed claim. An entity generally should continue to apply the guidance in ASC 715 after the entity has filed for bankruptcy when the employees continue to accrue benefits after the filing date.

Existing pension and other postretirement benefit arrangements may be restructured as part of the plan of reorganization. Examples of possible benefit plan changes that a plan of reorganization may include are:

- ▶ Nature and amount of benefits provided under the benefit plan
- ▶ Nature and amount of assets held by the benefit plan
- ▶ Eligibility requirements to participate in the benefit plan
- ▶ Termination of a benefit plan upon emergence from bankruptcy

The facts and circumstances giving rise to a defined benefit plan modification should be carefully considered including whether the modification has been approved by the court and when the modification was approved. For example, when the court amends a defined benefit plan to cease the accrual of pension benefits after the Chapter 11 filing ("freezing the benefit plan"), then the entity should evaluate the guidance in ASC 715-30-35-74 through 35-96 (curtailments) to determine whether a curtailment has occurred. However, if the modification is effective only when the entity emerges from bankruptcy protection, the accounting for the modification occurs at that time (either under fresh-start accounting or based on the guidance when an entity does not qualify for fresh-start accounting). See section 4.4.3, *Pension/OPEB*, for additional discussion of accounting for modifications of benefit plans upon emergence from bankruptcy.

In some cases, an entity may pay a one-time termination benefit to a portion of its workforce. In these situations, ASC 420 also should be considered. See section 3.9.14, *Restructuring charges, including one-time termination benefits*, for additional guidance.



### 3.9.12 Share-based payments

During the bankruptcy period, the entity continues to account for share-based payments, including modifications or cancellations, in accordance with ASC 718. If the court cancels the awards, the entity should account for the cancellation when it becomes effective. If awards are cancelled with no concurrent grant (or offer to grant when the service inception date precedes the grant date), the cancellation is accounted for as a settlement for no consideration, and any previously unrecognized compensation cost is recognized on the cancellation date. See our FRD, *Share-based payment*, for more information.

#### 3.9.12.1 Non-terminated share-based payment plans

During bankruptcy, an entity generally should continue to recognize compensation cost for share-based payments during the requisite service period for employee awards (or the vesting period for nonemployee awards) when the grantees continue to vest in the awards after the filing date. The entity should consider all facts and circumstances when assessing whether liability-classified awards should be presented as liabilities subject to compromise during bankruptcy and, if so, determine the expected amount of the allowed claim.

Under the share-based payment guidance in ASC 718, entities have to elect whether to account for forfeitures of share-based payments by (1) recognizing forfeitures of awards as they occur or (2) estimating the awards expected to be forfeited and adjusting the estimate when it is likely to change. If an entity's policy is to estimate forfeitures, the estimate of the instruments expected to vest should not consider changes to the awards that might, or will, occur if the entity emerges from bankruptcy. The accounting should be based on the terms of the award that exist at the reporting date and should not reflect changes to those terms that may occur at a future date, even if those changes (including cancellation) have been approved by the court prior to emergence but become effective only upon emergence. For non-terminated plans, an entity should continue to recognize compensation cost over the remaining service period after the entity emerges from bankruptcy.

See section 4 of our FRD, *Share-based payment*, for discussion on the recognition of compensation cost.

#### 3.9.12.2 Modifications to non-terminated share-based payment plans

Modifications that are only effective upon emergence from bankruptcy are not recorded until the entity emerges from bankruptcy. See section 4.4.7, *Share-based payments*, for the successor (i.e., emerging) entity's accounting for share-based payment awards upon emergence from bankruptcy.

### 3.9.13 Consolidation

ASC 810-10-15-10 cites bankruptcy of a subsidiary as a circumstance when a majority owner should deconsolidate a subsidiary, based on the assumption that the majority owner lost control over the subsidiary.<sup>4</sup> This principle generally applies regardless of whether the bankrupt subsidiary was previously considered a variable interest entity or a voting entity. However, consideration should be given to the bankruptcy status of the parent or other subsidiaries, particularly when a parent is also included in the bankruptcy proceedings.

In some instances, a parent and its subsidiaries may file for bankruptcy protection in the same court and might be treated collectively by that court. In other instances, a parent and its subsidiaries are not in the same court (i.e., the parent and subsidiary may not be incorporated in the same jurisdiction and legally may not be able to file in the same court). Careful consideration of how the entities are treated by the court(s) and any changes in the court's treatment (i.e., separation of the subsidiary's bankruptcy proceeding from the parent's bankruptcy proceeding) is necessary to appropriately apply the consolidation guidance.

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<sup>4</sup> This concept also is repeated in Regulation S-X 3A-02(a) *Consolidated financial statements of the entity and its subsidiaries*.

The bankruptcy status of entities in a consolidated group may affect whether the entities continue to be consolidated. Consolidation considerations include:

- ▶ The status of the bankruptcy proceedings
- ▶ The facts and circumstances of the parent's relationship with the subsidiary (i.e., majority shareholder, priority debt holder, single largest creditor)

The SEC staff indicated that it also would consider expectations about the length of the bankruptcy, and the likelihood that the registrant would regain control of the subsidiary upon emergence. The SEC staff indicated that it would be concerned if a registrant were to deconsolidate a subsidiary, recognize a gain, and reconsolidate the subsidiary in a short period.<sup>5</sup> A registrant should disclose any significant judgments made regarding control and consolidation.

The following table summarizes the more frequently occurring consolidation scenarios with respect to the application of ASC 810 to bankrupt entities and their investors. While consolidation considerations are facts and circumstances specific, the table summarizes our experience and general expectations.

| <b>Entity filing bankruptcy</b>                 | <b>Consolidation implication</b>                        |
|---|---|
| Subsidiary only                                 | Parent deconsolidates subsidiary                        |
| Parent only                                     | Parent continues to consolidate subsidiary              |
| Parent and subsidiary (different jurisdictions) | Parent deconsolidates subsidiary                        |
| Parent and subsidiary (same jurisdiction)       | Parent continues to consolidate subsidiary <sup>6</sup> |

For transactions in the scope of ASC 810, the deconsolidation guidance in ASC 810-10-40-5 generally will result in recognizing any retained noncontrolling interest in the former subsidiary at its fair value. Due to the complexities of determining the fair value of a noncontrolling investment in an entity that is struggling financially, the involvement of valuation professionals is encouraged. See our FRD, ***Fair value measurement***, for additional guidance on measuring fair value.

Upon deconsolidation, a reporting entity also should consider the accounting for its remaining interests in the former subsidiary, such as any previously eliminated intercompany receivables from the deconsolidated subsidiary or any claims as a creditor of the bankrupt subsidiary. In addition, the reporting entity should evaluate whether any of the claimants of the bankrupt entity have direct claims against the reporting entity or its remaining subsidiaries (e.g., through guarantees issued by the reporting entity), or whether the reporting entity has any direct obligation to fund operations of the bankrupt entity. Entities should appropriately account for (and disclose) any contingencies, such as potential litigation, commitments to fund operations, etc., related to deconsolidated subsidiaries in accordance with applicable US GAAP (e.g., ASC 450). In certain circumstances, the difference between the deconsolidated carrying amount of the subsidiary and the fair value of any of these retained interests will result in a potential gain. In order to recognize a gain in this instance, the parent would need to determine that it has no additional exposure related to the deconsolidated subsidiary. In some cases, this may not occur until the resolution of the subsidiary's bankruptcy. See section 19 of our FRD, ***Consolidation***, for further discussion of deconsolidation.

<sup>5</sup> Speech by Randolph Green, Professional Accounting Fellow at the SEC, at the 2003 AICPA National Conference on SEC Developments.

<sup>6</sup> The rationale for this conclusion is based on the fact that if both the parent and subsidiary file for bankruptcy protection in the same jurisdiction, they are under the control of the same parties. In this scenario, the parent would continue to consolidate the subsidiary because they are under common control.

The appropriate method of accounting for the remaining interest in the subsidiary requires careful consideration of the nature of the remaining interests. The remaining interest may be accounted for under the equity method in accordance with ASC 323 or as a financial asset. The use of the equity method of accounting requires that an entity have the ability to exercise significant influence over an investee. The facts and circumstances of the bankruptcy proceeding may call into question an entity's ability to exercise significant influence. In addition, we believe that a bankruptcy period that is expected to be relatively short (e.g., in a prepackaged bankruptcy) and the expectation that the parent will regain control of the subsidiary after it emerges from bankruptcy may indicate that the parent has the ability to exercise significant influence over the former subsidiary during the bankruptcy period. See section 3 of our FRD, *Equity method investments and joint ventures*, and see our FRD, *Certain investments in debt and equity securities*, for further discussion.

In certain circumstances, such as with respect to transfers of financial assets, a subsidiary may be distinguished as "bankruptcy remote." For example, a subsidiary may be "bankruptcy remote" from the entity in the group (the transferor) from which it receives assets. The transferred assets would be isolated from the transferor, and the transferor's creditors in all circumstances (including bankruptcy of the transferor). However, the facts and circumstances of the bankruptcy proceeding may influence an assessment of whether a subsidiary is bankruptcy remote.

### 3.9.13.1 Rare exceptions to the deconsolidation principle

As noted above, the guidance in ASC 810-10-15-10 cites bankruptcy of a subsidiary as one reason that a majority owner should not consolidate a subsidiary. We believe that guidance also applies to most prepackaged bankruptcy cases (see section 1.2.2) because the reorganization plan is still subject to court confirmation.

However, in rare circumstances, continued consolidation of a subsidiary in bankruptcy might be appropriate and perhaps more meaningful. One circumstance described by the SEC staff involved a parent that was the majority common shareholder and the priority debt holder of a bankrupt subsidiary.<sup>7</sup> These two positions resulted in the parent being the bankrupt subsidiary's single largest and dominant creditor. Because of its dominant creditor position, the parent was able to negotiate a prepackaged bankruptcy, which included retaining majority-voting control after the bankruptcy. In that case, the bankruptcy proceedings were expected to be completed in less than one year. In addition, based on the facts and circumstances, the entity most likely did not qualify for fresh-start accounting because there was not a change in control. See section 4.1, *Applicability of fresh-start accounting*, for further discussion.

### 3.9.14 Restructuring charges, including one-time termination benefits

Entities operating in bankruptcy continue to apply the guidance in ASC 420. Entities operating under bankruptcy protection may take certain steps to alter their operations, structure or business model prior to emerging from bankruptcy. Such steps may include announced workforce reductions, consolidation of facilities and even eliminating certain operations (either through a sale or through wind-down). Careful analysis of the entity's plan and the guidance in ASC 420 is warranted in such situations. See our FRD, *Exit or disposal cost obligations*, for further discussion of restructuring liabilities.

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<sup>7</sup> Speech by Randolph Green, Professional Accounting Fellow at the SEC, at the 2003 AICPA National Conference on SEC Developments.

We are aware that there is diversity in practice regarding whether restructuring charges are classified as reorganization items in the statement of operations. Entities typically follow one of two approaches in deciding whether to classify restructuring charges as “reorganization items:”

- ▶ An entity may classify such expenses as “reorganization items” under the view that they meet the definition of a reorganization item included in ASC 852-10-45-9 (that is, they “result from the reorganization and restructuring of the business”).
- ▶ An entity may elect to classify such expenses as operating expenses, separate and apart from reorganization items.

We believe the preferable accounting policy is to exclude restructuring costs from reorganization items. While not retained in Codification of ASC 852, Background Information and Basis for Conclusions (BC) paragraph 50 to SOP 90-7 included a threshold for classifying items as reorganization items. That threshold effectively limited the costs that could be classified as reorganization items to such costs that are unusual or infrequent in nature.

### 3.9.15

### Applicability of troubled debt restructuring accounting

#### Excerpt from Accounting Standards Codification

#### Debt – Troubled Debt Restructurings by Debtors

#### *Scope and Scope Exceptions*

#### **470-60-15-10**

The guidance in this Subtopic shall be applied to all troubled debt restructurings including those consummated under reorganization, arrangement, or other provisions of the Federal Bankruptcy Act or other federal statutes related thereto. This Subtopic does not apply, however, if under provisions of those federal statutes or in a quasi-reorganization or corporate readjustment (see Topic 852) with which a troubled debt restructuring coincides, the debtor restates its liabilities generally, that is, if such restructurings or modifications accomplished under purview of the bankruptcy court encompass most of the amount of the debtor’s liabilities.

A restructuring of debt is considered a “troubled debt restructuring” if the creditor, for economic or legal reasons related to the entity’s financial difficulties, grants a concession to the entity it would not otherwise consider. A troubled debt restructuring includes:

- ▶ A transfer of assets from the entity to the creditor in full or partial satisfaction of a debt
- ▶ An issuance of an equity interest to the creditor by the entity in full or partial satisfaction of a debt
- ▶ A modification of terms of a debt

For a debt restructuring to be considered troubled, the entity must be experiencing financial difficulty and the creditor must have granted a concession. ASC 470-60 provides guidance on the accounting for troubled debt restructuring. The troubled debt restructuring accounting model may result in a different carrying amount and different gain or loss recognition for the restructured debt than an entity would record under ASC 852.

## Excerpt from Accounting Standards Codification

### Debt – Troubled Debt Restructurings by Debtors

#### *Implementation Guidance and Illustrations*

##### **470-60-55-1**

Entities involved with Chapter 11 bankruptcy proceedings frequently reduce all or most of their indebtedness with the approval of their creditors and the court in order to provide an opportunity for the entity to have a fresh start. Such reductions are usually by a stated percentage so that, for example, the debtor owes only 60 cents on the dollar. Because the debtor would be restating its liabilities generally, this Subtopic would not apply to the debtor's accounting for such reduction of liabilities.

##### **470-60-55-2**

On the other hand, this Subtopic would apply to an isolated **troubled debt restructuring** by a debtor involved in bankruptcy proceedings if such restructuring did not result in a general restatement of the debtor's liabilities.

ASC 470-60 does not apply to entities that, in connection with bankruptcy proceedings, enter into debt restructurings that result in a general restatement of the entity's liabilities (that is, it does not apply when the restructuring or modification is accomplished under the purview of the court and encompasses most of the amount of the entity's liabilities).

See section 2.6 of our FRDs, *Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)*, or *Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)*, as applicable, for further discussion on accounting for a troubled debt restructuring, and see section 4.2, *Method for applying fresh-start accounting*, for the accounting under ASC 852.

A registrant may be required to file a Form 8-K related to the modification, exchange or extinguishment of any debt. Form 8-K requires registrants to file an amendment to a material definitive agreement with the SEC.

### 3.9.16 Contingent or 'success' fees

An entity operating under bankruptcy protection may enter into service arrangements that include payment terms that are contingent upon successful emergence from bankruptcy. Such arrangements may be structured to provide varying degrees of compensation to the service provider depending on the timing of emergence from bankruptcy protection. Frequently, the service provider receives no remuneration unless the entity emerges from bankruptcy protection. These arrangements are frequently referred to as "success fee" arrangements.

Entities should evaluate when "success fees" should be accrued. While facts and circumstances may result in entities arriving at different conclusions, we have observed that some entities consider such contracts to be executory contracts and do not accrue for the costs until earned and payable. That is, these costs are accounted for in the successor period. Others may conclude that it is appropriate to accrue such success fees when they become probable of payment. Such determination typically does not occur until approval by the court has been obtained for emergence from bankruptcy protection. Consequently, under this policy such fees are often recorded as one of the last entries by the predecessor entity when an entity adopts fresh-start accounting.

### 3.9.17 Section 363 asset sales

Under Chapter 11 of the Code, Section 363 provides a mechanism through which the trustee, upon approval by the court, can sell all, or a portion of, the entity's assets to a third party before achieving acceptance, by the creditors, of the plan of reorganization. Under a Section 363 sale, the trustee presents a fully negotiated asset purchase agreement to the court for its approval. The proceeds from a Section 363 sale become assets of the entity that can be used to satisfy the claims of its creditors. A Section 363 sale provides the buyer with title to the purchased assets free and clear of any prior liens and claims, including claims that remain unpaid by the entity after the sale is completed.

Certain large entities have found Section 363 asset sales to be an effective, efficient and timely means of starting the business anew through a newly created "buyer entity." In such circumstances, the "buyer entity" is the acquirer of all, or substantially all, of the assets of the bankrupt entity, thereby allowing it to restart the business in a new entity. In addition, as the "buyer entity" purchased the assets free and clear of any claims, the "buyer entity" is not liable for the outstanding claims against the bankrupt entity, as such claims remain in the bankrupt entity, subject to satisfaction through the plan of reorganization.

If the sale constitutes the sale of a business, the bankrupt entity would account for the Section 363 asset sale under ASC 810. If the assets being sold do not meet the definition of a business, the bankrupt entity would need to consider the nature of the assets being sold in order to determine the appropriate guidance to be applied to the transaction (e.g., ASC 610-20, *Gains and Losses from the Derecognition of Nonfinancial Assets*, ASC 860, *Transfers and Servicing*). See section 19.3 of our FRD, **Consolidation**, for further discussion. Although the bankrupt entity may have effectively sold all, or a portion of, its assets, it remains in bankruptcy until the court has approved (or "crammed-down") the plan of reorganization. The execution of a Section 363 sale does not represent, in and of itself, the emergence from bankruptcy.

Once a Section 363 sale has been consummated and the buyer pays the consideration, the court will decide how the proceeds of the sale are allocated among secured creditors with liens on the assets sold. If additional proceeds remain after the secured creditors with liens on the assets are paid, that amount is allocated to unsecured creditors and other claimants in accordance with the Code.

#### 3.9.17.1 Section 363 sale versus a plan of reorganization

Some argue that the approval of a Section 363 sale of substantially all of an entity's assets will have the practical effect of deciding many important issues that would ordinarily arise during the bankruptcy proceeding and be addressed as part of the plan of reorganization.

A sale of assets in bankruptcy can often be accomplished more quickly with a Section 363 sale rather than in the context of a plan of reorganization. A Section 363 sale requires only the approval of a judge while a plan of reorganization must be approved by a substantial number of creditors and meets certain other requirements to be "confirmed." A plan of reorganization is much more comprehensive than a Section 363 sale in addressing the overall financial situation of the entity and the effects of its plan of emergence from bankruptcy on creditors.

#### 3.9.17.2 Break-up fees paid to prospective acquirers in a Section 363 sale

In a Section 363 sale, the initial prospective acquirer (or "stalking horse") offers a specific price and terms for the acquisition of the entity's asset or assets. The initial prospective acquirer usually negotiates for payment of a "break-up fee" or "topping fee" in the event someone else becomes the prevailing bidder and the initial prospective acquirer does not become the approved acquirer.

The justification for paying a break-up fee is that the stalking horse has performed due diligence upon which other bidders may rely, and that it ensures that any competing bid is meaningfully more valuable.

Outside of a bankruptcy, break-up fees often exceed any reasonable estimate of the costs incurred because they are intended to discourage other buyers. However, in bankruptcy, participation by other bidders is encouraged, not discouraged. Accordingly, the fee must be reasonable as compared to the stalking horse's costs incurred and the tangible benefits conferred, and should bear a reasonable relationship to the consideration transferred.

We believe that break-up fees should be accrued by the entity as a postpetition liability. As these costs are administrative in nature, these liabilities will be subject to compromise. Such fees are generally presented as reorganization items.

### 3.9.17.3

#### Accounting for a Section 363 sale by the acquirer

To some, it may appear that a bankrupt entity utilizes a Section 363 sale to emerge from bankruptcy, as the core business of the bankrupt entity may begin anew in the "buyer entity." The legal and economic substance of a Section 363 sale, however, is simply the acquisition of assets by the "buyer entity." Similarly, the "buyer entity" typically is not a subsidiary of the bankrupt entity, neither before nor after the Section 363 sale transaction. From the perspective of the buyer entity, a Section 363 acquisition may represent either a business combination (if the assets meet the definition of a business) or an asset acquisition, both of which are accounted for under ASC 805. If accounted for as a business combination, careful identification of the acquirer is important, because the transaction may represent a reverse acquisition or an acquisition by a special purpose acquisition company. See our FRD, *Business combinations*, for additional information on business combinations and asset acquisitions, including section 3.2.2.2.5.1 on special purpose acquisition companies.

The following illustrates the accounting for a Section 363 sale:

#### Illustration 3-7: Accounting for a Section 363 sale in the financial statements of a "Newco"

Company A files for Chapter 11 bankruptcy on 31 December 20X0. Company A has three divisions, (1) automotive, (2) aerospace and (3) rail. On 1 March 20X1, the management of the aerospace and rail divisions forms a Newco and enters a bid to acquire the assets of the aerospace and rail divisions from Company A. On 1 June 20X1, the court approves the sale to Newco as a Section 363 sale.

Newco would account for the acquired assets under ASC 805 as a business combination if the acquired assets meet the definition of a business or as an asset acquisition if the acquired assets do not meet the definition of a business.

### 3.9.18

#### Foreign currency considerations

An entity in bankruptcy may lose control (or significant influence) over an investment in or within a "foreign entity" (as defined in ASC 830), in which case, special considerations apply. A foreign entity may include a subsidiary, division, branch, joint venture or equity method investment. That is, a foreign entity as defined by ASC 830 may differ from a legal entity. See section 1.2.2 and section 4.4.3 of our FRD, *Foreign currency matters*, for additional discussion on the definition of a foreign entity under ASC 830 and how to treat any cumulative translation adjustment in this scenario, respectively.

# 4 Accounting upon emergence from Chapter 11

The provisions of a reorganization plan provide for the specific treatment for all creditors and equity holders. The plan dictates the financial structure of the entity that emerges from bankruptcy upon confirmation of the plan. The confirmation of the plan by the court represents an official approval that binds the entity, creditors and equity holders. As such, confirmation of the plan by the court establishes the obligations, rights and interests of the entity, creditors and equity holders. The plan of reorganization is based on the expected value of the reorganized entity, as it is instrumental in determining the interests the creditors and equity holders receive upon emergence from bankruptcy.

## 4.1 Applicability of fresh-start accounting

### Excerpt from Accounting Standards Codification

#### Reorganizations – Overall

#### *Other Presentation Matters*

#### **852-10-45-17**

Entities whose plans have been confirmed by the court and have thereby emerged from Chapter 11 shall apply the reporting principles in paragraphs 852-10-45-19 through 45-29 as of the confirmation date or as of a later date, as discussed in the following paragraph, when all material conditions precedent to the plan's becoming binding are resolved.

#### **852-10-45-18**

The effects of a plan should be included in the entity's financial statements as of the date the plan is confirmed. However, inclusion shall be delayed to a date not later than the effective date if there is a material unsatisfied condition precedent to the plan's becoming binding on all the parties in interest or if there is a stay pending appeal. That might occur, for example, if obtaining financing for the plan or for the transfer of material assets to the debtor by a third party is a condition to the plan's becoming effective. Financial statements prepared as of the date after the parties in interest have approved a plan through the voting process, and issued after the plan has been confirmed by the court, shall report the effects of the plan if there are no material unsatisfied conditions.

#### **852-10-45-19**

If the reorganization value of the assets of the emerging entity immediately before the date of confirmation is less than the total of all postpetition liabilities and allowed claims, and if holders of existing voting shares immediately before confirmation receive less than 50 percent of the voting shares of the emerging entity, the entity shall adopt fresh-start reporting upon its emergence from Chapter 11. The loss of control contemplated by the plan must be substantive and not temporary. That is, the new controlling interest must not revert to the shareholders existing immediately before the plan was filed or confirmed.



While an entity that emerges from Chapter 11 bankruptcy generally is a new legal entity, it does not necessarily qualify for fresh-start accounting (i.e., a change in the historical book basis of the assets and liabilities of the emerging entity). An emerging entity qualifies for fresh-start accounting only if both of the following conditions are met:

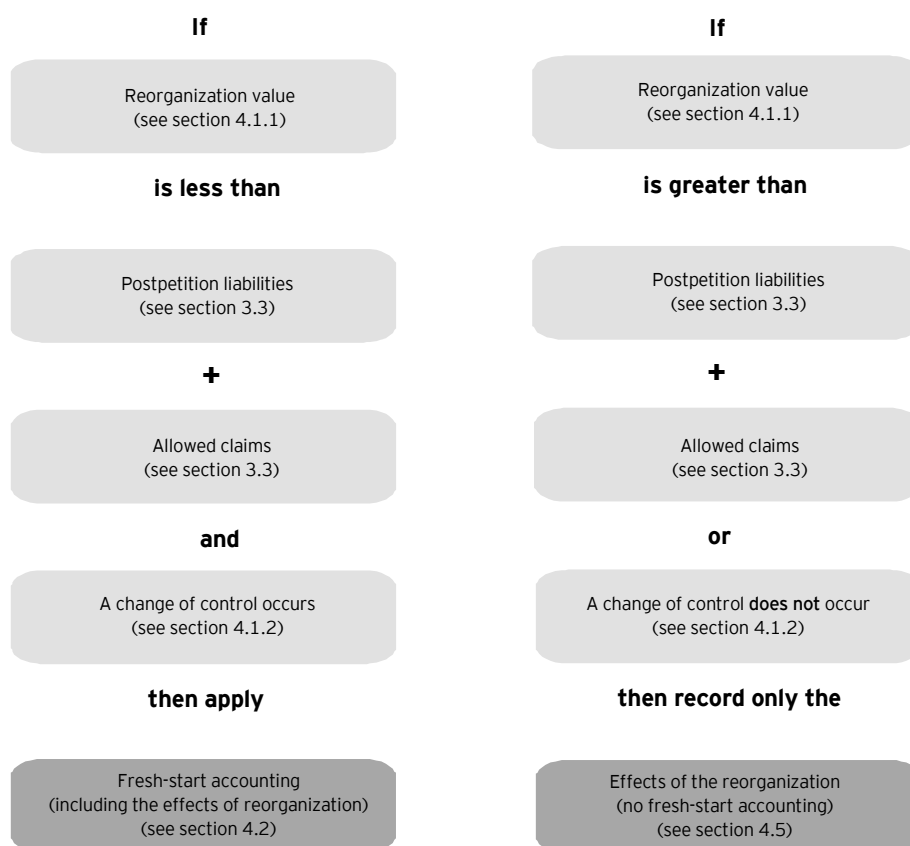
- ▶ The **reorganization value** of the assets (see section 4.1.1, *Reorganization value*, for more guidance) immediately before the date of confirmation is less than the **postpetition liabilities and allowed claims** (see section 3.3, *Liabilities under ASC 852*, for more guidance).
- ▶ Control changes (i.e., the prepetition shareholders lose control of the emerging entity by receiving less than 50% of the voting shares of the emerging entity) (see section 4.1.2, *Assessing changes in control*, for more guidance).

If either condition is not met, a new reporting entity is not created for accounting purposes, and the entity does not qualify for fresh-start accounting.

In fresh-start accounting, the reorganization value is assigned to the emerging entity's assets and liabilities. The emerging entity presents a predecessor statement of operations that reflects these adjustments. This presentation differs from purchase accounting for an acquired business because purchase accounting adjustments are not generally included in the acquired entity's statement of operations.

An entity that does not qualify for fresh-start accounting would continue to apply US GAAP, and the carrying amounts of its assets would **not** be adjusted to the reorganization value. Liabilities compromised (that is, liabilities for which the original payment amount or terms were modified) by a confirmed plan would be stated at the present value of the amounts to be paid. See section 4.5, *Entities that do not meet the criteria for fresh-start accounting*, for further discussion.

The following chart summarizes the guidance in ASC 852-10-45-19:



**Illustration 4-1: Determining whether to apply fresh-start accounting**

Entity A filed for bankruptcy, and the Bankruptcy Court allowed claims of \$3,450. The Bankruptcy Court confirmed a plan of reorganization that states that the reorganization value of Entity A is \$12,450. Immediately before the confirmation, the entity had postpetition liabilities of \$10,100.

The plan of reorganization specifies that the prepetition shareholders will receive 45% of the equity of Entity A when it emerges from Chapter 11, and the creditors of Entity A will receive the remaining 55%.

**Analysis**

The reorganization value of \$12,450 is less than the sum of the postpetition liabilities and allowed claims of \$13,550 (\$10,100 + \$3,450).

There has been a change in control of Entity A because the prepetition shareholders receive 45% of the equity of the Entity A (i.e., the prepetition shareholders receive less than 50% of the new equity).

Fresh-start accounting applies because both conditions have been met.

**4.1.1****Reorganization value****Excerpt from Accounting Standards Codification****Reorganizations – Overall****Glossary****852-10-20****Reorganization Value**

The value attributed to the reconstituted entity, as well as the expected net realizable value of those assets that will be disposed of before reconstitution occurs. Therefore, this value is viewed as the value of the entity before considering liabilities and approximates the amount a willing buyer would pay for the assets of the entity immediately after the restructuring.

The first criterion in determining whether to apply fresh-start reporting is that the reorganization value of the assets is less than the postpetition liabilities and allowed claims. The reorganization value is an amount established as part of the plan of reorganization, which must be approved by the court to emerge from bankruptcy protection. Reorganization value is intended to approximate the value of the entity's assets immediately after the restructuring (and immediately before the court confirms the plan), including assets that will be disposed of prior to emergence from bankruptcy (i.e., the amount a willing buyer would pay for the assets of the entity immediately after the restructuring). Value related to assets that are expected to be disposed of before reconstitution occurs is included in reorganization value because the proceeds from the sale of those assets will be used to satisfy some portion of the allowed claims. Postpetition liabilities and allowed claims and interest are satisfied by the reorganization value.

In some cases, the court may establish a range of values for reorganization value, rather than a point estimate. For example, this may occur if the bankruptcy proceeding is contentious, or if the number of shares being issued will be determined after emergence. When reorganization value is not established as a point estimate during the reorganization proceeding, the entity should use all available information to estimate reorganization value. The SEC staff has requested that registrants disclose how they determined reorganization value, including the methodology and assumptions used. See section 5.2, *Fresh-start disclosures*, for additional discussion about the required disclosures for determining reorganization value.

### 4.1.1.1 Reorganization value versus fair value

#### Nonauthoritative literature

##### Excerpt from SOP 90-7 (nonauthoritative)

58. The task force concluded that reorganization value can be a more objective measure of fair value than a purchase price in a business combination. This view is based on two factors. First, a purchase price in a nonbankruptcy business combination may exceed the fair value of the acquired entity, because such determinations may be influenced by a variety of factors unrelated to that entity. Second, in the reorganization process, extensive information available to the parties in interest, the adversarial negotiation process, the involvement of the Bankruptcy Court, the use of specialists by one or more of the parties in interest, and the fact that all elements of the determination are focused solely on the economic viability of the emerging entity result in an objective and reliable determination of reorganization value.

While paragraph 58 of SOP 90-7 is no longer authoritative, it remains instructive with respect to the differences between reorganization value and fair value. For example, fair value may differ from reorganization value due to the use of market participant assumptions in determining fair value pursuant to ASC 820, as opposed to the use of court-determined or negotiated assumptions in determining reorganization value.

### 4.1.1.2 Reorganization value versus enterprise value

As previously noted, a court may establish a range of values for reorganization value, rather than a point estimate. In such cases, the entity needs to select a point estimate of reorganization value for the fresh-start calculation. One method for determining reorganization value would be to determine the enterprise value or equity value of an entity, and adjust that amount to derive reorganization value. When doing so, it is important to understand the difference between other defined valuation measures (e.g., "enterprise value," "equity value," "going concern value") and "reorganization value" as defined in ASC 852.

For example, enterprise value is typically defined as the fair value of an entity's long-term debt and equity interests. Depending on the specific valuation, the enterprise value may include or exclude excess cash and other working capital accounts. Therefore, it is important for the entity to understand how the defined measure was calculated, including what estimates and assumptions were included or excluded from the analysis (e.g., whether pension costs, working capital liabilities, or environmental liabilities were included or excluded from the calculation of enterprise value). This knowledge is critical for an entity to determine the appropriate "reorganization value" for applying ASC 852.

The defined measure should use inputs that are consistent with the entity's emergence from bankruptcy. For example, the relevant credit risk associated with the entity's debt upon emergence from bankruptcy would typically be lower than the credit risk of the entity while in bankruptcy, because emergence from bankruptcy relieves uncertainty related to the bankruptcy process (e.g., whether the entity will successfully emerge from bankruptcy) and typically relieves the entity from certain prepetition claims. That is, one would generally expect a lower credit risk when valuing the entity's debt upon emergence, as compared to the credit risk while the entity is in bankruptcy.

The following example illustrates how an entity might use enterprise value to derive reorganization value.

**Illustration 4-2: Determining reorganization value based on enterprise value**

The court established a range of reorganization values, from \$20,000 to \$23,000 for an entity that filed for Chapter 11 bankruptcy protection. A valuation specialist engaged by the entity to assist in the determination of reorganization value estimates that the entity's enterprise value is \$11,550. This amount reflects the fair value related to the entity's long-term debt of \$2,000, and notes payable of \$2,150, but does not include working capital liabilities.

At the emergence date, the entity had the following liabilities:

|                                     |        |
|-------------------------------------|--------|
| Accounts payable                    | \$ 500 |
| Accrued liabilities                 | 8,100  |
| Other long-term accrued liabilities | 1,300  |
| Long-term debt                      | 2,000  |
| Notes payable                       | 2,150  |

**Analysis**

To determine its best estimate of reorganization value, the entity began with the enterprise value and added working capital liabilities that existed as of the emergence date:

|                                     |                  |
|-------------------------------------|------------------|
| Enterprise value                    | \$ 11,550        |
| Accounts payable                    | 500              |
| Accrued liabilities                 | 8,100            |
| Other long-term accrued liabilities | 1,300            |
| Reorganization value                | <u>\$ 21,450</u> |

Accordingly, the entity determined that its best estimate of reorganization value was \$21,450, which was within the range of reorganization values established by the court.

When deriving reorganization value from enterprise value, an entity should apply judgment, based on the facts and circumstances, to determine how to reflect liabilities that will not be settled in cash (e.g., certain deferred revenue, deferred tax liabilities). Liabilities that will be settled with equity interests in the reorganization would not be added to the enterprise value, since the interests of those creditors are already reflected in the value of the equity interests expected to be issued and the liabilities are forgiven upon emergence from bankruptcy.

#### 4.1.1.3 Reorganization value versus valuations used in goodwill impairment tests

Prior to or during bankruptcy, an entity may determine the fair value of its reporting units when conducting an annual or interim goodwill impairment test, as discussed in section 3.9.1, *Goodwill and indefinite-lived intangible asset impairment*, and in section 3 of our FRD, *Intangibles – Goodwill and other*. We believe that an entity generally should be able to explain differences between any valuations used for impairment testing and the point estimate selected from within a range of reorganization values established by the court. Such differences may be attributable to the reasons discussed above.

#### 4.1.1.4 Reorganization value when emergence is concurrent with a merger or acquisition

In some cases, an entity may emerge from bankruptcy concurrent with an acquisition of another entity. The court may approve the acquisition, and its approval of the reorganization plan might depend on the completion of the merger. In these cases, it is important to consider whether the reorganization value determined by the court reflects value that is attributable to synergies resulting from the acquisition, or value attributable solely to the bankrupt entity. Careful consideration also should be given to the sequence of the transactions, and the determination of the accounting acquirer, when determining how to reflect the emergence from bankruptcy in the financial statements.

## 4.1.2 Assessing changes in control

The second criterion in determining whether to apply fresh-start reporting is the evaluation of whether a change in control occurred. To meet this criterion, shareholders immediately before emergence must receive less than 50% of the voting shares of the emerging entity. The loss of control must be substantive and not temporary. That is, control must not revert to the pre-emergence shareholders. In this evaluation, the potential dilution resulting from warrants and options is generally not considered.

### Illustration 4-3: Assessing change in control upon emergence from bankruptcy

#### Example 1

Entity A filed for bankruptcy. The prepetition shareholders of Entity A collectively held 100% of outstanding shares.

The plan of reorganization specified that the shareholders would receive 52% of the equity of the emerging Entity A. The creditors of Entity A receive the remaining 48% of the equity of Entity A upon emergence.

However, employees would receive share-based payment awards, which if exercised, would reduce the existing shareholders' equity to 47% of the emerging Entity A.

#### Analysis

Entity A would not qualify for fresh-start accounting. The potentially dilutive effect of the share-based payments issued to employees is not considered in the fresh-start calculation. Therefore, since the existing shareholders of Entity A receive 52% of the equity of the emerging Entity A, there is no change in control, and fresh-start accounting would not apply.

#### Example 2

Entity B filed for bankruptcy. Before the filing, Shareholders X, Y and Z owned 50%, 30% and 20% of Entity B, respectively.

The plan of reorganization specified that Shareholder X would receive 100% of the equity of the emerging Entity B.

#### Analysis

The entity would not qualify for fresh-start accounting. Although no single party controlled Entity B prior to the bankruptcy filing, the evaluation of change in control is made on a collective basis. Collectively, Shareholders X, Y and Z own 100% of Entity B both before and after Entity B emerges from bankruptcy. There is no change in control, and fresh-start accounting would not apply.

However, Shareholder X would need to evaluate whether it obtained control of Entity B and should account for the acquisition as a business combination under ASC 805 if Entity A meets the definition of a business. Depending on the facts and circumstances, any "new basis" resulting from the business combination accounting might be "pushed-down" to the financial statements of Entity B. See Appendix B of our FRD, ***Business combinations***, for additional guidance.

### 4.1.3 Projecting the applicability of fresh-start accounting prior to emergence

An entity may need to evaluate whether fresh-start accounting will apply before it emerges from bankruptcy. For example, SEC registrants might be required to prepare pro forma financial statements illustrating the likely accounting upon emergence.

When determining whether to apply fresh-start accounting in the pro forma financial statements (that is, whether the criteria discussed in section 4.1, *Applicability of fresh-start accounting*, are likely to be met), the entity may need to estimate the total allowed claims as of the date of emergence. This is because only allowed claims are included in the fresh-start calculation (which may not be the same as all liabilities recorded in the balance sheet). Generally, we would not expect that liabilities recorded by the entity because of accounting principles (e.g., certain deferred revenue, deferred tax liabilities) to be allowed claims. However, the determination of allowed claims is ultimately at the discretion of the court.

Ultimately, the determination of whether an entity qualifies for fresh-start accounting is made as of the emergence date, which may occur well after the court declares reorganization value. The entity should disclose any risks and uncertainties related to its projections. For example, this would include the methodology and assumptions used to estimate reorganization value, if not yet established by the court.

## 4.2 Method for applying fresh-start accounting

### Excerpt from Accounting Standards Codification

#### Reorganizations – Overall

#### *Other Presentation Matters*

#### **852-10-45-20**

Entities that adopt fresh-start reporting in conformity with the preceding paragraph shall apply the following principles:

- a. The reorganization value of the entity shall be assigned to the entity's assets and liabilities in conformity with the procedures specified by Subtopic 805-20. If any portion of the reorganization value cannot be attributed to specific tangible or identified intangible assets of the emerging entity, such amounts shall be reported as goodwill in accordance with paragraph 350-20-25-2.
- b. Subparagraph not used.
- c. Deferred taxes shall be determined under the requirements of paragraph 852-740-45-1.
- d. Subparagraph not used.

The reorganization value of the emerging entity is assigned to the emerging entity's assets and liabilities in conformity with the business combinations guidance in ASC 805. That is, the application of fresh-start accounting is effectively treated as a business combination in which the reorganization value serves as the consideration transferred. The fresh-start adjustments are reflected in the predecessor entity's final statement of operations.

As a reminder, in most cases, the business combinations guidance incorporates the measurement principles of ASC 820. For assets required to be measured at fair value, the fair value of each asset should be determined based on its “highest and best use.” Fair value is defined as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” Therefore, when measuring the fair value of assets in fresh-start accounting, the effect of contractual terms (e.g., terms of restructured debt, leases, executory contracts, intangible assets) negotiated or set by the court during the bankruptcy proceeding should be considered, since they may differ from current market terms and/or the terms of previous contracts. See section 4 of our FRD, *Business combinations*, for additional discussion of the application of ASC 805 to specific assets and liabilities.

ASC 852 also requires the liabilities of the entity to be measured in accordance with the business combinations guidance in ASC 805. That is, postpetition liabilities and allowed claims existing upon an entity’s emergence from bankruptcy protection are measured at fair value in accordance with ASC 820, which might differ from the negotiated or allowed amounts. As such, an emerging entity should carefully apply the business combinations guidance to liabilities negotiated in bankruptcy. See our FRD, *Fair value measurement*, for additional guidance. As discussed in section 3.9.15, *Applicability of troubled debt restructuring accounting*, ASC 470-60 generally does not apply to entities that, in connection with bankruptcy proceedings, enter into debt restructurings that result in a general restatement of the entities’ liabilities.

If any portion of the reorganization value cannot be attributed to specific tangible or identifiable intangible assets of the emerging entity, the excess reorganization value should be reported as goodwill in accordance with the goodwill guidance in ASC 350. Goodwill may arise because certain assets and liabilities, such as employee benefit obligations and deferred taxes, are recorded at amounts other than fair value, based on the principles in ASC 805. Entities should disclose the factors that result in the recognition of goodwill in fresh-start accounting. Because one of the conditions of qualifying for fresh-start accounting is that the reorganization value of the assets is less than the postpetition liabilities and allowed claims, we do not expect a bargain purchase to result from emergence from bankruptcy.

#### 4.2.1 Date used for fresh-start accounting ('convenience dates')

The “convenience” exception (i.e., the ability to designate an effective acquisition date) that was included in Statement 141 was removed from the business combinations guidance in ASC 805. However, we do believe that an acquirer in a business combination could, in some circumstances, effectively designate a date, other than the date control of the target is obtained, as the acquisition date in order to align the date of acquisition for accounting purposes with an accounting close date. By analogy, we also believe that an entity emerging from bankruptcy protection and applying fresh-start accounting is permitted to designate a date other than the confirmation date (or, if applicable, the date when all material conditions of the plan are resolved) as the date upon which to apply fresh-start accounting.

Practically speaking, the difference between the designated convenience date and the actual date prescribed by ASC 852 should be no more than a few days and the results of operations and changes in financial position of the target during the intervening period must not be material to the emerging entity.

When assessing whether using a convenience date is appropriate, the emerging entity should evaluate whether the effect of using such a convenience date, aggregated with the effects of other known errors and accounting conventions, would have a material impact on the result of operations, financial position or cash flows of either the predecessor or successor entity.

The SEC staff has asked registrants that use convenience dates to disclose the convenience date and the confirmation date, the reason for selecting the convenience date and the conclusion that no material events or transactions occurred in the intervening period.

## 4.2.2 Example of fresh-start accounting

The following example illustrates the effect of reorganization and fresh-start accounting adjustments in the balance sheet of a qualifying entity emerging from Chapter 11 bankruptcy.

| <b>Illustration 4-4: Reorganization and fresh-start accounting adjustments</b> |   |                                       |                                    |                  |
|--|---|---------------------------------------|------------------------------------|------------------|
|  | <u>Preconfirmation/<br/>Predecessor</u> | <u>Reorganization<br/>adjustments</u> | <u>Fresh-start<br/>adjustments</u> | <u>Successor</u> |
| <b>Assets</b>  |   |                                       |                                    |                  |
| <b>Current assets</b>  |   |                                       |                                    |                  |
| Cash and cash equivalents  | \$ 600                                  | \$ (100) (a)                          | \$ -                               | \$ 500           |
| Accounts receivable, net   | 1,000                                   | -                                     | -                                  | 1,000            |
| Inventories  | 2,000                                   | -                                     | 200 (c)                            | 2,200            |
| Other current assets   | 700                                     | -                                     | -                                  | 700              |
| Total current assets   | 4,300                                   | (100)                                 | 200                                | 4,400            |
| Property and equipment, net  | 2,500                                   | -                                     | 500 (c)                            | 3,000            |
| Intangible assets, net   | 1,500                                   | -                                     | 400 (c)                            | 1,900            |
| Goodwill   | 4,000                                   | -                                     | 350 (c)                            | 4,350            |
| Other assets and deferred charges  | 500                                     | -                                     | -                                  | 500              |
| Total assets   | <u>\$ 12,800</u>                        | <u>\$ (100)</u>                       | <u>\$ 1,450</u>                    | <u>\$ 14,150</u> |
| <b>Liabilities and shareholders' equity (deficit)</b>                          |   |                                       |                                    |                  |
| <b>Current liabilities</b>   |   |                                       |                                    |                  |
| Accounts payable   | \$ 500                                  | \$ -                                  | \$ -                               | \$ 500           |
| Notes payable  | 1,600                                   | -                                     | -                                  | 1,600            |
| Exit financing facilities  | -                                       | 550 (b)                               | -                                  | 550              |
| Other notes payable (debtor-in-possession financing)                           | 550                                     | (550) (b)                             | -                                  | -                |
| Accrued payroll and other liabilities  | 800                                     | -                                     | -                                  | 800              |
| Total current liabilities  | 3,450                                   | -                                     | -                                  | 3,450            |
| Long-term debt   | 2,000                                   | -                                     | -                                  | 2,000            |
| Other long-term liabilities  | 1,300                                   | -                                     | -                                  | 1,300            |
| Total liabilities not subject to compromise                                    | 6,750                                   | -                                     | -                                  | 6,750            |
| Liabilities subject to compromise  | 9,300                                   | (9,300) (a)                           | -                                  | -                |
| Total liabilities  | 16,050                                  | (9,300)                               | -                                  | 6,750            |
| Common stock   | 600 (d)                                 | 800 (a)                               | (600) (d)                          | 800              |
| Additional paid-in capital   | 2,150                                   | 4,800 (a)                             | (350) (c, d, e)                    | 6,600            |
| Retained earnings (deficit)  | (6,000)                                 | 3,600 (a)                             | 2,400 (c, e)                       | -                |
| Total equity (deficit)   | (3,250)                                 | 9,200                                 | 1,450                              | 7,400            |
| Total liabilities and shareholders' equity (deficit)                           | <u>\$ 12,800</u>                        | <u>\$ (100)</u>                       | <u>\$ 1,450</u>                    | <u>\$ 14,150</u> |

a. The journal entry to record the cash paid and common stock in the emerging entity that was issued to the creditors for the liabilities subject to compromise, which is recorded as a reorganization adjustment, is as follows:

|   |          |        |
|---|----------|--------|
| Liabilities subject to compromise   | \$ 9,300 |        |
| Cash  |          | \$ 100 |
| Common stock (par value of the common stock issued to creditors)  |          | 800    |
| Additional paid-in capital (fair value of the common stock issued to creditors less par value)  |          | 4,800  |
| Retained earnings (gain on settlement of liabilities subject to compromise over the excess of carrying amount of the fair value of consideration paid to creditors (\$9,300 - \$100 - \$800 - \$4,800)) |          | 3,600  |

b. The journal entry to record the replacement of the debtor-in-possession financing with the exit financing facility (which is recorded as a reorganization adjustment) is as follows:

|  |        |        |
|--|--------|--------|
| Other notes payable (debtor-in-possession financing) | \$ 550 |        |
| Exit financing                                       |        | \$ 550 |



- c. The journal entries to record the fresh-start adjustment to allocate the reorganization value of \$14,150 to the assets, which would be recorded within reorganization items on the predecessor entity's final statement of operations and the entry to close out the effect on retained earnings (deficit) to additional paid-in capital, are as follows:

|                             |          |          |
|-----------------------------|----------|----------|
| Inventories                 | \$ 200   |          |
| Property and equipment, net | 500      |          |
| Intangible assets, net      | 400      |          |
| Goodwill                    | 350      |          |
| Reorganization items, net   |          | \$ 1,450 |
| Retained earnings (deficit) | \$ 1,450 |          |
| Additional paid-in capital  |          | \$ 1,450 |

The amounts above are calculated as shown below. In the first column, goodwill is determined by subtracting the total fair value of the assets from the reorganization value of the assets. Then, the net adjustment is calculated in the third column by subtracting the carrying amount of the assets from the fair value of the assets. The total net adjustment represents a gain from applying fresh-start accounting.

|   | Fair value | Carrying amount | Net adjustment |
|---|------------|-----------------|----------------|
| Reorganization value                            | \$ 14,150  |                 |                |
| Less: fair value of identifiable assets         |            |                 |                |
| Cash  | 500        | \$ 500          |                |
| Accounts receivable                             | 1,000      | 1,000           |                |
| Inventories                                     | 2,200      | 2,000           | \$ 200         |
| Other current assets                            | 700        | 700             |                |
| Property and equipment, net                     | 3,000      | 2,500           | 500            |
| Intangible assets, net                          | 1,900      | 1,500           | 400            |
| Other assets                                    | <u>500</u> | <u>500</u>      |                |
| Subtotal  | 9,800      | 8,700           |                |
| Goodwill  | \$ 4,350   | \$ 4,000        | <u>\$ 350</u>  |
| Adjustment from applying fresh-start accounting |            |                 | \$ 1,450       |

- d. The journal entry to record the fresh-start adjustment to cancel the predecessor common stock and associated paid-in capital is as follows (ASC 852-10-55-10 illustrates the exchange of predecessor stock in a separate column; there is diversity in practice in how this exchange is presented):

|                            |        |        |
|----------------------------|--------|--------|
| Common stock               | \$ 600 |        |
| Additional paid-in capital |        | \$ 600 |

- e. The journal entry to record the fresh-start adjustment to eliminate the accumulated deficit is follows (beginning balance of \$6,000 less \$3,600 recorded in journal entry (a)):

|  |          |          |
|--|----------|----------|
| Additional paid-in capital                       | \$ 2,400 |          |
| Retained earnings (to reset the deficit to zero) |          | \$ 2,400 |

### 4.2.3 Measurement period

The business combinations guidance in ASC 805 provides a measurement period that may extend beyond the closing date of the acquisition. While the reorganization guidance in ASC 852 refers to the business combinations guidance in ASC 805-20 for determining the value of the emerging entity's assets and liabilities, the reorganization guidance does not incorporate a "measurement period" similar to the business combinations guidance. We generally do not believe a "measurement period" concept applies to fresh-start reporting. Rather, the measurement period for an entity emerging from bankruptcy is the reorganization period, which ends with the confirmation of the plan of reorganization.

We believe management generally has the ability to identify assets without the need for a measurement period, and the court, through the approved plan of reorganization, determines the claims that are legally valid for the emerging entity. As such, there is no need for a measurement period in fresh-start accounting. Adjustments to assets and liabilities subsequent to the application of the method generally do not adjust the amount of goodwill recorded upon application of fresh-start accounting but rather are included in the results of operations in the period in which the adjustment is determined and are separately disclosed (see section 4.4.14, *Pre-confirmation contingencies*).

We also understand the SEC staff has objected to a registrant's conclusions that post emergence adjustments to estimates related to pre-confirmation contingencies should be allocated to goodwill rather than current income.<sup>8</sup>

We do not believe the guidance permits an emerging entity to update the reorganization value estimate, even if a significant amount of time has elapsed between when reorganization value was established and when the entity emerges from bankruptcy. Rather, the measurement period for an entity is the reorganization period, which ends with the confirmation of the plan of reorganization.

### 4.3 Delineation of periods prior to fresh-start from periods subsequent to fresh-start and disclosures

#### Excerpt from Accounting Standards Codification

##### Reorganizations – Overall

##### *Other Presentation Matters*

##### **852-10-45-21**

The financial statements of the entity as of and for the period immediately preceding the date determined in conformity with the guidance in paragraph 852-10-45-17 shall reflect all activity through that date in conformity with the guidance in paragraphs 852-10-45-1 through 45-16. Additionally, the effects of the adjustments on the reported amounts of individual assets and liabilities resulting from the adoption of fresh-start reporting and the effects of the forgiveness of debt shall be reflected in the predecessor entity's final statement of operations. Forgiveness of debt, if any, shall be reported as an extinguishment of debt and classified in accordance with Subtopic 220-20. Adopting fresh-start reporting results in a new reporting entity with no beginning retained earnings or deficit. When fresh-start reporting is adopted, the notes to the initial fresh-start financial statements shall disclose the additional information identified in paragraph 852-10-50-7.

##### **852-10-45-26**

Fresh-start financial statements prepared by entities emerging from Chapter 11 will not be comparable with those prepared before their plans were confirmed because they are, in effect, those of a new entity. Thus, comparative financial statements that straddle a confirmation date shall not be presented.

<sup>8</sup> 19<sup>th</sup> Annual National Conference on Current SEC Developments – "Quasi-Reorganizations," 1992.

**852-10-45-27**

Regulatory agencies may require the presentation of predecessor financial statements. However, such presentations shall not be viewed as a continuum because the financial statements are those of a different reporting entity and are prepared using a different basis of accounting, and, therefore, are not comparable. Attempts to disclose and explain exceptions that affect comparability would likely result in reporting that is so unwieldy it would not be useful.

When applying fresh-start accounting, results of operations for periods prior to emergence from bankruptcy and the application of fresh-start accounting should not be combined with the results of operations for periods after the application of fresh-start reporting. Rather, predecessor financial statements reporting the emerging entity's operations prior to the date it emerges from bankruptcy should be presented. In such cases, the predecessor's financial statements will not be comparable to the emerged entity's financial statements.

Any adjustments resulting from the adoption of fresh-start reporting, including adjustments to assets and liabilities due to the assignment of reorganization value and the effects of forgiveness of debt, are reflected in the final statement of operations of the predecessor entity. The successor entity's financial statements reflect the operations of the reorganized entity after the date it emerges from bankruptcy and applies fresh-start accounting. The reorganized entity thus has no beginning retained earnings or accumulated other comprehensive income. See Illustration 4-4 for examples of the journal entries that are recorded and the opening balance sheet of the emerged entity.

For example, an entity with a 31 December year-end that emerged from bankruptcy and adopted fresh-start accounting on 1 June would prepare the statements of operations, cash flows, stockholders' equity and comprehensive income and the notes for two separate periods: (1) the pre-emergence, debtor-in-possession period of 1 January through 31 May and (2) the post-emergence period of 1 June through 31 December. An entity generally includes a vertical "black line" between the two periods to highlight to the user that there are two different reporting entities that are not comparable, the "Predecessor Company" and the "Successor Company."

### 4.3.1 Cancellation of predecessor equity

We understand that there may be diversity in practice as to how an entity emerging from bankruptcy and applying fresh-start accounting accounts for the cancellation of predecessor equity. Based on discussions with the SEC staff, we believe that the most appropriate treatment of the cancellation of predecessor equity is to reflect the cancellation as a direct charge to retained earnings. This view is supported by the guidance in ASC 852-10-45-21, which states that the effect of the adjustments on the reported amounts of individual **assets** and **liabilities** resulting from the adoption of fresh-start reporting should be reflected in the predecessor entity's final statement of operations [**emphasis added**]. Because the guidance in ASC 852-10-45-21 refers only to assets and liabilities and does not reference equity, we believe the cancellation of the predecessor equity should not be shown as a reorganization item.

This view is also supported by the guidance in ASC 505-10-25-2, which states that adjustments, charges or credits resulting from transactions in the entity's own capital stock should be excluded from the determination of net income or the results of operations.

### 4.3.2 Foreign currency translation adjustments accumulated in equity

An entity emerging from bankruptcy may have retained investments in or within a foreign entity (as defined in ASC 830), if the foreign entity was not deconsolidated for the reasons described in section 3.9.13, *Consolidation*. If the foreign entity continues to be consolidated (or accounted for under the equity method) after the entity filed for bankruptcy, the entity might have accumulated foreign currency translation adjustments in equity. Similar to the accounting in a business combination, we would not expect any amounts accumulated in other comprehensive income related to a foreign entity to survive the fresh-start accounting.

That is, we believe that these amounts would be eliminated and reflected as a direct charge to retained earnings, for the same reasons as described in section 4.3.1, *Cancellation of predecessor equity*.

## 4.4 Specific issues encountered when applying fresh-start accounting

The application of fresh-start accounting requires the emerging entity to apply the business combinations guidance in ASC 805, and to generally measure assets and liabilities at fair value (see section 4.2, *Method for applying fresh-start accounting*). The discussion that follows addresses areas that are more frequently addressed in a plan of reorganization or fresh-start accounting.

### 4.4.1 Leases (updated March 2024)

If the court approves the assumption of a modified lease concurrent with the entity's emergence from bankruptcy, the entity should assess the changes in the lease (see our FRD, [Lease accounting: Accounting Standards Codification 842, Leases](#), for more guidance).

Consistent with the guidance in ASC 805-20-25-8, a lease acquired in a business combination retains its classification that existed prior to the business combination, unless the provisions of the lease agreement are modified such that they give rise to a new agreement. As such, the classification of an emerging entity's leases should not be affected by its emergence from bankruptcy unless the lease is modified as part of the reorganization plan.

Any changes in leases, including changes that result in a change in the classification of the lease are reflected in the predecessor financial statements. Consistent with ASC 852-10-45-21, the effects of the adjustments on the reported amounts of individual assets and liabilities resulting from the adoption of fresh-start reporting (i.e., those changes for certain lease-related assets and liabilities due specifically to recognizing the lease-related assets and liabilities at fair value upon the entity's emergence) are reflected in the predecessor entity's final statement of operations. To the extent that a lease modification that was part of the reorganization plan approved by the court resulted in a new lease, an emerging entity should record the new lease as of the modification date (typically when the court approves assumption of the modified lease).

Assets and liabilities related to leases should be recognized in accordance with ASC 805 as of the entity's emergence from bankruptcy. Certain lease-related assets and liabilities are an exception to the general recognition and measurement principles under ASC 805. Instead, the entity applies ASC 842's initial recognition and measurement provisions to recognize those lease-related assets and lease liabilities. See section 4.4.4.4 of our FRD, [Business combinations](#), for further discussion on the accounting for leases acquired in a business combination.

### 4.4.2 Income taxes

As discussed in section 3.4, *Reorganization items under ASC 852*, reorganization items generally do **not** include tax effect from reorganization items. See section 16.2 of our FRD, [Income taxes](#), for discussion of the accounting for income taxes upon emergence from bankruptcy.

## 4.4.3

## Pension/OPEB

**Excerpt from Accounting Standards Codification****Business Combinations – Identifiable Assets and Liabilities, and Any Noncontrolling Interest***Recognition***805-20-25-23**

Guidance on defined benefit pension plans is presented in Subtopic 715-30. If an acquiree sponsors a single-employer defined benefit pension plan, the acquirer shall recognize as part of the business combination an asset or a liability representing the funded status of the plan (see paragraph 715-30-25-1). Paragraph 805-20-30-15 provides guidance on determining that funded status. If an acquiree participates in a multiemployer plan, and it is probable as of the acquisition date that the acquirer will withdraw from that plan, the acquirer shall recognize as part of the business combination a withdrawal liability in accordance with Subtopic 450-20.

**805-20-25-25**

Guidance on defined benefit other postretirement plans is presented in Subtopic 715-60. If an acquiree sponsors a single-employer defined benefit postretirement plan, the acquirer shall recognize as part of the business combination an asset or a liability representing the funded status of the plan (see paragraph 715-60-25-1). Paragraph 805-20-30-15 provides guidance on determining that funded status. If an acquiree participates in a multiemployer plan and it is probable as of the acquisition date that the acquirer will withdraw from that plan, the acquirer shall recognize as part of the business combination a withdrawal liability in accordance with Subtopic 450-20.

*Initial Measurement***805-20-30-15**

Guidance on defined benefit pension plans is presented in Subtopic 715-30. Guidance on defined benefit other postretirement plans is presented in Subtopic 715-60. Paragraphs 805-20-25-23 and 805-20-25-25 require an acquirer to recognize as part of a business combination an asset or a liability representing the funded status of a single-employer defined benefit pension or postretirement plan. In determining that funded status, the acquirer shall exclude the effects of expected plan amendments, terminations, or curtailments that at the acquisition date it has no obligation to make. The projected benefit obligation assumed shall reflect any other necessary changes in assumptions based on the acquirer's assessment of relevant future events.

The guidance in ASC 805 describes the accounting for a defined benefit plan in a business combination and it should be applied at the date of emergence in fresh-start accounting. However, unlike a business combination, the changes to a benefit plan as a result of the bankruptcy proceeding and emergence from bankruptcy protection are included in the predecessor's statement of operations. In certain situations, an emerging entity may be obligated to make changes to a benefit plan, which may be contingent upon the entity's emergence from bankruptcy protection. The accounting for those changes that an entity is obligated to make as of the emergence date and as a result of the emergence from bankruptcy will most likely not occur prior to the date of emergence. Nonetheless, the impact of changes to a benefit plan should be reflected in the predecessor's statement of operations when measuring the benefit obligation that exists upon emergence. Generally, modifications to a benefit plan required by the plan of reorganization are classified as reorganization items in the statement of operations. Other modifications would not be presented as reorganization items.

#### 4.4.4 PBGC agreements

For employee benefit pension plans that qualify under the IRS Tax Code, entities make annual premium contributions to the Pension Benefit Guaranty Corporation (PBGC). The PBGC is a nonprofit federally created corporation that guarantees payment to benefit plan participants of certain pension benefits under defined benefit plans should the benefit plan sponsor be unable to fulfill its obligation. Entities that reorganize in bankruptcy often enter into agreements with the PBGC that provide for a settlement of the benefit plan liability through the assumption of the liability by the PBGC. As such, the liability to the PBGC is no longer a pension-related liability. Agreements with the PBGC typically require that payments be made by the entity at, or subsequent to, emergence from bankruptcy for the defined benefit plans that were assumed by the PBGC. Any related contingent liabilities should be accounted for (and/or disclosed) in accordance with applicable US GAAP (e.g., ASC 450).

The cash outflows to the PBGC should not be classified as financing activities in the statement of cash flows. The form of settlement of the pension liability does not change the substance of the activity and accordingly it should be classified as an operating cash flow activity. Consistent with ASC 852-10-45-21, the effects of the adjustments on the reported amounts of individual assets and liabilities resulting from the adoption of fresh-start reporting (i.e., those changes due to settlement of a pension liability in exchange for a PBGC liability) are recognized in the predecessor entity's final statement of operations.

#### 4.4.5 Contract liabilities (deferred revenue)

Prior to or during the bankruptcy proceeding, a contract liability related to a contract with a customer may have been recognized. Consistent with the application of the guidance in ASC 805 in fresh-start accounting, the entity should recognize a contract liability upon emergence from bankruptcy protection at fair value. See section 4.4.3.4.1 of our FRD, *Business combinations*, for further discussion of the accounting for liabilities related to contracts with customers.

In October of 2021, the FASB issued ASU 2021-08, *Accounting for Contract Assets and Contract Liabilities from Contracts with Customers*. This ASU changes how an entity accounts for revenue contracts it acquires in a business combination. The changes require entities to apply ASC 606, *Revenue from Contracts with Customers*, to recognize and measure contract assets and contract liabilities from contracts with customers in a business combination as if the acquirer had originated the acquired revenue contract. We believe this guidance would also apply to entities adopting fresh-start accounting. Prior to the adoption of ASU 2021-08, an entity would generally record contract liabilities upon emergence from bankruptcy at fair value, similar to other liabilities recorded in fresh-start accounting.

ASU 2021-08 is effective for fiscal years beginning after 15 December 2022, and interim periods therein for public business entities. For all other entities, it is effective for fiscal years beginning after 15 December 2023. Early adoption is permitted. Refer to our Technical Line publication, *A closer look at the new guidance on accounting for revenue contracts acquired in a business combination*, for additional information on how to apply this new ASU.

The predecessor entity would not recognize any change in contract liabilities as revenue, but rather as reorganization items.

#### 4.4.6 Derivatives and hedge accounting

With the application of the guidance in ASC 805 by the emerging entity, derivative contracts should be recognized at fair value based on the requirements outlined in ASC 815. As noted in section 3.4.1.3 of our FRD, *Business combinations*, prior classifications or designations of derivative instruments are reconsidered in connection with their remeasurement. To qualify for hedge accounting, the entity must designate those derivatives as hedges on or after the date of emergence from bankruptcy protection. The redesignation

requirement extends to all derivative contracts. For example, contracts that qualified for the normal purchases and sales exception or the shortcut method may no longer qualify for these exceptions on the date of the application of fresh-start accounting. See our FRD, *Derivatives and hedging*, for further guidance.

#### 4.4.7 Share-based payments

Bankruptcy courts often cancel share-based payment awards, and there is often no concurrent grant of awards (or offer to grant awards if the service inception date precedes the grant date). Therefore, the cancellation is accounted for as a settlement for no consideration. In this case, the remaining unrecognized compensation cost for awards canceled upon emergence from bankruptcy is recorded in the predecessor entity's financial statements. Refer to section 8.10 of our FRD, *Share-based payment*, for further discussion. Share-based payment awards granted post-emergence are accounted for as new awards in accordance with ASC 718.

In more limited circumstances, entities emerging from bankruptcy replace pre-bankruptcy awards with new awards that are granted concurrently with the cancellation of pre-bankruptcy awards. These actions could occur on the date of emergence, resulting in fresh-start accounting for the cancellation of awards and recording of new grants consistent with the guidance for share-based payments issued as part of a business combination. Changes to share-based payments that become effective upon emergence are accounted for in the application of fresh-start accounting in a manner similar to the accounting for awards issued in a business combination. See section 6.3 of our FRD, *Business combinations*, for additional discussion of the exchange of share-based payments in a business combination.

When determining the appropriate accounting for a share-based payment issued or modified in connection with a bankruptcy filing, the substance of both the award and any services expected to be received post-emergence should be evaluated. If an award is modified before it has vested and the required post-emergence services are not substantive, the entity should determine whether vesting was effectively accelerated (see section 8 of our FRD, *Share-based payment*).

##### 4.4.7.1 Share-based payment awards granted after emergence date

As part of the plan of reorganization, an emerging entity may be required to grant, in periods subsequent to emergence, share-based payment awards to individuals employed at the emergence date. In these situations, an entity should evaluate, prior to emergence, whether compensation cost should be recognized in periods prior to the grant date. If the criteria in ASC 718-10-55-108 are met, compensation cost should be recognized over the requisite service period beginning with the service inception date. Compensation cost recognized in periods prior to the grant date will be measured based on the fair value of the share-based payment awards at each reporting date until the grant date. See section 4 of our FRD, *Share-based payment*, for further discussion of the recognition of compensation cost for share-based payment awards.

Entities emerging from bankruptcy protection likely should re-evaluate the valuation assumptions used in option-pricing models for share options and similar instruments measured on, and subsequent to, emergence. Specifically, historical exercise behavior may no longer be relevant for estimating the expected term assumption. Similarly, historical volatility measures may no longer reflect the expected volatility of the emerging entity's share price over the options' expected term. ASC 718-10-S99 and ASC 718-10-30-20 provide guidance applicable to newly public entities and nonpublic entities, respectively, regarding measuring the cost of options and similar instruments. Entities emerging from bankruptcy may find this guidance helpful to their facts and circumstances. See section 6 of our FRD, *Share-based payment*, for further discussion of estimating fair value-based measurements for share-based payment awards.

#### 4.4.8 Parent regaining control of a bankrupt subsidiary or VIE

A former subsidiary (or consolidated VIE) that emerges from bankruptcy has likely changed its capital structure or shifted its strategic direction as part of its plan of reorganization. Under ASC 810, these activities are likely events that would require reconsideration of whether an entity has a variable interest in a VIE (or is the primary beneficiary of that VIE). See section 12 of our FRD, ***Consolidation***, for additional guidance on reconsideration events.

If the parent gains or regains control of a subsidiary that is a business, the parent applies the guidance in ASC 805. The guidance in ASC 805 requires that a new accounting basis be established for the emerged subsidiary. As such, the emerged subsidiary's assets and liabilities will mostly likely have a different basis than that of the pre-bankruptcy subsidiary. See our FRD, ***Business combinations***, for additional guidance. The same guidance applies when gaining or regaining control of a VIE that is a business.

If the parent gains or regains control of a VIE upon the VIE's emergence from bankruptcy and the VIE is not a business the parent would apply ASC 810-10-30.

See section 12 and section 13.4 of our FRD, ***Consolidation***, for more guidance on reconsideration events and initial measurement of a VIE that is not a business, respectively.

#### 4.4.9 Accounting policies for an emerging entity

An emerging entity that qualifies to apply fresh-start accounting upon emergence from bankruptcy is effectively viewed as a new reporting entity from an accounting perspective. As a result, the successor (i.e., emerging) entity may select new accounting policies upon emergence from bankruptcy protection. These policy elections do not represent a "change in accounting principle" because the reporting entity emerging from bankruptcy (i.e., the successor entity) is legally a different entity than the predecessor entity. As a result, the successor entity does not need to demonstrate the preferability of such an accounting policy if the policy differed from the accounting policy of the predecessor entity, as would otherwise be required under ASC 250-10-45-2. Similarly, assets and liabilities in fresh-start accounting are accounted for as if they were just acquired through a business combination. As a result, an emerging entity may elect to follow the fair value option permitted by ASC 825 beginning with the application of fresh-start accounting.

An emerging entity that does not qualify to apply fresh-start accounting upon emergence from bankruptcy is not viewed as a new reporting entity from an accounting perspective; therefore, ASC 250-10 would be applied to any changes to accounting principles.

An entity may need to reconsider the accounting for transactions, assets or liabilities that remain upon emergence for which a previously adopted accounting pronouncement allowed a modified retrospective or prospective transition approach. Because the emerging entity is considered a new entity for accounting purposes, it may no longer use transition relief that was provided to the predecessor entity. However, the SEC staff has observed that there is no US GAAP or other regulatory requirement to retrospectively adjust predecessor-period financial statements for accounting changes by a successor entity.<sup>9</sup>

##### 4.4.9.1 Adopting new accounting pronouncements

An entity emerging from bankruptcy that applies fresh-start accounting should follow only the accounting standards in effect at the date fresh-start reporting is adopted, which includes those standards eligible for early adoption. That is, an emerging entity should not adopt a new accounting principle prior to its permitted effective date.

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<sup>9</sup> SEC Regulations Committee Meeting Minutes, 26 September 2017.



#### 4.4.10 Offsetting assets and liabilities upon emergence

Frequently, an entity emerging from bankruptcy will still have certain known outstanding claims that are being resolved through the reorganization process. In certain circumstances, those payables are to entities from which the emerging entity also holds a receivable. We are aware that, in practice, the final resolution of those outstanding claims often results in a net balance being remitted to (or received from) the outside party.

In determining whether such balances should be offset upon emergence from bankruptcy, the provisions of ASC 210-20-45-1, the balance sheet netting discussion in ASC 815-10-45 and the actions taken by the court as it relates to allowed claims, are applicable and should be followed to determine if the right of offset exists. A right of offset is present when all of the following criteria are met:

- a. Each of the two parties owes the other determinable amounts. In making this evaluation, generally an entity considers the court's determination of allowed claims. That is, the court determines the amounts that are owed to the entity.
- b. The reporting party has the right to offset the amount owed with the amount owed by the other party.
- c. The reporting party intends to setoff.
- d. The right of setoff is enforceable at law.

In practice, we understand that the right of setoff often is not enforceable by law, thereby precluding the offsetting of such gross claim and receivable amounts in bankruptcy situations. However, if the court has formally approved the right of the emerging entity to offset the claim and receivable (such that the right would be enforceable by law), such offset may be applied if the other conditions for setoff in ASC 210-20-45-1 are met.

#### 4.4.11 Assigning goodwill to reporting units upon emergence

If goodwill is recognized as a result of the application or fresh-start accounting, then the guidance in ASC 350 addressing the assignment and testing of goodwill for impairment should be followed. All goodwill recorded as a result of the application of fresh-start accounting should be assigned to one or more reporting units as of the date of emergence. The methodology used to determine the amount of goodwill to assign to a reporting unit should be reasonable and supportable and should be applied in a consistent manner. In addition, that methodology should be consistent with the objectives of the process of assigning goodwill to reporting units as described in ASC 350-20-35-42 through 43. See our FRD, *Intangibles – Goodwill and other*, for further discussion on the assignment of goodwill to reporting units.

#### 4.4.12 Discontinued operations upon emergence in fresh-start accounting

The entity should determine whether a component to be disposed of as part of a plan of reorganization should be presented as a discontinued operation under ASC 205-20. The results of operations of a component(s) to be disposed of by sale are not presented as discontinued until both of the following conditions occur:

- ▶ The component(s) is either disposed of or meets the held for sale criteria.
- ▶ The disposal represents a strategic shift that has (or will have) a major effect on the entity's operations and financial results.

For disposals other than by sale (e.g., abandonment, distribution, spin-off), the component(s) that represents a strategic shift that has (or will have) a major effect on the entity's operations and financial results, is not presented as discontinued operations until the disposal occurs. See our FRD, *Discontinued operations*, for additional discussion.

The SEC staff indicated that a registrant applying fresh-start accounting should retrospectively revise its predecessor financial statements to reflect the successor's presentation of discontinued operations.<sup>10</sup> ASC 205-20, while not addressing predecessor financial statements, does not provide any exceptions to the requirement to revise all periods presented to reflect the effect of a discontinued operation. However, the SEC staff may provide relief via preclearance, depending on the facts and circumstances.

**Illustration 4-5: Presentation of a discontinued operation in predecessor financial statements**

Entity Z is a calendar year-end entity with three business components A, B and C. Entity Z files for Chapter 11 bankruptcy on 20 November 20X3. As of 31 December 20X3, none of the components met the criteria to be presented as discontinued operations in accordance with ASC 205-20.

As a part of developing its plan of reorganization under Chapter 11, Entity Z decides to sell business A. Assume that the criteria to classify component A as held for sale are met when the court confirmed Entity Z's plan of reorganization as of 31 October 20X4, the date it emerged from bankruptcy. On this date, component A also met the criteria to be presented as a discontinued operation. Entity Z qualifies for fresh-start accounting.

**Analysis**

In Entity Z's financial statements for the year ended 31 December 20X3, it would not reflect component A as a discontinued operation, because the criteria were not met as of that date.

However, when Entity Z presents the predecessor financial statements for the year ended 31 December 20X3 as a comparative period to 20X4, it would present component A as a discontinued operation.

#### 4.4.13

### Changes in segment reporting upon emergence

When an entity emerges from bankruptcy, its organizational structure may change (including, but not limited to the manner in which it earns revenues or incurs expenses, allocates resources, or assesses operating results). In these circumstances, entities should reconsider the determination of their operating segments and the aggregation criteria when determining their reportable segments under ASC 280. See section 4.6 of our FRD, *Segment reporting*, for additional discussion of the requirements to adjust prior periods retrospectively and for required disclosures. We believe that it would be appropriate to adjust the segment disclosures retrospectively in the financial statements of both the predecessor and successor entities.

#### 4.4.14

### Pre-confirmation contingencies

Prior to the revised guidance in ASC 805, AICPA Practice Bulletin No. 11 (PB 11) provided guidance with respect to accounting for pre-confirmation contingencies in fresh-start reporting. While the guidance in ASC 805 has superseded PB 11, it remains instructive when considering pre-confirmation contingencies that continue to exist upon an entity's emergence from bankruptcy protection. PB 11 indicated that subsequent to the adoption of fresh-start reporting, adjustments that result from a pre-confirmation contingency are to be included in net income in the period in which the adjustment is determined. Furthermore, under PB 11, the resolution of a pre-confirmation contingency does not adjust the amount of goodwill recorded upon the application of fresh-start accounting, but rather should be included in income or loss from continuing operations of the emerged entity and should be separately disclosed.

<sup>10</sup> SEC Regulations Committee Meeting Minutes, 8 April 2004 and SEC Staff Publication *Financial Reporting Manual*, paragraph 13210.2.

In some cases, when approving a plan of reorganization, the court might legally release the entity from certain pre-confirmation contingencies. If, even after such legal release, uncertainty remains as to the entity's potential liability, the entity should follow applicable US GAAP (e.g., ASC 450) regarding the accounting for such contingencies.

## 4.5 Entities that do not meet the criteria for fresh-start accounting

### Excerpt from Accounting Standards Codification

#### Reorganizations – Overall

#### *Other Presentation Matters*

#### **852-10-45-29**

Entities emerging from Chapter 11 that do not meet the criteria in paragraph 852-10-45-19 do not qualify for fresh-start reporting. Liabilities compromised by confirmed plans shall be stated at present values of amounts to be paid, determined at appropriate current interest rates. Forgiveness of debt, if any, shall be reported as an extinguishment of debt and classified in accordance with Subtopic 220-20.

In certain instances, entities that emerge from a Chapter 11 bankruptcy may not qualify for fresh-start accounting. In those circumstances, other US GAAP, instead of ASC 852 and ASC 805, continues to apply to assets held by the entity upon emergence from bankruptcy. We would not expect a change in the value of assets upon emergence from bankruptcy without application of fresh-start accounting.

Postpetition liabilities and allowed claims existing upon emergence from bankruptcy are measured at the present value of the amounts to be paid (which may differ from fair value). As discussed in section 3.9.15, *Applicability of troubled debt restructuring accounting*, ASC 470-60 does not apply to entities that, in connection with bankruptcy proceedings, enter into debt restructurings that result in a general restatement of the entity's liabilities. That is, ASC 470-60 does not apply when the restructuring or modification is accomplished under the purview of the court and encompasses most of the amount of the entity's liabilities. We generally believe a Chapter 11 reorganization results in a general restructuring of liabilities for which the troubled debt restructuring guidance in ASC 470-60 is not applicable.

Instead, the guidance in ASC 220-20-45 is applied to debt that is forgiven as a result of the bankruptcy. Gains or losses resulting from such forgiveness or extinguishments should be classified as reorganization items in the statement of operations, as discussed in section 3.4, *Reorganization items under ASC 852*.

If the emerging entity does not qualify for fresh-start reporting, the entity is considered the same reporting entity and is not a new reporting entity under ASC 250. Therefore, the financial statements are continuous and are not divided between the pre- and post-bankruptcy periods (i.e., there are no predecessor and successor periods).

If an entity emerging from bankruptcy has share-based payment awards and is not eligible for fresh-start accounting, the cancellation and replacement of the share-based payment awards should be evaluated as a modification and accounted for in accordance with the guidance in ASC 718. Refer to section 8 our FRD, **Share-based payment**, for further discussion on modifications.

A registrant may be required to file a Form 8-K related to the modification, exchange or extinguishment of any debt. Form 8-K requires registrants to file an amendment to a material definitive agreement with the SEC.

# 5 Chapter 11 disclosure considerations

## 5.1 Disclosures during the reorganization period

### Excerpt from Accounting Standards Codification

#### Reorganizations – Overall

##### *Disclosure*

##### **852-10-50-1**

This Section provides incremental disclosure guidance for entities with transactions within the scope of this Subtopic. It is incremental to disclosure guidance otherwise applicable to an entity under other generally accepted accounting principles (GAAP).

##### **852-10-50-2**

The notes to financial statements of an entity in Chapter 11 shall disclose both of the following:

- a. **Claims** not subject to reasonable estimation based on the provisions of Subtopic 450-20
- b. The principal categories of the claims subject to compromise.

##### **852-10-50-3**

The extent to which reported interest expense differs from stated contractual interest shall be disclosed. It may be appropriate to disclose this parenthetically on the face of the statement of operations.

##### **852-10-50-4**

Intra-entity receivables and payables of entities in reorganization proceedings shall be disclosed in the condensed combined financial statements referred to in paragraph 852-10-45-14.

##### **852-10-50-5**

Paragraph 852-10-45-16 identifies a situation in which disclosure of a probable issuance of common stock or common stock equivalents is required.

##### **Other Presentation Matters**

##### **852-10-45-16**

Earnings per share (EPS) shall be reported, if required, in conformity with Topic 260. If it is probable that the plan will require the issuance of common stock or common stock equivalents, thereby diluting current equity interests, that fact shall be disclosed.

Entities that file for bankruptcy protection continue to apply other US GAAP to the extent that it is not contrary to ASC 852. While ASC 852-10-50 does provide certain specific disclosure requirements, other US GAAP disclosure requirements outside those described in ASC 852 continue to apply.

For entities in bankruptcy, we believe that the current state of the bankruptcy proceedings should be disclosed. As the bankruptcy proceeds, more information about the expected settlement amount of allowed claims, claims subject to compromise and claims not subject to compromise is received. The notes to the financial statements should reflect the new information as well as current estimates of expected resolution of the claims. Provisions of the Code often relieve the entity from its obligation to pay interest that would have accrued on pre-confirmation debt during the bankruptcy period (see section 3.5, *Interest expense under ASC 852*). The difference between the amount expected to be paid and the amount that the entity was otherwise obligated to pay should be disclosed. Based on guidance that was included in SOP 90-7, but not carried forward to ASC 852, the SEC staff prefers that registrants parenthetically disclose this information (i.e., the difference between expected interest expense versus amounts that otherwise would have been the obligation) on the face of the statement of operations. See section 3.4, *Reorganization items under ASC 852*, for an example of a statement of operations and the presentation of interest expense.

Similarly, while an entity operating under bankruptcy protection continues to report earnings per share in conformity with the guidance in ASC 260, bankruptcy proceedings often result in the issuance of common stock or common stock equivalents that ultimately dilute the existing equity ownership interests. Based on the status of the bankruptcy proceeding, if it is probable that the reorganization plan will require the issuance of such dilutive interests, such expectation of dilution to current shareholders is required to be disclosed.

The following example (taken from ASC 852-10-55-3) illustrates the guidance in ASC 852-10-45-1 through 45-13 and ASC 852-10-50-2 through 50-3 relating to financial reporting practices during the period that an entity is in reorganization.

**Illustration 5-1: Financial statements and notes to the financial statement for an entity operating under Chapter 11**

XYZ Company is a manufacturing concern headquartered in Tennessee, with a fiscal year ending on December 31. On January 10, 19X1, XYZ filed a petition for relief under Chapter 11 of the federal bankruptcy laws. The following financial statements (balance sheet and statements of operations and cash flows) are presented as of and for the year ended December 31.

**Illustrative Financial Statements and Notes to Financial Statements for an Entity Operating Under Chapter 11**

| <b>XYZ Company<br/>(Debtor in Possession)<br/>Balance Sheet<br/>December 31, 19X1</b> |               |
|---|---------------|
| <b>Assets</b>   | <b>(000s)</b> |
| Current assets  |               |
| Cash  | \$ 110        |
| Accounts receivable, net  | 300           |
| Inventory   | 250           |
| Other current assets  | 30            |
| Total current assets  | 690           |
| Property, plant and equipment, net  | 430           |
| Goodwill  | 210           |
| Total Assets  | \$ 1,330      |

| <b>Liabilities and Shareholders' Deficit</b>                               | <b>(000s)</b>               |
|--|-----------------------------|
| Liabilities Not Subject to Compromise Current Liabilities:                 |                             |
| Short-term borrowings  | \$ 25                       |
| Accounts payable – trade   | 200                         |
| Other liabilities  | <u>50</u>                   |
| Total current liabilities  | 275                         |
| Liabilities Subject to Compromise  | <u>1,100</u> <sup>(a)</sup> |
| Total liabilities  | <u>1,375</u>                |
| Shareholders' (deficit)  |                             |
| Preferred stock  | 325                         |
| Common stock   | 75                          |
| Retained earnings (deficit)  | <u>(445)</u>                |
|  | <u>(45)</u>                 |
| Total Liabilities & Shareholders' (Deficit)                                | <u>\$ 1,330</u>             |
| <sup>(a)</sup> Liabilities subject to compromise consist of the following: |                             |
| Secured debt, 14%, secured by first mortgage on building                   | \$ 300,000 <sup>(b)</sup>   |
| Priority tax claims  | 50,000                      |
| Senior subordinated secured notes, 15%                                     | 275,000                     |
| Trade and other miscellaneous claims                                       | 225,000                     |
| Subordinated debentures, 17%   | <u>250,000</u>              |
|  | <u>\$ 1,100,000</u>         |

<sup>(b)</sup> The secured debt in this case should be considered, due to various factors, subject to compromise.

The accompanying notes are an integral part of the financial statements.

**XYZ Company**  
**(Debtor-in-Possession)**  
**Statement of Operations**  
**For the Year Ended December 31, 19X1**  
(000s)

|  | <b>19X1</b>      |
|--|------------------|
| Revenues:  |                  |
| Sales  | \$ 2,400         |
| Cost and expenses:   |                  |
| Cost of goods sold   | 1,800            |
| Selling, operating and administrative                                    | 550              |
| Interest (contractual interest \$5)                                      | <u>3</u>         |
|  | <u>2,353</u>     |
| Earnings before reorganization items and income tax benefit              | <u>47</u>        |
| Reorganization items:  |                  |
| Loss on disposal of facility   | (60)             |
| Professional fees  | (50)             |
| Provision for rejected executory contracts                               | (10)             |
| Interest earned on accumulated cash resulting from Chapter 11 proceeding | <u>1</u>         |
|  | <u>(119)</u>     |
| Loss before income tax benefit and discontinued operations               | (72)             |
| Income tax benefit   | <u>10</u>        |
| Loss before discontinued operations                                      | (62)             |
| Discontinued operations:   |                  |
| Loss from operations of discontinued products segment                    | <u>(56)</u>      |
| Net Loss   | <u>\$ (118)</u>  |
| Loss per common share:   |                  |
| Loss before discontinued operations                                      | \$ (0.62)        |
| Discontinued operations  | <u>\$ (0.56)</u> |
| Net loss   | <u>\$ (1.18)</u> |

The accompanying notes are an integral part of the financial statements.

**XYZ Company**  
**(Debtor-in-Possession)**  
**Statement of Cash Flows**  
**For the Year Ended December 31, 19X1**  
**Increase in Cash and Cash Equivalents**  
(000s)

|   | <b>19X1</b> |
|---|-------------|
| Cash flows from operating activities:   |             |
| Cash received from customers  | \$ 2,200    |
| Cash paid to suppliers and employees  | (2,070)     |
| Interest paid   | (3)         |
| Net cash provided by operating activities before reorganization items                     | 147         |
| Operating cash flows from reorganization items:   |             |
| Interest received on cash accumulated because of the Chapter 11 proceeding                | 1           |
| Professional fees paid for services rendered in connection with the Chapter 11 proceeding | (50)        |
| Net cash used by reorganization items   | (49)        |
| Net cash provided by operating activities   | 98          |
| Cash flows from investing activities:   |             |
| Capital expenditures  | (5)         |
| Proceeds from sale of facility due to Chapter 11 proceeding                               | 40          |
| Net cash provided by investing activities   | 35          |
| Cash flow used by financing activities:   |             |
| Net borrowings under short-term credit facility (postpetition)                            | 25          |
| Repayment of cash overdraft   | (45)        |
| Principal payments on prepetition debt authorized by court                                | (3)         |
| Net cash provided by financing activities   | (23)        |
| Net increases in cash and cash equivalents  | 110         |
| Cash and cash equivalents at beginning of year  | -           |
| Cash and cash equivalents at end of year  | \$ 110      |
| Reconciliation of net loss to net cash provided by operating activities                   |             |
| Net loss  | \$ (118)    |
| Adjustments to reconcile net loss to net cash provided by operating activities            |             |
| Depreciation  | 20          |
| Loss on disposal of facility  | 60          |
| Provision of rejected executory contracts   | 10          |
| Loss on discontinued operations   | 56          |
| Increases in postpetition payables and other liabilities                                  | 250         |
| Increase in accounts receivable   | (180)       |
| Net cash provided by operating activities   | \$ 98       |

The accompanying notes are an integral part of the financial statements.

**XYZ Company Notes to Financial Statements December 31, 19X1****Note X – Petition for Relief Under Chapter 11**

On January 10, 19X1, XYZ Company (the Debtor) filed petitions for relief under Chapter 11 of the federal bankruptcy laws in the United States Bankruptcy Court for the Western District of Tennessee. Under Chapter 11, certain claims against the Debtor in existence before the filing of the petitions for relief under the federal bankruptcy laws are stayed while the Debtor continues business operations as a debtor-in-possession. These claims are reflected in the December 31, 19X1 balance sheet as liabilities subject to compromise. Additional claims (liabilities subject to compromise) may arise after the filing date resulting from rejection of executory contracts, and from the determination by the court (or agreed to by parties in interest) of allowed claims for contingencies and other disputed amounts. Claims secured against the Debtor's assets (secured claims) also are stayed, although the holders of such claims have the right to move the court for relief from the stay. Secured claims are secured primarily by liens on the Debtor's property, plant, and equipment.

The Debtor received approval from the Bankruptcy Court to pay or otherwise honor certain of its prepetition obligations, including employee wages and product warranties. The Debtor has determined that there is insufficient collateral to cover the interest portion of scheduled payments on its prepetition debt obligations. Contractual interest on those obligations amounts to \$5,000, which is \$2,000 in excess of reported interest expense; therefore, the debtor has discontinued accruing interest on these obligations. See Note X in Example 2 (paragraph 852-10-55-11) for a discussion of the credit arrangements entered into after the Chapter 11 filings.

## 5.2

**Fresh-start disclosures****Excerpt from Accounting Standards Codification****Reorganizations – Overall***Disclosure***852-10-50-7**

Paragraph 852-10-45-21 requires additional information to be disclosed in the notes to the initial fresh-start financial statements when fresh-start reporting is adopted. That additional information consists of all of the following:

- a. Adjustments to the historical amounts of individual assets and liabilities
- b. The amount of debt forgiveness
- c. Significant matters relating to the determination of **reorganization value**, including all of the following:
  1. The method or methods used to determine reorganization value and factors such as discount rates, tax rates, the number of years for which cash flows are projected, and the method of determining **terminal value**
  2. Sensitive assumptions – that is, assumptions about which there is a reasonable possibility of the occurrence of a variation that would have significantly affected measurement of reorganization value
  3. Assumptions about anticipated conditions that are expected to be different from current conditions, unless otherwise apparent.

The application of fresh-start accounting will change the basis of the entity's financial statements and their presentation. The change in basis should be disclosed. Because the application of fresh-start accounting results in a new basis of accounting being reflected in the emerging entity's financial



statements, it is presented as if the old reporting entity has been terminated and a new one has been created. Therefore, it would not be appropriate to combine the periods prior to and subsequent to the date that fresh-start accounting is applied, generally referred to as the “predecessor” and “successor” periods, either in the financial statements, or in MD&A.

To emphasize this change, the successor and predecessor periods should be separated by a black line. For example, if an entity emerged from bankruptcy on 30 September 2010 and applied fresh-start accounting as of that date, the emerging entity’s 31 December 2010 statements of operations, comprehensive income, cash flows and changes in shareholders’ equity should include a nine-month predecessor period and a three-month successor period, separated by a black line. The columns associated with each of these periods would generally be labeled “Predecessor Entity” and “Successor Entity,” or something similar. In addition, the notes to the financial statements should reflect the relevant information for the predecessor and successor periods.

The SEC staff has requested that registrants provide disclosure regarding qualifying for fresh-start accounting and how their reorganization values were determined, when the court established a range. For example, if reorganization value was determined using a discounted cash flow approach, the SEC staff has asked registrants to disclose the discount rate used, the weighted average cost of capital, expected changes in cash flows from those indicated by current operations, number of years for which cash flows were projected and the method for calculating any terminal value. When reorganization value was determined using more than one valuation method, the SEC staff asked registrants to disclose the details of each valuation method, and to disclose how the entities weighted such valuations to arrive at a reorganization value.

When a convenience date is used, the SEC staff has asked registrants to disclose the significance of the dates and their conclusions that no material events or transactions occurred in the intervening periods.

The following example footnote (taken from ASC 852-10-55-5 through 55-10) illustrates the fresh-start-related guidance in ASC 852-10-45-19 through 45-27.

**Illustration 5-2: Notes to the financial statements upon emergence and application of fresh-start accounting**

**XYZ Company Notes to Financial Statements June 30, 19X2**

**Note X – Fresh-Start Accounting**

The Bankruptcy Court confirmed XYZ’s plan of reorganization as of June 30, 19X2. It was determined that XYZ’s reorganization value computed immediately before June 30, 19X2, the date of plan confirmation, was \$1,300,000, which consisted of the following:

|   |                     |
|---|---------------------|
| Cash in excess of normal operating requirements generated by operations | \$ 150,000          |
| Net realizable value of asset dispositions                              | 75,000              |
| Present value of discounted cash flows of the emerging entity           | <u>1,075,000</u>    |
| Reorganization value  | <u>\$ 1,300,000</u> |

XYZ Company adopted fresh-start reporting because holders of existing voting shares immediately before filing and confirmation of the plan received less than 50% of the voting shares of the emerging entity and its reorganization value is less than its postpetition liabilities and allowed claims, as shown in the following table:

|  |                    |
|--|--------------------|
| Postpetition current liabilities                       | \$ 300,000         |
| Liabilities deferred pursuant to Chapter 11 proceeding | <u>1,100,000</u>   |
| Total postpetition liabilities and allowed claims      | 1,400,000          |
| Reorganization value                                   | <u>(1,300,000)</u> |
| Excess of liabilities over reorganization value        | <u>\$ 100,000</u>  |

The reorganization value of the XYZ Company was determined in consideration of several factors and by reliance on various valuation methods, including discounting cash flow and price/earnings and other applicable ratios. The factors considered by XYZ Company included all of the following:

- a. Forecasted operating and cash flow results that gave effect to the estimated impact of both of the following:
  1. Corporate restructuring and other operating program changes
  2. Limitations on the use of available net operating loss carryovers and other tax attributes resulting from the plan of reorganization and other events.
- b. The discounted residual value at the end of the forecast period based on the capitalized cash flows for the last year of that period
- c. Market share and position
- d. Competition and general economic considerations
- e. Projected sales growth
- f. Potential profitability
- g. Seasonality and working capital requirements.

After consideration of XYZ Company's debt capacity and other capital structure considerations, such as industry norms, projected earnings to fixed charges, earnings before interest and taxes to interest, free cash flow to interest, and free cash flow to debt service and other applicable ratios, and after extensive negotiations among parties in interest, it was agreed that XYZ's reorganization capital structure should be as follows:

|                                      |                      |
|--------------------------------------|----------------------|
| Postpetition current liabilities     | 300,000              |
| Internal Revenue Services (IRS) note | 50,000               |
| Senior debt                          | 275,000 (a)          |
| Subordinated debt                    | 175,000              |
| Common stock                         | <u>350,000</u>       |
| Reorganization capital structure     | <u>1,150,000</u> (b) |

(a) Due \$50,000 per year for each of the next 4 years, at 12% interest, with \$75,000 due in the fifth year.

(b) See the table in paragraph 852-10-55-10 for the balance sheet adjustment required to reflect XYZ Company's reorganization value as of the date of plan confirmation.

The following entries record the provisions of the plan and the adoption of fresh-start reporting.

Entries to record debt discharge:

|                                   |              |           |
|-----------------------------------|--------------|-----------|
| Liabilities subject to compromise | \$ 1,100,000 |           |
| Senior debt – current             |              | \$ 50,000 |
| Senior debt – long-term           |              | 225,000   |
| IRS note                          |              | 50,000    |
| Cash                              |              | 150,000   |
| Subordinated debt                 |              | 175,000   |
| Common stock (new)                |              | 86,000    |
| Additional paid-in capital        |              | 215,000   |
| Gain on debt discharge            |              | 149,000   |

Entries to record exchange of stock for stock:

|                            |         |         |
|----------------------------|---------|---------|
| Preferred stock            | 325,000 |         |
| Common stock (old)         | 75,000  |         |
| Common stock (new)         |         | 14,000  |
| Additional paid-in capital |         | 386,000 |

Entries to record the adoption of fresh-start reporting and to eliminate the deficit:

|   |         |         |
|---|---------|---------|
| Inventory   | 50,000  |         |
| Property, plant and equipment   | 175,000 |         |
| Reorganization in value in excess of amounts allocable to identifiable assets | 175,000 |         |
| Gain on debt discharge  | 149,000 |         |
| Additional paid-in capital  | 351,000 |         |
| Goodwill  |         | 200,000 |
| Deficit   |         | 700,000 |

The effect of the plan of reorganization on XYZ Company's balance sheet, as of June 30, 19X2, is as follows.

|  | Adjustments to Record Confirmation of Plan |                     |                   |                   | XYZ Company's             |
|--|--|---------------------|-------------------|-------------------|---------------------------|
|  | Preconfirmation                            | Debt discharge      | Exchange of stock | Fresh start       | Reorganized Balance Sheet |
| <b>Assets:</b>   |  |                     |                   |                   |                           |
| Current Assets   |  |                     |                   |                   |                           |
| Cash   | \$ 200,000                                 | \$ (150,000)        |                   |                   | \$ 50,000                 |
| Receivables  | 250,000                                    |                     |                   |                   | 250,000                   |
| Inventory  | 175,000                                    |                     |                   | \$ 50,000         | 225,000                   |
| Assets held for sale   | 25,000                                     |                     |                   |                   | 25,000                    |
| Other current assets   | <u>25,000</u>                              |                     |                   |                   | <u>25,000</u>             |
|  | 675,000                                    | (150,000)           |                   | 50,000            | 575,000                   |
| Property, plant, and equipment   | 175,000                                    |                     |                   | 175,000           | 350,000                   |
| Assets held for sale   | 50,000                                     |                     |                   |                   | 50,000                    |
| Goodwill   | 200,000                                    |                     |                   | (200,000)         |                           |
| Reorganization value in excess of amounts allocable to identifiable assets |  |                     |                   | <u>175,000</u>    | <u>175,000</u>            |
|  | <u>\$ 1,100,000</u>                        | <u>\$ (150,000)</u> |                   | <u>\$ 200,000</u> | <u>\$ 1,150,000</u>       |
| <b>Liabilities and Shareholders' Deficit:</b>                              |  |                     |                   |                   |                           |
| Liabilities Not Subject to Compromise                                      |  |                     |                   |                   |                           |
| Current liabilities  |  |                     |                   |                   |                           |
| Short-term borrowings  | \$ 25,000                                  |                     |                   |                   | \$ 25,000                 |
| Current maturities of senior debt  |  | \$ 50,000           |                   |                   | 50,000                    |
| Accounts payable trade   | 175,000                                    |                     |                   |                   | 175,000                   |
| Other liabilities  | <u>100,000</u>                             |                     |                   |                   | <u>100,000</u>            |
|  | 300,000                                    | 50,000              |                   |                   | 350,000                   |
| Liabilities Subject to Compromise  |  |                     |                   |                   |                           |
| Prepetition liabilities  | 1,100,000                                  | (1,100,000)         |                   |                   |                           |
| IRS note   |  | 50,000              |                   |                   |                           |
| Senior debt, less current maturities                                       |  | 225,000             |                   |                   | 225,000                   |
| Subordinated debt  |  | 175,000             |                   |                   | 175,000                   |
| Shareholders' deficit:   |  |                     |                   |                   |                           |
| Preferred stock  | 325,000                                    |                     | \$ (325,000)      |                   |                           |
| Additional paid-in capital   |  | 215,000             | 386,000           | \$ (351,000)      | 250,000                   |
| Common stock – old   | 75,000                                     |                     | (75,000)          |                   |                           |
| Common stock – new   |  | 86,000              | 14,000            |                   | 100,000                   |
| Retained earnings (deficit)  | (700,000)                                  | 149,000             |                   | 700,000           |                           |
|  |  |                     |                   | <u>(149,000)</u>  |                           |
|  | <u>(300,000)</u>                           | <u>450,000</u>      | <u>-</u>          | <u>200,000</u>    | <u>350,000</u>            |
|  | <u>\$ 1,100,000</u>                        | <u>\$ (150,000)</u> | <u>\$ -</u>       | <u>\$ 200,000</u> | <u>\$ 1,150,000</u>       |

## 5.2.1 Disclosure of pre-confirmation contingencies

As discussed in section 4.4.14, *Pre-confirmation contingencies*, the adjustment of pre-confirmation contingencies included in income or loss from continuing operations of the emerged entity should be separately disclosed.

In some cases, when approving a plan of reorganization, the court might legally release the entity from certain pre-confirmation contingencies. If, even after such legal release, uncertainty remains as to the entity's potential liability, the entity should follow applicable US GAAP (e.g., ASC 450) regarding the disclosure of such contingencies.

## 5.2.2 Fair value measurement disclosures

ASC 820 requires certain disclosures for assets and liabilities measured at fair value on a nonrecurring basis (e.g., impaired assets) in the period in which the measurement is performed. In addition to disclosing the reason for any nonrecurring fair value measurements made subsequent to the initial recognition of the asset or liability, entities are required to disclose the level of the fair value hierarchy within which the fair value measurements are categorized, valuation techniques, inputs used, any changes in those techniques or inputs, and, for fair value measurements categorized within Level 3 of the fair value hierarchy, the quantitative information about the significant unobservable inputs used and a description of the valuation processes used.

See section 20 of our FRD, *Fair value measurement*, for more guidance and example disclosures. An entity should consider whether such disclosures would be relevant for assets and liabilities remeasured in fresh-start accounting.

## 5.3 Plan confirmation disclosures

In addition to the disclosures discussed above, an entity emerging from bankruptcy should disclose sufficient detail about the confirmation plan.

The following illustrative footnote disclosure (taken from ASC 852-10-55-11) discusses the details of XYZ Company's confirmed plan of reorganization. In this illustration, a tabular presentation entitled "Plan of Reorganization Recovery Analysis" is incorporated in the footnote. The plan of reorganization recovery analysis may alternatively be presented as supplementary information to the financial statements.

### **Illustration 5-3: Notes to the financial statement upon emergence and application of fresh-start accounting**

#### **Note X – Plan of Reorganization**

On June 30, 19X2, the Bankruptcy Court confirmed the Company's plan of reorganization. The Company accounted for the reorganization using fresh-start reporting. Accordingly, all assets and liabilities are adjusted to fair value in accordance with accounting requirements for business combinations under ASC 805. The excess of reorganization value over the fair value of tangible and intangible assets was recorded as "reorganization value in excess of amounts allocable to identifiable assets." The confirmed plan provided for the following:

- ▶ Secured Debt – The Company's \$300,000 of secured debt (secured by a first mortgage lien on a building located in Nashville, Tennessee) was exchanged for \$150,000 in cash and a \$150,000 secured note, payable in annual installments of \$27,300 commencing on June 1, 19X3, through June 1, 19X6, with interest at 12% per annum, with the balance due on June 1, 19X7.

- ▶ Priority Tax Claims – Payroll and withholding taxes of \$50,000 are payable in equal annual installments commencing on July 1, 19X3, through July 1, 19X8, with interest at 11% per annum.
- ▶ Senior Debt – The holders of approximately \$275,000 of senior subordinated secured notes received the following instruments in exchange for their notes: \$87,000 in new senior secured debt, payable in annual installments of \$15,800 commencing March 1, 19X3, through March 1, 19X6, with interest at 12% per annum, secured by first liens on certain property, plants, and equipment, with the balance due on March 1, 19X7; \$123,000 of subordinated debt with interest at 14% per annum due in equal annual installments commencing on October 1, 19X3, through October 1, 19X9, secured by second liens on certain property, plant, and equipment; and 11.4% of the new issue of outstanding voting common stock of the Company.
- ▶ Trade and Other Miscellaneous Claims – The holders of approximately \$225,000 of trade and other miscellaneous claims received the following for their claims: \$38,000 in senior secured debt, payable in annual installments of \$6,900 commencing March 1, 19X3, through March 1, 19X6, with interest at 12% per annum, secured by first liens on certain property, plants, and equipment, with the balance due on March 1, 19X7; \$52,000 of subordinated debt, payable in equal annual installments commencing October 1, 19X3, through October 1, 19X8, with interest at 14% per annum; and 25.7% of the new issue of outstanding voting common stock of the Company.
- ▶ Subordinated Debentures – The holders of approximately \$250,000 of subordinated unsecured debt received, in exchange for the debentures, 48.9% of the new issue outstanding voting common stock of the Company.
- ▶ Preferred Stock – The holders of 3,250 shares of preferred stock received 12% of the outstanding voting common stock of the new issue of the Company in exchange for their preferred stock.
- ▶ Common Stock – The holders of approximately 75,000 outstanding shares of the Company's existing common stock received, in exchange for their shares, 2% of the new outstanding voting common stock of the Company.

The following table (Plan of Reorganization Recovery Analysis) summarizes the adjustments required to record the reorganization and the issuance of the various securities in connection with the implementation of the Plan.

|                                      | Recovery                       |                   |                   |                   |                   |                   |                             |                   |                     |      |
|--------------------------------------|--------------------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-----------------------------|-------------------|---------------------|------|
|                                      | Elimination of Debt and Equity | Surviving Debt    | Cash              | IRS Note          | Senior Debt       | Subordinated Debt | Common Stock <sup>(a)</sup> |                   | Total Recovery      |      |
|                                      |                                |                   |                   |                   |                   |                   | %                           | Value             | \$                  | %    |
| Postpetition liabilities             | \$ 300,000                     | \$ 300,000        |                   |                   |                   |                   |                             |                   | \$ 300,000          | 100% |
| <i>Claim or Interest</i>             |                                |                   |                   |                   |                   |                   |                             |                   |                     |      |
| Secured debt                         | 300,000                        |                   | \$ 150,000        |                   | \$ 150,000        |                   |                             |                   | 300,000             | 100  |
| Priority tax claim                   | 50,000                         |                   |                   | \$ 50,000         |                   |                   |                             |                   | 50,000              | 100  |
| Senior debt                          | 275,000                        | \$ (25,000)       |                   |                   | 87,000            | \$ 123,000        | 11.4%                       | \$ 40,000         | 250,000             | 91   |
| Trade and other miscellaneous claims | 225,000                        | (45,000)          |                   |                   | 38,000            | 52,000            | 25.7                        | 90,000            | 180,000             | 80   |
| Subordinated debentures              | 250,000                        | (79,000)          |                   |                   |                   |                   | 48.9                        | 171,000           | 171,000             | 68   |
|                                      | <u>1,100,000</u>               |                   |                   |                   |                   |                   |                             |                   |                     |      |
| Preferred stockholders               | 325,000                        | (283,000)         |                   |                   |                   |                   | 12.0                        | 42,000            | 42,000              |      |
| Common stockholders                  | 75,000                         | (68,000)          |                   |                   |                   |                   | 2.0                         | 7,000             | 7,000               |      |
| Deficit                              | (700,000)                      | 700,000           |                   |                   |                   |                   |                             |                   |                     |      |
| Total                                | <u>\$ 1,100,000</u>            | <u>\$ 200,000</u> | <u>\$ 300,000</u> | <u>\$ 150,000</u> | <u>\$ 275,000</u> | <u>\$ 175,000</u> | <u>100.0%</u>               | <u>\$ 350,000</u> | <u>\$ 1,300,000</u> |      |

(a) The aggregate par value of the common stock issued under the plan is \$100,000.

# 6 Liquidation basis of accounting

## 6.1 Introduction

Most entities conduct business under the assumption that their operations will continue indefinitely. However, when it is clear that an entity will no longer operate, it might be liquidated. Some of the more common reasons for liquidation are:

- ▶ The entity has been performing poorly and is unable to meet its obligations.<sup>11</sup>
- ▶ The entity has been forced to do so by a regulator (e.g., financial institutions or insurance companies with inadequate reserves).
- ▶ The entity is subject to other contractually mandated liquidation.
- ▶ The entity was designed with a finite life.
- ▶ The entity's purpose is no longer relevant (e.g., owners or management want to pursue a new strategy or objective).
- ▶ Investors or shareholders want a return of their capital for other reasons.
- ▶ The entity is a benefit plan that is terminated by its plan sponsor.
- ▶ The entity is an investment fund that is terminated by its investment manager.

An entity may file for liquidation under Chapter 7 of the Code instead of reorganizing under Chapter 11.<sup>12</sup> A Chapter 7 filing can be either voluntary or involuntary. Once a Chapter 7 petition has been filed, the court appoints a trustee to facilitate the liquidation process. The trustee generally appoints a creditors' committee from among the 20 largest creditors who are not insiders. The committee represents all of the creditors in providing oversight for the entity's liquidation.

In a voluntary or involuntary liquidation filing under Chapter 7, the automatic stay provisions ensure that all creditor rights, including priority rights, are protected. The automatic stay provision ensures that secured and other creditors cannot interfere with the assets or ensuing asset liquidation. The automatic stay provision generally remains in effect until the court confirms the liquidation.

Once a Chapter 7 petition has been filed and confirmed, the court will order a formal liquidation of the entity. The assets or proceeds from the liquidation are first used to pay administrative expenses associated with the liquidation. Next, they are distributed to the entity's secured creditors, and then to its unsecured creditors. After the distribution of all assets (or proceeds from liquidation), the trustee will present a final liquidation report to the court. Based on that report, the court will discharge the entity from bankruptcy.

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<sup>11</sup> If an entity begins to experience financial difficulties, the issues raised in section 2, *Before bankruptcy or liquidation*, would apply.

<sup>12</sup> Some entities also may voluntarily decide to liquidate instead of filing for Chapter 7.

In some circumstances, a liquidating entity might stop reporting under US GAAP. For example, it might choose to prepare financial statements on a modified-cash basis or special framework, if that basis would be more meaningful to users of the financial statements (and comply with the needs of regulators and other parties). However, those financial statements would not be described as complying with US GAAP. The remainder of this chapter addresses when an entity prepares financial statements in accordance with US GAAP under the liquidation basis of accounting.

### **Excerpt from Accounting Standards Codification**

#### **Presentation of Financial Statements – Liquidation Basis of Accounting**

##### ***Overview and Background***

##### ***205-30-05-1***

The Liquidation Basis of Accounting Subtopic provides guidance on when and how an entity should prepare its financial statements using the liquidation basis of accounting and describes the related disclosures that should be made.

##### ***Glossary***

##### ***205-30-20***

##### ***Liquidation***

The process by which an entity converts its assets to cash or other assets and settles its obligations with creditors in anticipation of the entity ceasing all activities. Upon cessation of the entity's activities, any remaining cash or other assets are distributed to the entity's investors or other claimants (albeit sometimes indirectly). Liquidation may be compulsory or voluntary. Dissolution of an entity as a result of that entity being acquired by another entity or merged into another entity in its entirety and with the expectation of continuing its business does not qualify as liquidation.

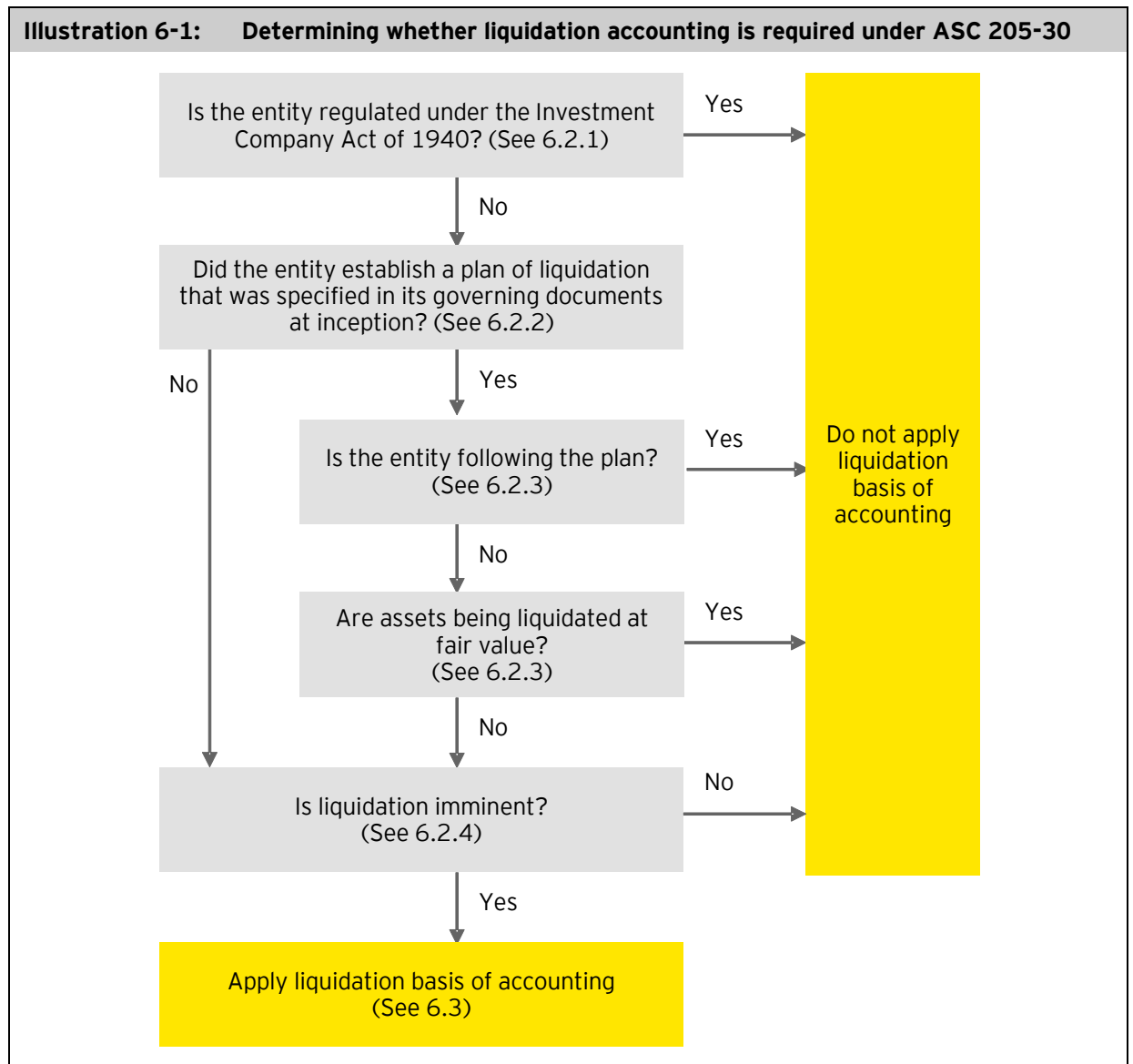
ASC 205-30 requires entities to begin preparing financial statements on the liquidation basis when liquidation is imminent. That is, liquidation basis of accounting is not an election. Liquidating an individual asset (or group of assets) or settling certain liabilities would not qualify as liquidation, as defined in ASC 205-30. Rather, liquidation refers to the process of converting *all* of an entity's assets to cash or other assets and settling obligations with creditors before the entity stops all activities. See section 6.2.6, *Liquidation of an entity (including acquisitions, mergers and spin-offs)*, for guidance on when the liquidating entity is acquired or merged into another entity. See our FRD, *Impairment or disposal of long-lived assets*, for guidance on when an entity is liquidating an individual asset (or group of assets), either by sale or by abandonment.

Judgment may be required when determining whether and how to apply the liquidation basis of accounting.

## **6.2**

### **When to apply the liquidation basis of accounting**

ASC 205-30 requires liquidation accounting when liquidation is imminent, unless an entity is outside the scope of the guidance or is following a liquidation plan established at its inception. This assessment is shown in Illustration 6-1.



If the liquidation basis of accounting does not apply, the entity would apply other US GAAP (see section 2, *Before bankruptcy or liquidation*). For example, a liquidating entity should comply with the requirements in ASC 275. A liquidating entity discloses its liquidation plan, even if it does not have to apply the liquidation basis of accounting (because it is an investment company registered under the 1940 Act or is liquidating according to a plan established at its inception).

## 6.2.1

### Investment companies registered under the 1940 Act

#### Excerpt from Accounting Standards Codification

##### Presentation of Financial Statements – Liquidation Basis of Accounting

##### *Scope and Scope Exceptions*

##### **205-30-15-1**

The guidance in this Subtopic applies to all entities except for investment companies regulated under the Investment Company Act of 1940. Other entities shall not apply this scope exception by analogy.



ASC 205-30 applies to all entities (including employee benefit plans, nonpublic entities and not-for-profits) except for investment companies regulated under the 1940 Act. ASC 205-30 is explicit that entities not regulated under the 1940 Act, such as private equity funds and hedge funds, may not apply the scope exception for entities regulated by the 1940 Act by analogy. This language prevents investment companies (as defined in ASC 946) from claiming that, because they measure their assets at fair value, they are entitled to the same scope exception as entities regulated under the 1940 Act.

The FASB initially proposed that *all* entities reporting under US GAAP would have to apply liquidation accounting when liquidation is imminent. However, in redeliberations the FASB exempted entities regulated under the 1940 Act, because the 1940 Act requires them to calculate net asset value using fair value at all times. The FASB considered excluding all investment companies (as defined in ASC 946) from the scope of ASC 205-30, but decided that investors in funds not regulated under the 1940 Act would benefit from an estimate of how much cash or other consideration they might recover in liquidation. Therefore, the FASB decided that all entities not regulated under the 1940 Act should be in the scope of ASC 205-30.<sup>13</sup>

## 6.2.2 Liquidation plan established at inception

### Excerpt from Accounting Standards Codification

#### Presentation of Financial Statements – Liquidation Basis of Accounting

##### *Recognition*

##### **205-30-25-1**

An entity shall prepare financial statements in accordance with the requirements of this Subtopic when **liquidation** is imminent unless the liquidation follows a plan for liquidation that was specified in the entity's governing documents at the entity's inception.

An entity that liquidates according to a plan established at its inception (e.g., a limited-life entity), would not apply liquidation accounting, assuming the plan is substantive and specifies when and how the entity will liquidate. The FASB concluded that investors in these types of entities would know that the entity plans to liquidate, and the investors often interact freely with management. As a result, the FASB observed that the benefits of switching to the liquidation basis of accounting from the going concern basis of accounting would not justify the costs.<sup>14</sup>

To qualify as a substantive liquidation plan, the plan does not need to require liquidation on a specific calendar date. For example, liquidation upon a triggering event or a milestone would be substantive if the liquidation plan was established at the entity's inception and it specified how the entity will liquidate. However, liquidation that occurs solely upon a decision to do so by the entity's board of directors, investors or plan sponsor, would not be a substantive liquidation plan.

Limited-life entities, such as private equity funds, typically outline in their governing documents a liquidation plan that includes a specific date by which the entity will liquidate. This would constitute a liquidation plan as contemplated by ASC 205-30. Similarly, many joint ventures have limited lives to achieve specific objectives, such as in the oil and gas or construction industries. In those industries, agreements may specify how the assets and liabilities will be divided among the parties upon liquidation, or how the net assets of the joint venture will be liquidated and the cash disbursed to the parties, which also would constitute a plan for liquidation as contemplated by ASC 205-30.

<sup>13</sup> Paragraph BC6 of ASU 2013-07.

<sup>14</sup> Paragraphs BC9 and BC10 of ASU 2013-07.

A trust created to purchase subordinated bonds issued by the sponsor of the trust also might have a liquidation plan, as described in ASC 205-30. Typically, the terms of the bonds are identical to those of the preferred shares issued by the trust, except that the bonds have an explicit maturity date. The trust documents often require either liquidation of the trust upon repayment of the debt or redemption of the preferred shares.

In contrast, most operating companies and open-ended investment companies, such as hedge funds, do not outline a liquidation plan. Although some entities have a stated legal expiration date, the entity's governing documents established at inception generally would not specify a plan for the distribution of assets. Most employee benefit plans have plans for liquidation upon termination of the plan, but they generally do not specify a date or specific event upon which liquidation would occur. These entities likely would not have a plan for liquidation as contemplated by ASC 205-30 and would be required to apply liquidation basis accounting.

### **Illustration 6-2: Determining whether a liquidation plan exists**

#### **Example 1**

Two parties create a special purpose acquisition company (SPAC, sometimes referred to as a "blank check" company) on 1 January 20X0. The SPAC is a public investment vehicle that has the purpose of investing in an operating company but has no operations itself. The governing documents of the SPAC require it to complete a business combination by 31 December 20X0 or liquidate and distribute to the parties cash in proportion to their original investment.

#### **Analysis**

The SPAC has a liquidation plan established at its inception that specifies when and how the SPAC would liquidate, as contemplated by ASC 205-30. Under this plan, the SPAC does not have a choice over whether the SPAC liquidates if it does not complete the business combination. Therefore, it would not apply the liquidation basis of accounting if it were to liquidate under that plan.

#### **Example 2**

On 1 January 20X0, a trust is created to invest in securities on behalf of multiple parties (but is not registered under the 1940 Act). The governing documents of the trust specify that if at any point after the initial capitalization the minimum return on investment is not met, the trust sponsor will liquidate the trust and distribute the proceeds to the investors on record as of that date.

#### **Analysis**

The trust does not have a liquidation plan established at its inception that specifies both when and how the trust would liquidate, as contemplated by ASC 205-30. Although the investors might be aware of the possibility that the trust would liquidate if the minimum return on investment is not met, there is no certainty about whether or when such event would occur, such that any liquidation would be unexpected by the investors. Therefore, upon determining that liquidation is imminent, the trust would apply the liquidation basis of accounting.

### **Question 6-1**

**If an entity established (and is following) a liquidation plan at inception, can it still apply the liquidation basis of accounting?**

No, an entity that established (and is following) a liquidation plan at inception may not apply the liquidation basis of accounting, based on the guidance in ASC 205-30-25-1. Liquidation basis is not an election. However, as an alternative, the entity could provide additional disclosures (e.g., costs expected to be incurred during the liquidation period) to provide users with information about the amount that the entity expects to be obligated to pay during liquidation. The entity also is permitted to disclose other information that would be consistent with the objective of liquidation basis financial statements.

## 6.2.3

## Following a liquidation plan

**Excerpt from Accounting Standards Codification****Presentation of Financial Statements – Liquidation Basis of Accounting***Recognition***205-30-25-3**

An entity shall presume that its plan of liquidation does not follow a plan that was specified in the entity's governing documents at its inception if the entity is forced to dispose of its assets in exchange for consideration that is not commensurate with the **fair value** of those assets. Other aspects of the entity's plan of liquidation also might differ from a plan that was specified in the entity's governing documents at its inception (for example, the date at which liquidation shall commence). However, those factors should be considered in determining whether to apply the liquidation basis of accounting only to the extent that they affect whether the entity expects to receive consideration in exchange for its assets that is not commensurate with fair value.

*Implementation Guidance and Illustrations**General, Illustrations***205-30-55-3**

The governing documents from Entity B's inception specified that its contractual life would end in Year 10. On March 11 of Year 6, Entity B's board of directors determined that the entity would not be able to meet its debt obligations and voted to begin liquidating the entity earlier than planned. Entity B required approval from Entity C, a third party, to make its plan of liquidation effective. Entity B obtained approval from Entity C on April 10 of Year 6. No other parties could block the execution of the plan of liquidation, and the likelihood that Entity B would return from liquidation was remote. Under the plan of liquidation, Entity B anticipated that it would not have sufficient time to sell its assets in exchange for consideration that would approximate the **fair value** of those assets. Entity B should begin preparing its financial statements using the liquidation basis of accounting as of April 10 of Year 6, which is the date that the entity had obtained all of the approvals required to make its plan of liquidation effective.

If a plan to liquidate is established at inception, an entity would need to assess whether it is following the plan when liquidation becomes imminent.

All facts and circumstances are considered when assessing whether a liquidation is being executed according to the plan established at the entity's inception. However, as discussed by the FASB in paragraph BC11 of ASU 2013-07, the key factor in the assessment is determining whether the entity expects to sell its assets for less than fair value. See section 6.2.3.1, *Fair value versus liquidation value*, for a discussion of how these concepts differ. Liquidation accounting would be required when an entity is liquidating assets for other than fair value.

Other aspects of executing the liquidation plan, such as timing, may sometimes differ from the plan in the governing documents. However, these differences generally would not affect the determination of whether the liquidation plan is being followed if the entity still expects to sell its assets at fair value.

We believe it would be rare for private equity funds to apply liquidation accounting because they often liquidate according to a plan established at their inception, liquidating their assets at fair value, in an orderly manner. In contrast, most hedge funds do not have a liquidation plan at inception, and therefore would apply liquidation accounting when liquidation is imminent, even if they expect to receive fair value for the funds' assets.

If an entity deviates from a liquidation plan established at its inception in material aspects, it would apply the liquidation basis of accounting. We believe any such deviations and the reasons for them should be disclosed.

**Illustration 6-3: Assessing whether an entity is following a plan established at its inception**

A private equity fund establishes a liquidation plan in its governing documents, which states that the fund will terminate 10 years from that date. The general partner (GP) of the fund can extend the life of the fund for two additional one-year periods. The private equity fund is not registered under the 1940 Act, and therefore doesn't qualify for the scope exception in ASC 205-30.

**Example 1**

After the 10-year term expires and the GP extended the life of the fund by two additional years, the GP begins to liquidate the fund's assets and wind down the fund.

**Analysis**

The fund is liquidating according to plan, and therefore it would not apply the liquidation basis of accounting.

**Example 2**

After five years, the GP decides it cannot implement the fund's strategy and generate the desired returns. As a result, the GP decides to liquidate the fund's assets in an orderly manner at fair value, rather than continue the fund's operations through the expected termination date of 10 years.

**Analysis**

While the fund is liquidating earlier than called for under the plan established at its inception, the assets of the fund are being liquidated at fair value. Therefore, the fund would not apply the liquidation basis of accounting.

**Example 3**

After five years, a key fund manager resigns. According to the governing documents of the fund, this event forces liquidation of the fund and the return of capital to investors within 90 days. As a result, the fund expects to be unable to sell its assets at fair value.

**Analysis**

The fund is not liquidating according to the plan established at its inception since it is being forced to sell its assets for amounts other than fair value. The fund would apply the liquidation basis of accounting.

### 6.2.3.1

#### **Fair value versus liquidation value**

Financial statement preparers often question the difference between the use of fair value and liquidation value when an entity is being liquidated. The FASB Codification master glossary defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." According to ASC 820, an orderly transaction is one that "assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction." That is, the hypothetical transaction assumes that market participants have sufficient knowledge and awareness of the asset, obtained through customary due diligence even if this process may not have yet begun (or may never occur at all). Thus, the concept of an orderly transaction is meant to distinguish fair value for transactions in the normal course of business from the price in a distressed sale.

On the other hand, the liquidation value of assets is intended to reflect the cash expected to be received and paid during dissolution, not necessarily an amount that would be received if assets were sold in a transaction between market participants. There are two types of liquidation value:

- ▶ **Orderly liquidation value** – The value an entity expects to receive for an asset sold given sufficient time to market the asset in a customary manner to multiple potential buyers; generally, this amount equals fair value, however, it may not, for example, when it does not reflect the time value of money.
- ▶ **Distressed liquidation value** – The value an entity expects to receive for an asset sold considering there may be insufficient time for adequate market exposure or considering that the asset may be only marketed to a single market participant; this amount tends to be lower than fair value because the appropriate time needed for customary marketing and negotiating is not available. Thus, certain illiquid assets, in particular, are frequently settled for amounts below fair value.

See our FRD, [Fair value measurement](#), for additional guidance.

## 6.2.4

### Determining when liquidation is imminent

#### Excerpt from Accounting Standards Codification

##### Presentation of Financial Statements – Liquidation Basis of Accounting

##### Recognition

##### 205-30-25-2

Liquidation is imminent when either of the following occurs:

- a. A plan for liquidation has been approved by the person or persons with the authority to make such a plan effective, and the likelihood is **remote** that any of the following will occur:
  1. Execution of the plan will be blocked by other parties (for example, those with shareholder rights)
  2. The entity will return from liquidation.
- b. A plan for liquidation is imposed by other forces (for example, involuntary bankruptcy), and the likelihood is remote that the entity will return from liquidation.

##### Implementation Guidance and Illustrations

##### General, Illustrations

##### 205-30-55-2

Entity A is a manufacturer of goods. In 20X3, Entity A began experiencing financial difficulty because of declining market demand for its goods. On September 19, 20X3, Entity A's board of directors approved a plan for **liquidation**. The board of directors had the authority to make the plan effective. There were no other parties that could block the execution of the plan, and the likelihood that the entity would return from liquidation was remote. Entity A should begin applying the liquidation basis of accounting as of September 19, 20X3, which is the date that Entity A's board of directors approved the plan for liquidation.

An entity in the scope of ASC 205-30 that is not following a liquidation plan established at its inception applies the liquidation basis of accounting when liquidation is *imminent*.

ASC 205-30 states that liquidation is *imminent* when either of the following occurs:

- ▶ The party or parties with the authority to approve a liquidation plan do so, and the likelihood is remote that (1) the plan will be blocked and (2) the entity will return from liquidation.
- ▶ Other forces (e.g., involuntary bankruptcy) impose a plan for liquidation, and the likelihood that the entity will return from liquidation is remote.

An entity's legal structure and governing documents usually state which parties are authorized to approve a liquidation plan (e.g., shareholders, board of directors). After those authorized approve the liquidation plan, management would evaluate whether other parties could block the plan.

Some governing bodies have unilateral authority to liquidate an entity and cannot be blocked by investors or shareholders, even if the governing bodies must tell investors or shareholders about the planned liquidation. In other cases, investors or shareholders may approve a liquidation plan. For some entities, such as defined benefit plans, liquidation requires regulatory approval. Depending on the facts and circumstances, assessing the chances of shareholders or regulators blocking a liquidation plan may require judgment.

Liquidation accounting should be used beginning when liquidation is imminent, even though liquidation may take years to execute. Liquidation accounting is used throughout that period. The liquidation basis of accounting only applies when the entity's operations are intended to permanently cease. The liquidation basis of accounting is not applied if the entity intends to restart operations when economic conditions improve.

#### **Illustration 6-4: Determining when liquidation is imminent**

##### **Example 1**

The governing documents of Company ABC give its board of directors the unilateral authority to approve and execute a liquidation plan. No other parties can block the plan. On 16 June 20X0, the board approved a liquidation plan. Management concluded that the likelihood is remote that Company ABC will return from liquidation. Management expects it will take three years to liquidate Company ABC, due to lawsuits against Company ABC related to environmental issues.

##### **Analysis**

Liquidation became imminent on 16 June 20X0. The authorized party approved the liquidation plan on this date, and no other parties can block the plan. It is irrelevant that management expects it will take three years to liquidate Company ABC, since management concluded that the likelihood is remote that Company ABC will return from liquidation.

##### **Example 2**

The governing documents of Company DEF give its board of directors the authority to approve and execute a liquidation plan. On 30 October 20X0, the board of directors approved a liquidation plan. Numerous shareholder and creditor lawsuits were filed to block the liquidation of Company DEF. As a result, management is unable to conclude that the likelihood is remote that liquidation will be blocked.

##### **Analysis**

Liquidation would not be imminent on 30 October 20X0. Although the authorized party approved the liquidation plan on this date, management was unable to conclude that the likelihood is remote that liquidation would be blocked.

**Example 3**

XYZ Fund is a hedge fund (not registered under the 1940 Act), which was created solely as an investment for a single investor. XYZ Fund does not have a liquidation plan established at inception. The investor submitted a redemption request to XYZ Fund on 19 May 20X0, which cannot be rescinded, and no other parties can block the redemption. The fund expects to sell its investments at fair value.

**Analysis**

Liquidation would be imminent on 19 May 20X0. The redemption request forced the fund manager to plan the liquidation of XYZ Fund since XYZ Fund was created solely for its single investor. The likelihood is remote that XYZ Fund will return from liquidation since the redemption request cannot be rescinded or blocked by other parties. It is irrelevant that XYZ Fund expects to sell its investments at fair value since it does not have a liquidation plan established at inception.

**Example 4**

The governing documents of an employee benefit plan specify how the plan's assets would be distributed if the plan sponsor terminated the plan, but they do not state a date or specific event upon which such distribution would occur. The board of directors of the plan sponsor voted on 15 November 20X0 to terminate the employee benefit plan effective 1 January 20X1. The participants of the plan were notified on 1 December 20X0. The employee benefit plan expects to sell its investments at fair value and distribute its assets according to its governing documents. Regulatory approval is not required (or is deemed perfunctory).

**Analysis**

Liquidation would be imminent on 15 November 20X0. The termination of the employee benefit plan by the plan sponsor forced the plan's liquidation, and the likelihood is remote that other parties could block the liquidation, since regulatory approval is not required. The likelihood is remote that the plan will return from liquidation. It is irrelevant that the employee benefit plan expects to sell its investments at fair value since it does not have a liquidation plan established at inception. Specifying how plan assets would be distributed upon termination does not constitute a plan. It is irrelevant that the employee benefit plan will not be liquidated until 1 January 20X1, or that the participants were notified on 1 December 20X0.

**Example 5**

GPC Corporation manufactures building products materials. Because of a downturn in the economy and reduction in new housing construction, on 22 September 20X0, GPC's board of directors decided to "mothball" the company's manufacturing facilities until the economy improves. In the meantime, GPC Corporation will liquidate its entire inventory and terminate all its manufacturing employees.

**Analysis**

Liquidation would not be imminent on 22 September 20X0. GPC Corporation could continue as a going concern if economic conditions improve. Therefore, the likelihood is not remote that GPC Corporation will return from liquidation. The board of directors would need to take action to liquidate all assets and permanently cease operations before liquidation would be imminent.

## 6.2.5 Convenience date

One question that arises in practice is whether a liquidating entity must apply liquidation accounting as of the date liquidation became imminent (as described in ASC 205-30) or whether the entity would be permitted to use a “convenience date.”

We believe that in some cases it may be appropriate to apply liquidation accounting starting from a date other than the date when liquidation became imminent. However, the difference between the designated convenience date and the actual date prescribed by ASC 205-30 should be no more than a few days. When assessing whether it is appropriate to use a convenience date, the liquidating entity evaluates whether the effect of using a convenience date, aggregated with the effects of other errors and accounting conventions, would materially affect the financial statements. The materiality on both the period before liquidation, under the going concern basis (if presented) and after liquidation becomes imminent, should be considered.

## 6.2.6 Liquidation of an entity (including acquisitions, mergers and spin-offs)

### Excerpt from Accounting Standards Codification

#### Presentation of Financial Statements – Liquidation Basis of Accounting

##### Glossary

##### 205-30-20

##### Liquidation

The process by which an entity converts its assets to cash or other assets and settles its obligations with creditors in anticipation of the entity ceasing all activities. Upon cessation of the entity's activities, any remaining cash or other assets are distributed to the entity's investors or other claimants (albeit sometimes indirectly). Liquidation may be compulsory or voluntary. Dissolution of an entity as a result of that entity being acquired by another entity or merged into another entity in its entirety and with the expectation of continuing its business does not qualify as liquidation.

If an entity were dissolved because another entity acquires it or it merges into another entity, and the business of the dissolved entity is expected to continue, liquidation accounting would not be applied in the financial statements of the acquired or merged entity. For example, a parent might transfer the net assets of a wholly owned subsidiary into the parent and dissolve the subsidiary. That transaction would be a common control transaction; the subsidiary would not apply the liquidation basis of accounting in its financial statements. See Appendix C of our FRD, *Business combinations*, for additional guidance on accounting for common control transactions. Similarly, a parent might spin off or split off a business and dissolve the legal entity that previously held it. The parent would not apply liquidation accounting but would instead apply ASC 845 and ASC 505-60.

- ▶ When a business that is a subsidiary in a consolidated group is being liquidated (and not sold or spun-off), the parent will need to determine whether it continues to have a controlling financial interest pursuant to ASC 810. See section 3.9.13, *Consolidation*, for additional guidance.
- ▶ If the liquidating subsidiary's financial statements are separately presented, a determination is needed about whether the subsidiary's liquidation is imminent and therefore whether the subsidiary should use the liquidation basis in its standalone financial statements.
- ▶ It would be inappropriate to consolidate the subsidiary's liquidation basis financial statements with the financial statements of the parent if the parent is continuing as a going concern. Rather, consideration would be given to whether the subsidiary should be presented as a discontinued operation or considered held for sale in the parent's consolidated financial statements. Many of the issues raised in section 2, *Before bankruptcy or liquidation*, would likely be applicable to the financial statements of the subsidiary that are consolidated.



## 6.2.7 Liquidation becomes imminent or occurs after the balance sheet date

We generally do not believe that liquidation becoming imminent or occurring after the balance sheet date are events that by themselves would require recognition in the current period financial statements, though subsequent events disclosure would be required under ASC 855. However, liquidation becoming imminent or occurring subsequent to the balance sheet date but prior to the issuance of the financial statements may confirm facts and circumstances that existed as of the balance sheet date. The evaluation of subsequent events requires consideration of facts and circumstances, and is an area of professional judgment, in particular with respect to estimates at the balance sheet date. See section 2, *Before bankruptcy or liquidation*, for further discussion.

## 6.3 Applying liquidation basis accounting

Once an entity determines that applying the liquidation basis of accounting is appropriate, the recognition and measurement of assets, and of certain liabilities, will likely change. When an entity is liquidating, the financial statements provide information about the resources that will be available to creditors and investors. As a result, the financial statements fundamentally differ from those of an entity that expects to continue as a going concern.

Write-downs or write-offs of property, plant and equipment, other long-lived assets or goodwill, or other adjustments that should be recorded in operating results before liquidation becomes imminent, are not liquidation adjustments. That is, liquidation accounting does not replace proper application of other US GAAP as it relates to the impairment of assets before liquidation becomes imminent.

The following table summarizes the treatment of certain items in liquidation basis financial statements:

| Item  | Accounting  | Reference         |
|---|---|-------------------|
| <b>Assets</b>   | Recognized at amount expected to be collected; costs to sell or dispose are separately accrued  | See section 6.3.1 |
| <b>Deferred charges (e.g., prepaid assets) and goodwill</b>   | Written off on the date liquidation basis of accounting is adopted (assumes no cash or consideration is expected to be collected)   | See section 6.3.1 |
| <b>Items expected to be sold not previously recognized (e.g., internally generated intangible assets)</b> | Recognized at amount expected to be collected; can be aggregated  | See section 6.3.1 |
| <b>Liabilities (e.g., debt, deferred revenues, pension obligations)</b>                                   | Recognized at amounts required by other US GAAP   | See section 6.3.2 |
| <b>Income expected to be earned (e.g., income from pre-existing orders)</b>                               | Recognized if reasonable basis for estimation exists after evaluating whether such amounts are not already reflected in the value of an asset   | See section 6.3.3 |
| <b>Expenses</b>   | Accrued if they can be reasonably estimated, even if they would have been incurred absent the liquidation   | See section 6.3.3 |
| <b>Noncontrolling interests</b>   | Adjusted for proportionate share of assets and liabilities measured on liquidation basis  | See section 6.3.6 |
| <b>Adjustments to convert from going concern basis to liquidation basis</b>                               | Not recognized in statement of changes in net assets in liquidation or going concern financial statements (disclosed as a component of "Adjustments relating to the adoption of liquidation basis of accounting") | See section 6.4.2 |

ASC 205-30 applies to financial reporting for periods after which liquidation is imminent (e.g., after the entity files for Chapter 7). If an entity with a 31 December 20X8 year-end files for Chapter 7 on 1 February 20X9, then the entity would *not* apply ASC 205-30 when preparing its financial statements as of 31 December 20X8, although it would disclose the bankruptcy filing in its subsequent event disclosures. The guidance in section 2, *Before bankruptcy or liquidation*, would apply in its 31 December 20X8 financial statements.

### 6.3.1 Initial recognition and measurement of assets

#### Excerpt from Accounting Standards Codification

##### Presentation of Financial Statements – Liquidation Basis of Accounting

###### *Recognition*

###### **205-30-25-4**

When using the liquidation basis of accounting, an entity shall recognize other items that it previously had not recognized (for example, trademarks) but that it expects to either sell in liquidation or use to settle liabilities. Those items may be recognized in the aggregate.

###### **205-30-25-6**

An entity shall accrue estimated costs to dispose of assets or other items that it expects to sell in liquidation and present those costs in the aggregate separately from those assets or items.

###### *Initial Measurement*

###### **205-30-30-1**

An entity shall measure assets to reflect the estimated amount of cash or other consideration that it expects to collect in settling or disposing of those assets in carrying out its plan for **liquidation**. In some cases, **fair value** may approximate the amount that an entity expects to collect. However, an entity shall not presume this to be true for all assets.

###### **205-30-30-3**

An entity shall not apply discounting provisions in measuring the accruals for estimated disposal costs in accordance with paragraph 205-30-25-6 and expected income and expenses in accordance with paragraph 205-30-25-7.

A liquidating entity measures assets at amounts it expects to receive when it settles or disposes of each asset. That is, an entity stops applying the recognition and measurement provisions of other US GAAP to its assets once it begins applying the liquidation basis of accounting. The measurement might be similar to that for assets held for sale under ASC 360. For example, assets are not depreciated under the liquidation basis of accounting, and the amounts are presented net of any accumulated depreciation. However, the amount an entity expects to collect might differ from the measurement required under ASC 360 if, for example, the entity does not expect to sell the asset in an orderly manner. Under the liquidation basis of accounting, an asset could be measured at an amount greater than its carrying amount under the going concern basis of accounting.

ASC 205-30 does not specify how to measure the amount expected to be collected (e.g., whether to use a best estimate or probability-weighted approach), so judgment should be applied. The FASB observed in paragraph BC25 of ASU 2013-07 that an entity likely would have information from offers or discussions with third parties. The FASB also stated in paragraph BC13 of ASU 2013-07 that the measurement approach for assets in ASC 205-30 is appropriate, because it gives users of the financial statements information about the cash or other consideration that an investor might reasonably expect to receive after liquidation. In contrast, going concern financial statements provide information about the entity's economic performance and position.

In some circumstances, the fair value (i.e., exit price) of an asset will approximate the cash that an entity expects to collect. However, ASC 205-30 does not presume that all assets would be disposed of in an orderly fashion, and therefore it does not specify fair value as the appropriate liquidation measurement. See section 6.2.3.1, *Fair value versus liquidation value*, for more discussion of the differences between liquidation value and fair value. While disposing of an asset in an orderly manner generally would maximize the cash received, this may not be true for an illiquid asset with significant holding or maintenance costs. In such cases, selling the asset quickly might be more advantageous. Due to the inherent uncertainty in determining the cash to be received upon selling an asset, an entity's best estimate of the liquidation value may be equal to (or derived from) its current fair value. An entity is not precluded from using fair value to measure its assets in liquidation as long as such amount represents the best estimate of liquidation value (i.e., the cash that an entity expects to collect).

The sale or changes in a price of an asset after the balance sheet date but before the financial statements are issued (or are available to be issued) may provide evidence of the amount expected to be collected at the balance sheet date. Judgment may be required to determine whether the sale or changes in price that occur after the balance sheet date reflect conditions that existed as of the balance sheet date and are recognized or nonrecognized subsequent events under ASC 855.

Typically, recognized subsequent events provide additional evidence about conditions that existed at the balance sheet date. Conversely, nonrecognized subsequent events occur after the balance sheet date but before financial statements are issued or are available to be issued and do not provide evidence about conditions that existed at the balance sheet date. Some of these events may be of such a nature that disclosure of them is required to keep the financial statements from being misleading.

An entity separately would accrue the costs it expects to incur when selling assets. Accrued costs are separately presented from the related assets in the statement of net assets in liquidation; that is, the assets are presented on a gross basis. An entity should not discount accruals for estimated costs to be incurred in the process of disposing assets for the effects of the time value of money.

If an entity expects to sell an asset in liquidation, ASC 205-30 would require it to be recognized, even if US GAAP did not previously permit the asset to be recognized. For example, an entity would recognize internally generated intangible assets (e.g., trademarks, patents, licenses) at the amount expected to be collected upon sale. The completeness of the list of identified assets expected to be sold should be challenged when first applying the liquidation basis of accounting. See section 4.2.5.3 of our FRD, ***Business combinations***, for a non-exhaustive list of intangible assets that could be sold in liquidation. These items can be aggregated in the statement of net assets in liquidation.

Since goodwill cannot be sold, we generally would expect that goodwill would be written off in the opening statement of net assets in liquidation, even if no impairment were recognized under ASC 350 when the entity was a going concern (which is expected to be rare). However, some of the value previously attributed to goodwill might be attributable to internally generated intangible assets that the entity previously was prohibited from recognizing.

Similarly, other charges that were deferred based on accounting principles or policies (e.g., prepaid insurance, prepaid rent) generally would not be recognized under the liquidation basis of accounting as they would not be expected to be sold for cash or other consideration.

**Illustration 6-5: Initial recognition and measurement of assets under the liquidation basis of accounting**

On 1 November 20X1, XYZ Corporation filed for Chapter 7 bankruptcy, and liquidation is imminent as of that date. Management expects to collect \$15 million from the sale of its building, which had a carrying amount of \$10 million (net of depreciation) as of 1 November 20X1. After 31 December 20X1, but before the 20X1 financial statements were authorized for issuance, XYZ Corporation sold the building for \$15 million and incurred one-time legal fees of \$1 million.

**Analysis**

The building would be recognized in the opening statement of net assets in liquidation on 1 November 20X1 at \$15 million (the amount expected to be collected). The \$5 million increase would be disclosed with significant assumptions used in making the estimate (but would not be recorded in the statement of changes in net assets in liquidation). XYZ Corporation would not recognize any depreciation from 1 November 20X1 to 31 December 20X1 in the statement of changes in net assets.

XYZ Corporation also would accrue a \$1 million liability for the estimated costs to sell the building in the initial statement of assets in liquidation, separately from the building.

## 6.3.2 Initial recognition and measurement of liabilities

**Excerpt from Accounting Standards Codification**

**Presentation of Financial Statements – Liquidation Basis of Accounting**

*Recognition*

**205-30-25-5**

An entity shall recognize liabilities in accordance with the recognition provisions of other Topics that otherwise would apply to those liabilities, including paragraph 405-20-40-1.

*Initial Measurement*

**205-30-30-2**

An entity shall measure liabilities in accordance with the measurement provisions of other Topics that otherwise would apply to those liabilities (excluding the accrual of estimated disposal costs as described in paragraph 205-30-25-6 and expected income and expenses as described in paragraph 205-30-25-7). In applying those other Topics, an entity shall adjust its liabilities to reflect changes in assumptions that are a result of the entity's decision to liquidate (for example, timing of payments). However, an entity shall not anticipate being legally released from being the primary obligor under a liability, either judicially or by the creditor.

**Liabilities – Extinguishments of Liabilities**

*Derecognition*

**405-20-40-1**

Unless addressed by other guidance (for example, paragraphs 405-20-40-3 through 40-4 or paragraphs 606-10-55-46 through 55-49), a debtor shall derecognize a liability if and only if it has been extinguished. A liability has been extinguished if either of the following conditions is met:

- a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes the following:
  1. Delivery of cash
  2. Delivery of other financial assets

3. Delivery of goods or services
  4. Reacquisition by the debtor of its outstanding debt securities whether the securities are cancelled or held as so-called treasury bonds.
- b. The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor. For purposes of applying this Subtopic, a sale and related assumption effectively accomplish a legal release if nonrecourse debt (such as certain mortgage loans) is assumed by a third party in conjunction with the sale of an asset that serves as sole collateral for that debt.

When applying the liquidation basis of accounting, liabilities are accounted for in accordance with US GAAP that would otherwise apply, except for the accrual of estimated disposal costs and other expected expenses. Assumptions in the measurement of a liability affected by the entity's decision to liquidate, such as the timing of payments, are adjusted to reflect current expectations. Such liabilities are discounted if required by the applicable US GAAP.

ASC 205-30 explicitly prohibits an entity from derecognizing a liability in anticipation of being legally released from an obligation, or settling a liability, when applying the liquidation basis of accounting. That is, even if an entity does not have enough cash or other assets to satisfy its legal obligations, and default, settlement, or release by the court is likely (or occurs subsequent to the end of the reporting period), an entity would not adjust the liability's carrying amount to reflect that expectation unless other US GAAP would require it. In paragraph BC15 of ASU 2013-07, the FASB concluded that an entity generally would not be able to estimate the amount that it would be required to pay, so it should continue to apply other US GAAP. Entities should consider the guidance in ASC 855, which distinguishes between subsequent events that should be recognized in the financial statements (recognized subsequent events) and those that should be disclosed (nonrecognized subsequent events).

Events that cause liquidation to become imminent (e.g., filing for Chapter 7 bankruptcy) also could trigger accounting changes for a liability under the applicable US GAAP. For example, refer to the following sections for issues that should be considered during liquidation (this list is not exhaustive):

- ▶ Section 2.3.1, *Covenant violations*, for classification of debt
- ▶ Section 2.3.2, *Troubled debt restructurings*, for modifications or exchanges of debt
- ▶ Section 2.8, *Derivatives and hedge accounting*, although we generally would not expect an entity in liquidation to have effective hedges
- ▶ Section 2.9, *Restructurings, disposals or exit activities and discontinued operations*, for guidance on the recognition and measurement of liabilities for such activities
- ▶ Section 3.9.6, *Liabilities previously recorded at fair value, including derivatives*
- ▶ Section 3.9.9, *Leases*, for guidance on leases rejected in bankruptcy
- ▶ Section 3.9.11, *Pension/OPEB*, for guidance on curtailments and modifications
- ▶ If applicable, a liquidating entity also would be required to follow ASC 450 and ASC 740, when accounting for contingencies and uncertain tax positions, respectively. Liquidating entities also should consider ASC 480, and the effect of liquidation on the classification and measurement of contingently redeemable or mandatorily redeemable shares.
- ▶ A liquidating employee benefit plan would continue to follow the requirements of ASC 960 with respect to the accumulated benefit plan obligation, although assumptions used to measure the obligation should be updated to reflect the termination.

**Illustration 6-6: Measurement of liabilities under the liquidation basis of accounting**

Company XYZ is the defendant in various lawsuits related to environmental issues. Management concluded that a loss is probable, and that it can reasonably estimate the loss. Management projects the following cash payments as of 31 December 20X0.

| (in millions) | <u>Estimated<br/>payment</u> | <u>Discounted<br/>(10% rate)</u> |
|---------------|------------------------------|----------------------------------|
| 20X1          | \$ 4.0                       | \$ 3.6                           |
| 20X2          | 4.5                          | 3.7                              |
| 20X3          | 5.0                          | 3.8                              |
| 20X4          | 5.5                          | 3.8                              |
| 20X5          | <u>6.0</u>                   | <u>3.7</u>                       |
| Total         | <u>\$ 25.0</u>               | <u>\$ 18.6</u>                   |

In accordance with ASC 450, Company XYZ recognized a liability of \$18.6 million as of 31 December 20X0, representing its best estimate of future payments.

On 16 June 20X1, liquidation became imminent. Management expects that liquidation will be complete by 31 December 20X3, and that all settlements related to lawsuits against Company XYZ will be paid before that date. Management projects the following cash payments as of 16 June 20X1 (the changes in the expected timing of payments are due to Company XYZ's liquidation):

| (in millions) | <u>Estimated<br/>payment</u> | <u>Discounted<br/>(10% rate)</u> |
|---------------|------------------------------|----------------------------------|
| 20X1          | \$ 7.0                       | \$ 6.4                           |
| 20X2          | 9.0                          | 7.4                              |
| 20X3          | 9.0                          | 6.8                              |
| 20X4          | -                            | -                                |
| 20X5          | -                            | -                                |
| Total         | <u>\$ 25.0</u>               | <u>\$ 20.6</u>                   |

**Analysis**

Company XYZ would begin to apply the liquidation basis of accounting on 16 June 20X1. On that date, Company XYZ would increase the environmental liability by \$2 million (\$20.6 million less \$18.6 million). Because the change in the expected timing of the payments is due to the liquidation, this change would not be recognized in the Company XYZ's income statement for the period before liquidation (the "stub period"). The increase in the liability would be disclosed.

**6.3.3****Accrual of expenses and income****Excerpt from Accounting Standards Codification****Presentation of Financial Statements – Liquidation Basis of Accounting****Recognition****205-30-25-7**

An entity shall accrue costs and income that it expects to incur or earn (for example, payroll costs or income from preexisting orders that the entity expects to fulfill during liquidation) through the end of its liquidation if and when it has a reasonable basis for estimation.

**Initial Measurement****205-30-30-3**

An entity shall not apply discounting provisions in measuring the accruals for estimated disposal costs in accordance with paragraph 205-30-25-6 and expected income and expenses in accordance with paragraph 205-30-25-7.

A liquidating entity accrues any costs it expects to incur through the end of its liquidation when they are reasonably estimable, including both one-time and recurring expenses. Such costs are accrued even if the entity would have incurred the costs as a going concern (e.g., administrative costs, payroll costs, audit fees, legal and professional fees, management fees, incentive fees, realtor commissions, rent, insurance). Because liquidation basis financial statements are designed to provide users with information about the amount that the entity is (or expects to be) obligated to pay during liquidation, accruing liquidation expenses (even though those expenses would not have been accrued if the entity were a going concern) is consistent with those objectives.

A significant assumption in the estimate of recurring expenses is the length of time expected to complete the liquidation, which may require judgment. The longer liquidation is expected to take, the more difficult it would be to estimate the costs that will be incurred. Management should use all available information about the entity's assets and liabilities, as well as other expertise available (e.g., external liquidation advisors) to make a reasonable estimate.

ASC 205-30-30-3 also requires an entity to accrue income that it expects to earn through the end of its liquidation on an undiscounted basis, if it has a reasonable basis for estimation. Evaluating whether an entity has a reasonable basis for estimating income is specific to the entity's facts and circumstances and the nature of the asset that is expected to generate the income. Consider the judgments made with respect to financial assets. Factors that could be considered when evaluating whether the entity has a reasonable basis to estimate income include investment specific characteristics (e.g., credit quality, leverage rate, operating expectations), general market conditions (e.g., market interest rates, investor sentiment), and the estimated disposal date for the investment. In determining income to accrue upon adoption of liquidation basis of accounting, an entity may not be able to estimate reasonably the precise date of disposal for each of its financial assets. If the entity uses fair value as its best estimate of liquidation value because it does not have a reasonable basis to determine the proceeds from disposal, management should carefully consider whether a portion of the income accrual is already reflected in the fair value measurement. For example, the fair value of equity and fixed-income investments incorporates cash flows associated with these instruments expected to be earned in the future (i.e., dividends or coupon payments, respectively). When recognizing any additional income accrual for amounts expected to be collected by the entity through the disposal date, management should exclude income already reflected in the fair value measurement. However, adjustments to the income accrual may be needed for the effect of discounting for the time value of money for the period between the reporting date and expected liquidation date, if such amounts can be reasonably estimated, to comply with the guidance in ASC 205-30-30-3.<sup>15</sup>

Similarly, if an entity expects to sell inventory before liquidation, and the amount expected to be collected upon the sale of the inventory exceeds its carrying amount, that excess would be accrued if management can reasonably estimate the amount and it is not already reflected in the liquidation value of the inventory.

ASC 205-30 does not specify how to estimate income or expenses when the outcome might vary (e.g., whether to use a best estimate or probability-weighted approach). Estimating amounts expected to be collected during liquidation will require judgment.

Disclosures about this estimate are required (see section 6.5, *Disclosure requirements*). An entity should not discount accruals for estimated costs to be incurred, or income to be earned, for the effects of the time value of money. An entity discounts other liabilities if required by applicable US GAAP.

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<sup>15</sup> Consistent with the going concern basis of accounting, dividends and interest earned through the measurement date but not yet received would be accrued if these amounts are not reflected in the fair value of the asset (e.g., fair value is determined using a "clean price" and therefore excludes accrued interest).

**Illustration 6-7: Accruing costs and income expected to be incurred or earned during liquidation**

For Entity X, liquidation became imminent on 31 December 20X0. Therefore, Entity X applies the liquidation basis of accounting as of that date. Management expects that the liquidation process will be complete in two years, by 31 December 20X2.

**Example 1**

In 20X0, Entity X had operating expenses of \$1 million, which included rent expenses, payroll costs and audit fees. Management has the ability to estimate these operating expenses, expects them to recur annually and be consistent through the final date of liquidation.

**Analysis**

In its statement of net assets in liquidation as of 31 December 20X0, Entity X would accrue \$2 million in estimated costs to be incurred (\$1 million annually \* 2 years).

**Example 2**

Entity X had inventory of \$1 million as of 31 December 20X0. Management expects to sell the inventory for \$1.3 million, based on orders received. Entity X does not have any contract liabilities related to future sales of this inventory (that is, it has not received any cash in advance from customers for the purchase of this inventory). Entity X expects that it will incur an additional \$100,000 in expenses to ship this inventory.

**Analysis**

In its statement of net assets in liquidation as of 31 December 20X0, Entity X would accrue \$300,000 (\$1.3 million less \$1.0 million) for the revenue that Entity X expects to earn on the sale of the inventory, since it can reasonably estimate that amount. Entity X also would accrue the shipping costs of \$100,000 separately. Entity X would disclose any significant assumptions in this calculation. Neither of these amounts would be discounted in the initial statement of net assets in liquidation.

**6.3.4****Subsequent measurement****Excerpt from Accounting Standards Codification****Presentation of Financial Statements – Liquidation Basis of Accounting*****Subsequent Measurement*****205-30-35-1**

At each reporting date, an entity shall remeasure its assets and other items it expects to sell that it had not previously recognized (for example, trademarks), liabilities (if required under the relevant Topic for those liabilities), and the accruals of disposal or other costs or income to reflect the actual or estimated change in carrying value since the previous reporting date in accordance with paragraphs 205-30-30-1 through 30-3.

At each reporting date, an entity in liquidation remeasures its assets at the amount it expects to collect, and remeasures the accruals of expense and income at the amount it expects to incur or earn. An entity would remeasure its liabilities if required by other US GAAP. An entity would not reflect the expected settlement of a liability for other than its recorded amount in the measurement of that liability at the end of the reporting period (even if settlement occurs after the end of the reporting period) unless other US GAAP would require it. Entities should consider the guidance in ASC 855, which distinguishes between subsequent events that should be recognized in the financial statements (recognized subsequent events) and those that should be disclosed (nonrecognized subsequent events).



Remeasurements are presented in the statement of changes in net assets in liquidation. The applicable US GAAP may require an entity to recognize a change in the remeasurement of a liability in other comprehensive income (e.g., remeasurement of derivatives with effective hedges, accounting for pension plans). Since there is no statement of shareholders' equity required to be presented under the liquidation basis, we believe it would be appropriate to separately present this change in the statement of changes in net assets in liquidation, if significant. See section 6.4, *Financial statement presentation*, for examples of financial statements under the liquidation basis.

### 6.3.5 Change in accounting principles

Unless specifically exempted, it would appear that entities applying the liquidation basis of accounting would be required to apply any applicable new ASUs issued by the FASB, even if the ASU is issued or becomes effective after liquidation becomes imminent. For example, if the FASB issues a new standard that affects the recognition or measurement of liabilities, a liquidating entity would be required to adopt it (absent any specific exemptions). New standards that only affect the recognition or measurement of assets, income or expenses generally would not be applied by a liquidating entity, given the specific measurement requirements of ASC 205-30.

### 6.3.6 Noncontrolling interests

If a parent and its consolidated but less-than-wholly owned subsidiary are both liquidating (see section 3.9.13, *Consolidation*), a question may arise as to whether to recognize (and if so, how to measure) the noncontrolling interest in the subsidiary. A noncontrolling interest in an entity is any equity interest in the consolidated entity that is not attributable to the parent. ASC 810 requires that the noncontrolling interest be classified as a separate component of consolidated equity.

Since equity is not presented in a statement of net assets in liquidation, we generally believe it would be appropriate to allocate the net assets in liquidation to the controlling and noncontrolling interest. This may result in a change in the measurement of the noncontrolling interest, compared with the measurement under the going concern basis of accounting, since the measurement of assets for an entity in liquidation differs from that of a going concern. It also would generally be appropriate to allocate the changes in net assets in liquidation between the controlling and noncontrolling interest.

#### Illustration 6-8: Noncontrolling interest in liquidating subsidiary

For Entity P, liquidation became imminent on 31 December 20X0. Therefore, Entity P applies the liquidation basis of accounting as of that date. Entity P has an 80% investment in a subsidiary, Entity S, which files for bankruptcy in the same jurisdiction as Entity P. After considering the guidance in ASC 810, Entity P concludes that it controls (and consolidates) Entity S during liquidation. The net assets of Entity S are shown in the table below (details omitted). Assume that there are no intercompany receivables or payables.

| (amounts in thousands)  | Before liquidation | Statement of net assets in liquidation |
|---|--------------------|--|
| Total assets  | \$ 9,000           | \$ 11,000                              |
| Total liabilities   | \$ 7,000           | \$ 9,500                               |
| Entity P's equity in Entity S                                     | 1,600              |  |
| Noncontrolling interest in Entity S                               | 400                |  |
| Total equity  | \$ 2,000           |  |
| Net assets in liquidation attributable to Entity P                |                    | 1,200                                  |
| Net assets in liquidation attributable to noncontrolling interest |                    | 300                                    |
| Net assets in liquidation   |                    | \$ 1,500                               |

Entity S's net assets in liquidation are \$1,500 (\$11,000 less \$9,500). That amount is allocated between the controlling interest (Entity P) and the noncontrolling interest in accordance with their 80% and 20% ownership interests in Entity S, respectively.

The change in the allocation of Entity S's net assets as a result of applying liquidation accounting, a decrease of \$500 (\$9,000 less \$7,000 before liquidation less \$1,500), would be disclosed. See section 6.4.2, *Example of adjustments from going concern basis to liquidation basis of accounting*, for examples of these adjustments.

### 6.3.7 Share-based payments

The accounting for share-based payment awards outstanding during liquidation depends on the terms of the original awards, and any cancellations or modifications of awards (including changes in intentions about the manner in which those awards will be settled).

For example, a liquidating entity might have vested share-based payments that were initially classified as equity when the entity was a going concern. However, upon liquidation, facts and circumstances may change such that the entity announces it no longer intends to settle those awards in shares, but rather, it intends to cash-settle those awards. An entity should account for such a change as a modification from an equity-classified award to a liability-classified award.

As discussed in section 6.3.2, *Initial recognition and measurement of liabilities*, when applying the liquidation basis of accounting, liabilities are accounted for in accordance with US GAAP (e.g., ASC 718) that would otherwise apply. As discussed in ASC 205-30-30-2, assumptions in the measurement of a liability affected by the entity's decision to liquidate, such as the timing of payments, are adjusted to reflect current expectations. Due to the complexities involved in measuring the fair value of a liability-classified share-based payment award for a liquidating entity, the involvement of valuation professionals is encouraged.

An entity also should disclose information about these awards that would be relevant to users of the financial statements, such as the nature and the terms of awards that existed during the period and the potential effects of those awards on shareholders, including information about the potential dilution to shareholders when liquidation is complete.

See our FRD, [Share-based payment](#), for additional guidance.

### 6.3.8 Foreign currency considerations

Under the liquidation basis of accounting, assets are measured at the amount expected to be collected. Accordingly, assets denominated in a foreign currency should be measured in the functional currency of the liquidating entity using the exchange rate in effect at the date liquidation became imminent. Assets should be remeasured at the end of the reporting period using the exchange rate at that date, consistent with the principle in ASC 205-30 that assets should be measured at the amount expected to be collected under the liquidation basis of accounting.

However, liabilities are measured at the amount that would otherwise be required under US GAAP. Accordingly, an entity would apply ASC 830 to liabilities during liquidation. See our FRD, [Foreign currency matters](#), for additional guidance.

Translation expresses the functional currency financial statements of a subsidiary in the reporting currency when the subsidiary's functional currency differs from the parent's functional currency. Under ASC 830, translation adjustments would be reported in other comprehensive income. However, since there is no equity under the liquidation basis of accounting, we believe it would be appropriate to separately present this change in the statement of changes in net assets in liquidation, if material.

**Illustration 6-9: Assets denominated in a foreign currency**

On 1 November 20X1, XYZ Corporation filed for Chapter 7 bankruptcy, and liquidation is imminent as of that date. XYZ Corporation has a US\$ functional currency but owns a building in Europe. It expects to collect €10 million from the sale of its building as of 1 November 20X1, when the exchange rate was \$1.30 to €1. That is, XYZ Corporation expects to collect \$13 million for the sale of the building, after converting the proceeds into US\$.

As of 31 December 20X1, management still expects to sell the building for €10 million. However, the exchange rate has increased to \$1.35 to €1. That is, XYZ Corporation expects to collect \$13.5 million for the sale of the building after converting the proceeds into US\$, an increase of \$500,000 (\$13.5 million less \$13 million).

**Analysis**

The building would be recognized in the statement of net assets in liquidation at \$13 million and \$13.5 million on 1 November 20X1 and 31 December 20X1, respectively. The \$500,000 increase would be recognized in the statement of changes in net assets.

## 6.4

### Financial statement presentation

**Excerpt from Accounting Standards Codification**

**Presentation of Financial Statements – Liquidation Basis of Accounting**

*Glossary*

**205-30-20**

***Statement of Changes in Net Assets in Liquidation***

A statement that presents the changes during the period in net assets available for distribution to investors and other claimants during liquidation.

***Statement of Net Assets in Liquidation***

A statement that presents a liquidating entity's net assets available for distribution to investors and other claimants as of the end of the reporting period.

***Other Presentation Matters***

**205-30-45-1**

At a minimum, an entity that applies the liquidation basis of accounting shall prepare the following:

- a. A statement of net assets in liquidation
- b. A statement of changes in net assets in liquidation.

A liquidating entity must present, at a minimum:

- ▶ A statement of net assets in liquidation (a statement that presents a liquidating entity's net assets available for distribution to investors and other claimants as of the end of the reporting period)
- ▶ A statement of changes in net assets in liquidation (a statement that presents the changes in net assets during the period that they are available for distribution to investors and other claimants during liquidation)

If liabilities exceed total assets, the statements should be labeled as "statement of [changes in] net liabilities in liquidation." Judgment is required to determine the level of detail to present in a statement of net assets in liquidation, and in a statement of changes in net assets in liquidation, because ASC 205-30 does not provide specific guidance.

ASC 205-30 does not require a statement of cash flows or a statement of shareholder's equity. Disclosure of an entity's capital structure and the different liquidation preferences of its equity instruments (e.g., preferred shares) would likely be appropriate.

Entities may provide other statements if desired or required by a regulator. For example, an investment company that is applying ASC 205-30 may present a schedule of investments.

## 6.4.1

### Stub periods

#### Excerpt from Accounting Standards Codification

##### Presentation of Financial Statements – Liquidation Basis of Accounting

##### *Other Presentation Matters*

##### **205-30-45-2**

The liquidation basis of accounting shall be applied prospectively from the day that liquidation becomes imminent. The initial statement of changes in net assets in liquidation shall present only changes in net assets that occurred during the period since liquidation became imminent.

The statement of changes in net assets in liquidation begins on the date at which liquidation becomes imminent and ends on the reporting date. To identify the changes in net assets that occur during the first liquidation period, the FASB acknowledged in paragraph BC17 of ASU 2013-07 that a statement of net assets in liquidation on the date at which liquidation becomes imminent would likely be necessary, although it is not required to be included in the liquidation basis financial statements.

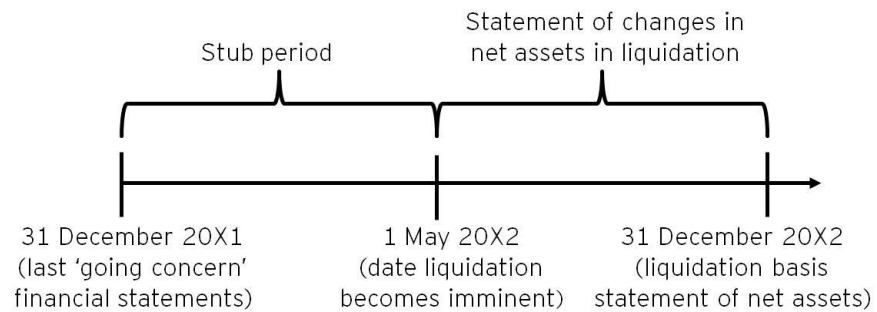
The FASB also stated in paragraph BC18 of ASU 2013-07 that an entity is not required to present financial statements for the "stub period" (i.e., the period between its last balance sheet as a going concern and the date at which liquidation becomes imminent). However, an entity may separately present the stub period if it chooses or if another party (e.g., regulator, bank) requires it. For example, Rules 210.3-02 and 210.3-04 of Regulation S-X require registrants to provide balance sheets for the last two years and statements of operations, cash flows and changes in shareholders' equity for the last three years (two years for smaller reporting companies and emerging growth companies in their initial registration statement). Therefore, an SEC registrant applying ASC 205-30 would be required to present the stub periods, usually separated by a double black line.

The effects of adopting the liquidation basis of accounting are not recognized in the going concern income statement. In addition, ASC 205-30 is clear that changes from the going concern financial statements to the liquidation basis of accounting also are *not* part of the initial statement of changes in net assets. We generally believe it would be appropriate for entities to disclose changes between the going concern and liquidation basis financial statements.

The following illustration depicts the stub period:

#### Illustration 6-10: Stub period

For Entity X, liquidation became imminent on 1 May 20X2. Therefore, Entity X applies the liquidation basis of accounting as of that date. Entity X has a calendar fiscal year.



#### Analysis

US GAAP does not require Entity X to present financial statements under the going concern basis for the stub period from 1 January 20X2 to 1 May 20X2. However, it may choose to do so if desired or required by another party (e.g., the SEC).

Entity X would present a statement of net assets in liquidation as of 31 December 20X2, and a statement of changes in net assets for the period from 1 May 20X2 to 31 December 20X2.

To prepare the statement of changes in net assets, Entity X would prepare a statement of net assets in liquidation as of 1 May 20X2, although would not be required to include that statement in its liquidation basis financial statements.

The statement of changes in net assets in liquidation does not include the adjustments from the going concern basis to the liquidation basis.

## 6.4.2

### Example of adjustments from going concern basis to liquidation basis of accounting

The following example illustrates the changes that an entity might record when converting from the going concern basis of accounting to the liquidation basis. The illustration assumes that for BAS Corporation, liquidation became imminent on 1 May 20X2. Therefore, BAS Corporation applies liquidation accounting as of that date. This illustration also ignores the effects of income taxes for simplicity.

**Illustration 6-11: Worksheet to convert from going concern to liquidation basis of accounting**

| 1 May 20X2  |                       |   |                            |  |
|---|-----------------------|---|----------------------------|--|
| (amounts in thousands)                                  | Before<br>liquidation | Adjustments<br>needed as of<br>30 April | Liquidation<br>adjustments | Statement of<br>net assets in<br>liquidation |
| <b>Assets</b>   |                       |   |                            |  |
| Cash and cash equivalents                               | \$ 600                | \$ -                                    | \$ -                       | \$ 600                                       |
| Accounts receivable, net                                | 1,000                 | (10) (a)                                | -                          | 990  |
| Inventories   | 2,000                 | (40) (b)                                | -                          | 1,960  |
| Other current assets                                    | 700                   | -                                       | -                          | 700  |
| <b>Total current assets</b>                             | <b>4,300</b>          | <b>(50)</b>                             | <b>-</b>                   | <b>4,250</b>                                 |
| Property and equipment, net                             | 2,500                 | (200) (c)                               | (20) (f)                   | 2,280  |
| Intangible assets, net                                  | 900                   | - (d)                                   | 2,100 (g)                  | 3,000  |
| Goodwill  | 1,300                 | - (d)                                   | (1,300) (h)                | -  |
| Prepaid insurance                                       | 200                   | -                                       | (200) (i)                  | -  |
| Internally generated intangible assets                  | -                     | -                                       | 1,100 (j)                  | 1,100  |
| Accrued income from pre-existing orders                 | -                     | -                                       | 300 (k)                    | 300  |
| <b>Total assets</b>                                     | <b>\$ 9,200</b>       | <b>\$ (250)</b>                         | <b>\$ 1,980</b>            | <b>\$ 10,930</b>                             |
| <b>Liabilities</b>                                      |                       |   |                            |  |
| Accounts payable  | \$ 500                | \$ -                                    | \$ -                       | \$ 500                                       |
| Notes payable   | 2,900                 | -                                       | -                          | 2,900  |
| Accrued liabilities                                     | 800                   | -                                       | -                          | 800  |
| Accrued expenses expected to be incurred in liquidation | -                     | -                                       | 1,600 (l)                  | 1,600  |
| Accrued costs to sell and dispose of assets             | -                     | -                                       | 460 (m)                    | 460  |
| <b>Total current liabilities</b>                        | <b>4,200</b>          | <b>-</b>                                | <b>2,060</b>               | <b>6,260</b>                                 |
| Long-term debt  | 3,300                 | -                                       | -                          | 3,300  |
| <b>Total liabilities</b>                                | <b>7,500</b>          | <b>-</b>                                | <b>2,060</b>               | <b>9,560</b>                                 |
| <b>Net assets in liquidation</b>                        |                       |   |                            | <b>\$ 1,370</b>                              |
| Common stock  | 600                   | -                                       |                            |  |
| Additional paid-in capital                              | 2,150                 | -                                       |                            |  |
| Accumulated other comprehensive income                  | 200                   | -                                       |                            |  |
| Retained earnings (deficit)                             | (1,250)               | (250) (e)                               |                            |  |
| <b>Total shareholders' equity</b>                       | <b>1,700</b>          | <b>(250)</b>                            |                            |  |
| <b>Total liabilities and shareholders' equity</b>       | <b>\$ 9,200</b>       | <b>\$ (250)</b>                         |                            |  |

(a) Immediately before determining that liquidation is imminent, management determined that accounts receivable of \$10 were uncollectible, which was recognized in loss from operations (net loss) during the stub period (that is, during the going concern financial statements for the period from 1 January to 30 April 20X1).

(b) The company has two types of inventory, A and B, which each have a carrying amount of \$1,000, for a total of \$2,000. Immediately before determining that liquidation is imminent, management remeasured Inventory A at the lower of cost or market and determined that amount to be \$960. The entity recognized an expense of \$40 in loss from operations (net loss) during the stub period (\$1,000 less \$960). No additional adjustment is required to the carrying amount of inventory B (the lower of cost or market remains \$1,000). Therefore, the total carrying amount of inventory is \$1,960.

- (c) Immediately before determining that liquidation is imminent, management tested property and equipment for impairment under the held for sale model in ASC 360-10. This amount includes two assets. The entity determined that the fair value less costs to sell was \$2,300 and, therefore, recognized an impairment of \$200 (\$2,500 carrying amount less \$2,300) in loss from operations (net loss) during the stub period.
- (d) The entity tested goodwill and intangible assets for impairment but determined that no impairment was necessary during the stub period.
- (e) As a result of the expenses in entries (a) – (d), the entity recognized a net loss of \$250, which is reflected in the accumulated deficit during the stub period.
- (f) Upon determining that liquidation is imminent, the entity reduced property and equipment by \$20, to \$2,280, to reflect the amount the entity expects to collect. To sell the property and equipment quickly, the entity does not expect to collect fair value less costs to sell of \$2,300. The remaining property and equipment account includes property of \$2,200 and equipment of \$80.
- (g) The entity increased the carrying amount of its intangible assets by \$2,100, because management expects to collect \$3,000 from its intangible assets, as shown in the table below:

|                         | <u>Cost basis<br/>before<br/>liquidation</u> | <u>Amount<br/>expected to<br/>be collected</u> | <u>Liquidation<br/>adjustment</u> |
|-------------------------|--|--|-----------------------------------|
| Contractual rights      | \$ 400                                       | \$ 900   | \$ 500                            |
| Patents                 | 300  | 1,500  | 1,200                             |
| Customer relationships  | 200  | 600  | 400                               |
| Total intangible assets | <u>\$ 900</u>                                | <u>\$ 3,000</u>                                | <u>\$ 2,100</u>                   |

- (h) Since the entity cannot sell its goodwill, it will be written off in the liquidation adjustments to the opening statement of net assets in liquidation, even though no impairment was previously required under ASC 350 (which is expected to be rare).
- (i) Since the entity cannot sell its prepaid insurance, the costs are written off in the liquidation adjustments, even though the policy remains in effect.
- (j) Management expects to sell internally generated intangible assets, including its trademarks and brand names, for \$1,100. The entity would disclose any significant assumptions in this estimate.
- (k) Management expects to sell its inventory as shown in the following table:

|                 | <u>Cost basis<br/>before<br/>liquidation</u> | <u>Lower of<br/>cost or<br/>market</u> | <u>Adjustment<br/>recorded in<br/>operations</u> | <u>Expected<br/>sales price</u> | <u>Accrued<br/>income<br/>from pre-<br/>existing<br/>orders</u> |
|-----------------|--|--|--|---------------------------------|---|
| Inventory A     | \$ 1,000                                     | \$ 960                                 | \$ (40)  | \$ 960                          | \$ -  |
| Inventory B     | 1,000  | 1,000                                  | -  | 1,300                           | 300   |
| Total inventory | <u>\$ 2,000</u>                              | <u>\$ 1,960</u>                        | <u>\$ (40)</u>                                   | <u>\$ 2,260</u>                 | <u>\$ 300</u>   |

Management expects that it will incur an additional \$100 in expenses to sell and ship inventory, which is accrued in entry (m). The entity would disclose any significant assumptions in this estimate.

- (l) Management expects to incur liquidation expenses of \$1,600, including payroll costs, legal fees, audit fees, rental expense, and other expenses that would have otherwise been incurred even if the entity were not liquidating.
- (m) Management expects to incur costs to dispose of its assets, as shown in the table below:

|   |               |
|---|---------------|
| Inventories <sup>(k)</sup>  | \$ 100        |
| Property and equipment  | 110           |
| Intangible assets previously recognized (contractual rights, patents, customer relationships) | 120           |
| Trademarks and brand names  | 130           |
|   | <u>\$ 460</u> |

The entity does not record liquidation adjustments to its accumulated deficit. Rather, the items above would be disclosed. The entity is not required to include the statement of net assets in liquidation as of 1 May 20X2 in its financial statements.

The statement of changes in net assets includes summarized increases and decreases in net assets resulting from, but not limited to, the following items:

- ▶ Changes in the amount expected to be collected upon the sale of assets
- ▶ Remeasurement of liabilities in accordance with US GAAP
- ▶ Changes in the expenses expected to be incurred, or income to be generated
- ▶ Liquidating activities, such as settlement of a liability

#### Illustration 6-12: Statement of net assets in liquidation

BAS Corporation recorded the following transactions during the period from 1 May 20X2 to 31 December 20X2 (ignoring the effects of income taxes for simplicity):

| Assets  | 1 May 20X2       | Change in<br>net assets | 31 December<br>20X2 |
|---|------------------|-------------------------|---------------------|
| Cash and cash equivalents                               | \$ 600           | \$ 1,100 (x)            | \$ 1,700            |
| Accounts receivable, net                                | 990              | 310 (n)                 | 1,300               |
| Inventories   | 1,960            | (1,000) (o)             | 960                 |
| Other current assets                                    | 700              | (360) (p)               | 340                 |
| <b>Total current assets</b>                             | <b>4,250</b>     | <b>50</b>               | <b>4,300</b>        |
| Property and equipment, net                             | 2,280            | (2,200) (q)             | 80                  |
| Intangible assets, net                                  | 3,000            | (3,000) (r)             | -                   |
| Internally generated intangible assets                  | 1,100            | 10 (s)                  | 1,110               |
| Accrued income from pre-existing orders                 | 300              | (280) (o)               | 20                  |
| <b>Total assets</b>                                     | <b>\$ 10,930</b> | <b>\$ (5,420)</b>       | <b>\$ 5,510</b>     |
| <b>Liabilities</b>                                      |                  |                         |                     |
| Accounts payable  | \$ 500           | \$ (240) (t)            | \$ 260              |
| Notes payable   | 2,900            | (2,900) (u)             | -                   |
| Accrued liabilities                                     | 800              | (410) (t)               | 390                 |
| Accrued expenses expected to be incurred in liquidation | 1,600            | (810) (v)               | 790                 |
| Accrued costs to sell and dispose of assets             | 460              | (330) (w)               | 130                 |
| <b>Total current liabilities</b>                        | <b>6,260</b>     | <b>(4,690)</b>          | <b>1,570</b>        |
| Long-term debt  | 3,300            | (1,650) (t)             | 1,650               |
| <b>Total liabilities</b>                                | <b>9,560</b>     | <b>(6,340)</b>          | <b>3,220</b>        |
| <b>Net assets in liquidation</b>                        | <b>\$ 1,370</b>  | <b>\$ 920 (x)</b>       | <b>\$ 2,290</b>     |

<sup>(x)</sup> The entity collected the existing \$990 in receivables, offset by an increase in receivables of \$1,300 from the sale of Inventory B (see entry (o)). This entry does not affect total net assets in liquidation.

<sup>(n)</sup> The entity sold Inventory B for \$1,300, as expected and recorded the related receivables in entry (n). In addition, shortly before year-end, the entity received an order for Inventory A at \$20 above its carrying amount, which was fulfilled shortly after year-end. The entity accrued \$20 as additional income expected to be earned, which resulted in an increase in net assets in liquidation.

<sup>(p)</sup> The entity sold other current assets for \$360 as expected and recorded the cash received, which does not affect total net assets in liquidation.

<sup>(q)</sup> The entity sold property with a carrying amount of \$2,200 for \$2,230 in cash, an excess of \$30 over its carrying amount. This sale increased net assets in liquidation. The entity still holds equipment as of 31 December 20X2, for which it expects to receive \$80.



- (<sup>r</sup>) The entity sold intangible assets for \$3,000, as expected and recorded the cash received. This entry does not affect total net assets in liquidation.
- (<sup>s</sup>) Based on current negotiations, management now expects to sell internally generated intangible assets, including its trademarks and brand names, for \$1,110, an excess of \$10 over the previous carrying amount. This change in estimate increased net assets in liquidation. The entity would disclose any significant assumptions in this estimate.
- (<sup>t</sup>) The entity paid \$240, \$410 and \$1,650 on its accounts payable, accrued liabilities, and long-term debt, respectively, consistent with the amounts previously recorded. These entries do not affect total net assets in liquidation.
- (<sup>u</sup>) The entity was able to negotiate and execute a settlement on the notes payable (which were originally recorded at \$2,900) for \$2,000, a difference of \$900, which increases total net assets in liquidation.
- (<sup>v</sup>) The entity spent \$850 on expenses in liquidation, reducing the accrual to \$750. However, management's current estimate of expenses to be incurred in liquidation is \$790, a difference of \$40 (\$790 less \$750), decreasing net assets in liquidation. The net change is \$810 (\$850 spent less an increase in the accrual of \$40).
- (<sup>w</sup>) The entity incurred \$330 in costs to sell inventory, property and equipment, and intangible assets, as expected. Management still expects to incur \$130 to sell its internally generated intangible assets, and that the costs to dispose of any remaining assets will be nominal.
- (<sup>x</sup>) These amounts represent the sum of entries above.

**BAS Corporation**  
**Consolidated Statement of Net Assets in Liquidation**  
**(Liquidation Basis)**  
**31 December 20X2**

**(in thousands)**

**Assets**

|                           |              |
|---------------------------|--------------|
| Cash and cash equivalents | \$ 1,700     |
| Accounts receivable, net  | 1,300        |
| Inventories               | 960          |
| Other current assets      | 340          |
| Total current assets      | <u>4,300</u> |

|   |                 |
|---|-----------------|
| Property and equipment, net             | 80              |
| Intangible assets, net                  | -               |
| Internally generated intangible assets  | 1,110           |
| Accrued income from pre-existing orders | 20              |
| <b>Total assets</b>                     | <u>\$ 5,510</u> |

**Liabilities**

|   |              |
|---|--------------|
| Accounts payable  | \$ 260       |
| Notes payable   | -            |
| Accrued liabilities                                     | 390          |
| Accrued expenses expected to be incurred in liquidation | 790          |
| Accrued costs to sell and dispose of assets             | 130          |
| Total current liabilities                               | <u>1,570</u> |

|                   |              |
|-------------------|--------------|
| Long-term debt    | <u>1,650</u> |
| Total liabilities | <u>3,220</u> |

|                                  |                 |
|----------------------------------|-----------------|
| <b>Net assets in liquidation</b> | <u>\$ 2,290</u> |
|----------------------------------|-----------------|

**BAS Corporation**  
**Consolidated Statement of Changes in**  
**Net Assets in Liquidation**  
**(Liquidation Basis)**  
**For the Period 1 May 20X2 to 31 December 20X2**

**(in thousands)**

|   |        |     |
|---|--------|-----|
| Recognition of other income expected to be collected from sale of inventory | \$ 20  | (o) |
| Cash collected on sale of assets in excess of previously recognized amounts | 30     | (q) |
| Increases to internally generated intangible assets                         | 10     | (s) |
| Gain on settlement of notes payable   | 900    | (u) |
| Accrual of additional estimated costs to be incurred in liquidation         | (40)   | (v) |
|   | \$ 920 |     |

The entity might choose to show more detail, depending on the facts and circumstances, and what would be most meaningful to the users of the financial statements.

## 6.5

**Disclosure requirements****Excerpt from Accounting Standards Codification****Presentation of Financial Statements – Liquidation Basis of Accounting***Disclosure***205-30-50-1**

An entity shall make all disclosures required by other Topics that are relevant to understanding the entity's **statement of net assets in liquidation** and **statement of changes in net assets in liquidation**. The disclosures shall convey information about the amount of cash or other consideration that an entity expects to collect and the amount that the entity is obligated or expects to be obligated (in the case of the accruals described in paragraphs 205-30-25-6 through 25-7) to pay during the course of **liquidation**.

**205-30-50-2**

At a minimum, an entity shall disclose all of the following when it prepares financial statements using the liquidation basis of accounting:

- a. That the financial statements are prepared using the liquidation basis of accounting, including the facts and circumstances surrounding the adoption of the liquidation basis of accounting and the entity's determination that liquidation is imminent.
- b. A description of the entity's plan for liquidation, including a description of each of the following:
  1. The manner by which it expects to dispose of its assets and other items it expects to sell that it had not previously recognized as assets (for example, trademarks)
  2. The manner by which it expects to settle its liabilities
  3. The expected date by which the entity expects to complete its liquidation.
- c. The methods and significant assumptions used to measure assets and liabilities, including any subsequent changes to those methods and assumptions.
- d. The type and amount of costs and income accrued in the statement of net assets in liquidation and the period over which those costs are expected to be paid or income earned.

A liquidating entity must disclose information about the liquidation plan, including the date the board of directors (or entity with the appropriate authority) approved the dissolution, and the date liquidation basis of accounting is adopted (if different).

The financial statements also should disclose how the liquidation basis of accounting differs from the going concern basis of accounting. An entity also is required to disclose the cash or other consideration that an entity expects to collect or pay during liquidation, including the methods and significant assumptions used in the liquidation basis financial statements, as well as the type and amount of costs and income accrued and the period over which it expects to pay those costs or earn the income.

In addition, disclosures required by other US GAAP relevant to understanding the entity's liquidation basis financial statements continue to be required. For example, if an entity believes that the amount it expects to collect for a particular asset would also represent fair value, it should make the disclosures in ASC 820. See our FRD, *[Fair value measurement](#)*, for additional guidance.

When determining the relevance of disclosures required under other US GAAP to the entity's liquidation basis financial statements, it is critical to remember that the objective is to convey information that enables investors to estimate the amount they might reasonably expect to receive after liquidation, as discussed by the FASB in paragraph BC13 of ASU 2013-07.

See section 7, *SEC filing issues for bankruptcy and liquidation*, for additional guidance.

## 6.5.1 Risks and uncertainties

ASC 275 requires disclosures of the risks and uncertainties existing as of the balance sheet date in the following areas: (1) nature of operations, (2) use of estimates in the preparation of the financial statements, (3) certain significant estimates and (4) current vulnerability due to certain concentrations.

Disclosure is required when management knows prior to issuing financial statements that:

- ▶ It is at least reasonably possible (as defined in ASC 450) that management's estimate of the effect on the financial statements of a condition, situation or set of circumstances existing at the date of the financial statements will change in the near-term as a result of one or more future confirming events
- ▶ The effect of the change would be material to the financial statements

The disclosure would indicate the nature of the uncertainty and an indication that it is at least reasonably possible that a change in the estimate will occur in the near-term. Disclosure of the factors that cause the estimate to be sensitive to change is encouraged.

While ASC 275 focuses on changes in estimates that may occur in the near term, to meet the objective of liquidation we believe it generally would be appropriate to extend these disclosures to cover the remaining liquidation period, even if that period extends beyond the near term.

See section 2.12, *Risks and uncertainties*, for additional guidance.

# 7 SEC filing issues for bankruptcy and liquidation

## 7.1 SEC reporting considerations prior to bankruptcy

Entities that are experiencing financial difficulty should consider whether additional disclosures are required within periodic filings. This may include updating the description of the business or adding risk factor disclosures. Management should also determine that it has appropriately disclosed in the liquidity and capital resources discussion in MD&A a clear picture of the registrant's ability to generate cash and to meet existing and known or reasonably likely future cash requirements. These disclosures should give investors an opportunity to look at the registrant through the eyes of management by providing a historical and prospective analysis of the registrant's liquidity, with particular emphasis on the registrant's prospects for the future. The discussion of liquidity should identify the balance sheet, income/loss and cash flow items that are indicators of the entity's liquidity. Examples of liquidity indicators include, but are not limited to, unused credit lines, debt-equity ratios, bond ratings and restrictions under existing debt agreements.

Additionally, management should consider whether critical accounting estimates should be updated. The SEC staff believes that MD&A should make investors aware of the sensitivity of financial statements to the methods, assumptions and estimates underlying the financial statements. The SEC staff has noted that entities' disclosures about critical accounting estimates are often too general and should be expanded to include a description of the significant estimates and assumptions made by management. In addition, the SEC staff has identified the need for entities to provide early warning disclosures in MD&A if it is reasonable to expect a material impairment in a future period. The SEC staff will question a registrant about the adequacy of its disclosures when there appear to be indicators of impairment but the registrant has not recognized an impairment charge.

See section 5 of our [2023 SEC annual reports – Form 10-K](#) and section 3.7 of our [2024 SEC quarterly reports – Form 10-Q](#) for additional information regarding these disclosures in periodic filings.

## 7.2 Announcement of a bankruptcy filing

When a registrant, subsidiary of a registrant, or investee of a registrant (referred to collectively as “a registrant” below) comes under the jurisdiction of a court or governmental authority, including a filing to initiate a proceeding under the Code, it must file an Item 1.03 Form 8-K within four business days to report:

- ▶ The name or other identification of the proceeding
- ▶ The identity of the court or governmental authority
- ▶ The date that jurisdiction was assumed
- ▶ The identity and date of appointment of any receiver, fiscal agent or similar officer appointed to the registrant

If a plan of reorganization or liquidation is executed or becomes effective during the reporting period, it should be filed as an exhibit to the Form 10-Q or Form 10-K filed for the period.

The SEC staff also has asked registrants to disclose in their annual reports the facts and circumstances that led to the registrant's decision to file for Chapter 7 or Chapter 11, including discussion of why the registrant remained in bankruptcy for a period of time (when applicable).

Some entities have liquidation plans established at inception (e.g., limited partnerships established for investment purposes), as discussed in section 6.2.2, *Liquidation plan established at inception*. If a registrant deviates from a liquidation plan established at its inception in material aspects, we believe any such deviations and the reasons for them should be disclosed.

Chapter 11 of the Bankruptcy Code allows the SEC to participate as a statutory party in a reorganization. While the SEC "may raise and may appear and be heard on any issue in the case," generally, the SEC's role is limited. The SEC will:

- ▶ Review the disclosure document to determine if the registrant is telling investors and creditors the important information they need to know
- ▶ Ensure that stockholders are represented by an official committee, if appropriate

Although the SEC does not negotiate the economic terms of reorganization plans, they may take a position on important legal issues that will affect the rights of public investors in bankruptcy cases. For example, the SEC may step in if they believe that the registrant's officers and directors are using the bankruptcy laws to shield themselves from lawsuits for securities fraud.

In some cases, a plan for reorganization or liquidation requires approval by shareholders. The requirements for proxies and the content of such forms (i.e., pro forma financial statements) are discussed in the EY SEC Manual.

## 7.2.1 Pro forma financial information

Pro forma financial information giving effect to a plan of reorganization and/or fresh-start accounting is sometimes required in SEC registration statements, proxy statements and Form 8-Ks as required by Article 11 (Article 8 for smaller reporting companies) of Regulation S-X. Pro forma information is not required in Form 10-K or in the annual shareholders report. It generally includes a condensed income statement for the latest year and subsequent year-to-date interim period, a condensed balance sheet as of the end of the latest period presented, and accompanying explanatory notes.

When preparing the pro forma financial statements, transaction accounting adjustments would likely need to reflect fair value adjustments for assets and liabilities if the criteria for fresh-start accounting under ASC 852 are met. Examples of other transaction accounting adjustments may include giving effect to a reorganization plan filed with and confirmed by a bankruptcy court showing adjustments for allowed claims, exit financing facilities and the recapitalization of a company emerging from bankruptcy.

The SEC, consistent with its policy of encouraging forward-looking disclosures, permits a registrant to substitute financial forecasts for pro forma income statements. If used, these forecasts must follow presentation guidelines issued in the AICPA's Guide for Prospective Financial Statements, and they must be accompanied by a recent historical income statement. [Rule 11-03 of Regulation S-X]

Further guidance on pro forma financial information for entities emerging from bankruptcy can be found in section 5.5.2 of our publication ***2023 Pro forma financial information: A guide for applying Article 11 of Regulation S-X***.

## 7.3 Request for modified Exchange Act reporting

Registrants in bankruptcy are not relieved of their SEC reporting obligations. However, the SEC staff has expressed a general position that it will accept reports that differ in form or content from reports required to be filed under the Securities Exchange Act of 1934 (Exchange Act). A registrant may request that it be permitted to file modified reports with the SEC by requesting a “no-action” position from the SEC staff. SEC Staff Legal Bulletin 2 provides the SEC staff’s views on requests to modify the Exchange Act periodic reporting of registrants that are either reorganizing or liquidating under the provisions of the Code. The SEC staff indicated that it would not issue a favorable response to a request for modified reporting if an active market for the registrant’s securities exists.<sup>16</sup> Specifically, the SEC staff required registrants to demonstrate that their securities are not traded on a national securities exchange and that there is otherwise minimal trading in the securities.

A registrant should submit its request promptly after it has entered bankruptcy. The SEC staff will consider a request as submitted “promptly” if it is filed before the date the registrant’s first periodic report is due following the registrant’s filing for bankruptcy.

If the SEC staff grants a registrant’s request for modified reporting, the registrant instead may file the monthly reports the registrant files with the court in lieu of reports on Forms 10-K and 10-Q. A registrant must file each monthly report with the SEC on a Form 8-K within 15 calendar days after the monthly report is due to the court. This relief applies only to filings on Forms 10-K and 10-Q. A registrant still would be required to satisfy all other provisions of the Exchange Act, including filing the current reports required by Form 8-K and satisfying the proxy, registrant tender offer and going-private provisions.

A registrant that files such modified reports is not considered “current” in its Exchange Act reporting with respect to those reports due while its bankruptcy proceedings were pending. That is, the registrant is not considered current in its Exchange Act reporting when: (1) determining eligibility to use the Securities Act of 1933 (Securities Act) Form S-3; (2) satisfying the current public information requirement of Securities Act Rule 144(c)(1); or (3) satisfying the reporting registrant definition of Rule 902(l) of Regulation S.

### 7.3.1 Delinquent registrants

Generally, the Division of Corporation Finance will not issue comments asking a delinquent registrant to file separately all of its delinquent filings if the registrant files a comprehensive annual report on Form 10-K that includes all material information that would have been included in those filings.

The Division’s decision not to seek the filing of additional reports when a registrant files a comprehensive annual report does not absolve a registrant from any liability under the Exchange Act for failing to file all required reports and would not foreclose enforcement action for the registrant’s filing delinquencies. In addition, filing a comprehensive annual report does not result in the registrant being considered “current” for purposes of Regulation S, Rule 144, or Form S-8 registration statements.<sup>17</sup> In addition, the registrant would not be eligible to use Form S-3 until it establishes a sufficient history of making timely filings.<sup>18</sup>

### 7.3.2 Suspended reporting under Rule 12h-3

Exchange Act Rule 12h-3 provides a means to suspend a registrant’s obligation to file periodic reports under Section 15D of the Exchange Act. The SEC staff has taken the position that modified Exchange Act reporting in accordance with a grant of a request would be sufficient for purposes of meeting the reporting requirement of Rule 12h-3. Accordingly, a registrant that otherwise satisfies the conditions of Rule 12h-3 may suspend reporting upon emergence from its bankruptcy proceedings if it has been granted relief in response to a request and has satisfied the conditions of that grant.

<sup>16</sup> SEC Staff Compliance and Disclosure Guidance – Exchange Action Sections, Question 130.01.

<sup>17</sup> SEC Staff Compliance and Disclosure Guidance – Exchange Action Sections, Question 130.02.

<sup>18</sup> Paragraph 1320.4 of SEC Staff Division of Corporation Finance’s Financial Reporting Manual, updated 1 July 2019.

## 7.4 Emerging from bankruptcy

When a plan of reorganization or liquidation has been confirmed, a registrant must then file an Item 1.03 Form 8-K within four business days, disclosing:

- ▶ The identity of the court or governmental authority
- ▶ The date that the order confirming the plan was entered by the court or governmental authority
- ▶ A summary of the material features of the plan
- ▶ The number of shares or other units of the registrant or its parent issued and outstanding, the number for future issuance in respect of claims and interests filed and allowed under the plan, and the aggregate total of such numbers
- ▶ Information as to the assets and liabilities of the registrant or its parent as of the date that the order confirming the plan was entered, or a date as close thereto as practicable (i.e., an audited balance sheet)

The registrant also is required to file any such plan of reorganization or liquidation, as confirmed, as an exhibit to Form 8-K under Item 9.01.

With respect to asset-backed securities, disclosure also is required under Item 1.03 if the depositor or servicer becomes aware of any instances of bankruptcy or receivership described above with respect to the sponsor, depositor, servicer, trustee, significant obligor, credit enhancement or support provider, or other material party to the asset-backed securities issue.

After a registrant's reorganization plan becomes effective and the Form 8-K is filed, a registrant must file Exchange Act periodic reports for all periods that begin after the plan becomes effective. Any post-reorganization filings under the Securities Act or the Exchange Act must include audited financial statements prepared in accordance with US GAAP for all periods for which audited financial statements are required even though the registrant may have been subject to bankruptcy proceedings during some portion of those periods.

A registrant emerging from bankruptcy may issue shares of equity or debt securities. However, a registrant reporting on a modified basis would not be considered "current" and is subject to limitations similar to those that apply to delinquent registrants described in section 7.3.1, *Delinquent registrants*. Item 101 of Regulation S-K requires a registrant to include information in the Form 10-K and most registration statements about the development of the registrant's business, including any bankruptcy. Such information should include the effects a bankruptcy has had on the registrant's structure and capitalization.

After a registrant's liquidation plan under Chapter 7 becomes effective, the registrant must continue to disclose material events relating to the liquidation on Form 8-K. At the time the liquidation is complete, the registrant must file a final Form 8-K to report that event.

### 7.4.1 Reporting on MD&A after emergence from bankruptcy

Item 303 of Regulation S-K (MD&A) requires a registrant to analyze the financial statements using year-to-year comparisons based on the financial statements included in the filing. A registrant emerging from bankruptcy would have a change in accounting basis if it applied fresh-start accounting, and as a result, its financial statements would present predecessor and successor periods. Therefore, the registrant should not combine the predecessor and successor periods within MD&A.

The SEC staff acknowledged, “There may be situations where comparisons other than those of the historical financial information may provide valuable supplemental and in certain cases, more relevant analyses, to fully discuss trends and changes.” When a registrant determines that a supplemental discussion in MD&A based on pro forma information is appropriate and will enhance the discussion, FRM 9220.7 states that the registrant should generally present pro forma financial information in a format consistent with S-X Article 11, but it acknowledges that other formats may be appropriate depending on the facts and circumstances.

Accordingly, upon emerging from bankruptcy, the registrant should consider providing supplemental pro forma results for the combined reporting period and compare those results to the pro forma results for the immediately preceding period. See section 7.2.1, *Pro forma financial information*, for guidance on preparing pro forma adjustments upon emerging from bankruptcy. The registrant should explain the differences between the historical and pro forma amounts for the periods presented. Generally, the SEC staff has not expected registrants to provide pro forma results for earlier periods, other than perhaps revenue and cost of sales. If additional details for prior periods are necessary to understand the implications of the fresh-start accounting, the registrant is encouraged to discuss the issue with the SEC staff before filing.<sup>19</sup>

In some cases, registrants report non-GAAP measures that exclude the effects of the emergence from bankruptcy (or payments that were accelerated due to the bankruptcy proceedings). Management should provide the disclosures required by Item 10(e) of Regulation S-K, including the reasons why the non-GAAP measures provide useful information to investors.

## 7.5 Liquidating trusts under Rule 12g

Sometimes, as part of its plan of liquidation and dissolution, a registrant forms a liquidating trust, transfers its remaining assets to the trust and distributes interests in the trust to its shareholders. Exchange Act Rule 12g would typically require the registrant to register its interests with the SEC. An entity may request relief from this requirement. However, a registrant’s certificate of dissolution must be filed and declared effective before the SEC staff would consider granting relief from Rule 12g for the interests in the liquidating trust.<sup>20</sup>

## 7.6 Shell companies

A registrant might liquidate all or the majority of its assets but remain in existence as a “shell” company. A “shell” company is a registrant, other than an asset backed entity, with no or nominal operations and (a) no or nominal assets, and/or (b) assets consisting solely of cash and cash equivalents. Shell companies are subject to certain unique provisions. For example, they must separately identify themselves as such on periodic reports and are prohibited from using Form S-8.

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<sup>19</sup> SEC Regulations Committee Meeting Minutes, 9 April 2008.

<sup>20</sup> SEC Staff Compliance and Disclosure Guidance - Exchange Action Sections, Question 116.07.



# 8 Quasi-reorganizations

## 8.1 Introduction to quasi-reorganizations

### Excerpt from Accounting Standards Codification

#### Reorganizations – Quasi-Reorganizations

##### *Overview and Background*

##### **852-20-05-1**

This Subtopic addresses the accounting applicable to a corporate readjustment procedure in which, without the creation of a new corporate entity and without the intervention of formal court proceedings, an entity restates its balance sheet to fair value. This corporate readjustment procedure may eliminate an accumulated deficit and/or prevent future charges to its income statement that otherwise would be made. The accounting permitted through such a procedure is an exception to the general rule discussed in paragraph 852-20-25-2.

##### **852-20-05-2**

Readjustments of this kind fall in the category of what are called quasi-reorganizations. This Subtopic does not deal with the general question of quasi-reorganizations, but only with cases in which the exception permitted in paragraph 852-20-25-2 is availed of by a corporation. Such cases are referred to as readjustments. The accounting and reporting issues that arise and are addressed in this Subtopic consist of what is permitted in a readjustment and what is permitted thereafter.

##### **852-20-05-3**

This Subtopic does not address quasi-reorganizations involving only deficit reclassifications.

Under limited circumstances, an entity that encounters significant financial difficulties may choose not to file for bankruptcy but may instead undergo a quasi-reorganization. A quasi-reorganization is a corporate readjustment procedure in which an entity restates its balance sheet to fair value without first creating a new corporate entity and without completing formal court proceedings. However, quasi-reorganization accounting should not result in an increase of net assets. The adjustments to restate the balance sheet to fair value are first recorded against retained earnings (if it exists) and then against additional paid-in capital. Retained earnings/accumulated deficit is then reset to zero as of the effective date of the quasi-reorganization.

The reasons for undertaking a quasi-reorganization may vary. In some cases, entities use a quasi-reorganization so they can pay dividends. Some jurisdictions allow entities to pay dividends only from retained earnings; therefore, the ability to reset the accumulated deficit to zero would enable an entity to pay dividends as soon as it generates income, when it would not otherwise have been able to do so. For this reason, US GAAP requires an entity to meet certain criteria to apply quasi-reorganization accounting. Without these restrictive criteria, an entity could undertake a quasi-reorganization and pay dividends to shareholders at its discretion, leaving creditors at risk.

### Excerpt from Accounting Standards Codification

#### Reorganizations – Quasi-Reorganizations

##### *Scope and Scope Exceptions*

##### **852-20-15-1**

The guidance in this Subtopic applies to all public and nonpublic entities that are corporations.

##### **852-20-15-2**

The guidance in this Subtopic applies only to readjustments in which the current income, or retained earnings or accumulated deficit account, or the income account of future years is relieved of charges that would otherwise be made against it, and is therefore limited to readjustments of the type specified in paragraph 852-20-25-2.

##### **852-20-15-3**

The guidance in this Subtopic does not apply to the following transactions and activities:

- a. Quasi-reorganizations involving only deficit reclassifications
- b. Charges against additional paid-in capital in other types of readjustments such as readjustments for the purpose of correcting erroneous credits made to additional paid-in capital in the past
- c. Financial reporting for entities that enter and intend to emerge from **Chapter 11** reorganization, at the time of such reorganization.

A quasi-reorganization is an accounting procedure that involves reclassifying accumulated deficits against other surplus equity accounts and remeasuring assets and liabilities. The accounting for quasi-reorganizations does not address entities that enter and intend to emerge from Chapter 11 reorganizations (which are accounted for under ASC 852-10).

## 8.2

### Criteria to apply quasi-reorganization accounting

### Excerpt from Accounting Standards Codification

#### Reorganizations – Quasi-Reorganizations

##### *Recognition*

##### **852-20-25-1**

This Section addresses the conditions under which a corporation may recognize a readjustment of its retained earnings or accumulated deficit balance.

##### **852-20-25-2**

The general requirement is that additional paid-in capital, however created, shall not be used to relieve the income account of the current or future years of charges that would otherwise be made to the income account. As an exception to this requirement, if a reorganized entity would be relieved of charges that would be required to be made against income if the existing corporation were continued, it may be 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.

##### **852-20-25-3**

If a corporation elects to restate its assets, capital stock, additional paid-in capital, and retained earnings or accumulated deficit through a readjustment and therefore avail itself of permission to relieve its future income account or retained earnings account of charges that would otherwise be made against it, it shall make a clear report to its shareholders of the restatements proposed to be made, and obtain their formal consent. It shall 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 that justify charges to additional paid-in capital.

The primary benefit of quasi-reorganization accounting is that an entity is able to eliminate an accumulated deficit against other equity accounts and remeasure its assets to fair value, without the cost and obstacles of a formal legal proceeding. This outcome would be desirable for many entities that have incurred losses and want a clean slate (no accumulated deficit) once they begin generating income. However, application of quasi-reorganization would reduce the comparability of the resulting financial statements with those of prior periods. Therefore, to prevent abuse, US GAAP allows this accounting procedure only when certain criteria are met.

Under ASC 852-20, an entity can apply quasi-reorganization accounting only if it:

- ▶ Provides the following to its shareholders:
  - ▶ The facts related to the quasi-reorganization
  - ▶ The proposed adjustments resulting from the quasi-reorganization
  - ▶ A balance sheet as of the date of the readjustment, in which the adjustment of carrying amounts is reasonably complete
- ▶ Obtains formal consent from its shareholders (see section 8.2.1, *Shareholder consent*)

The SEC staff specified conditions, which are codified in ASC 852-20-S99-1, that registrants must meet to apply quasi-reorganization accounting. We believe these criteria also should be used by a privately held entity when determining whether it is appropriate to apply quasi-reorganization accounting.

### Excerpt from Accounting Standards Codification

#### Reorganizations – Quasi Reorganizations

##### *SEC Materials*

##### **852-20-S99-1**

The following is the text of FRR 210. Quasi-reorganization.

ASR 25: (5/29/41)

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 a new corporate entity and without the intervention of formal court proceedings, is enabled to eliminate a deficit whether resulting from operations of 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 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 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 principle 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.

***SEC Materials, SEC Staff Guidance***

***Staff Accounting Bulletins***

***SAB Topic 5.S, Quasi-Reorganization***

***852-20-S99-2***

The following is the text of SAB Topic 5.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<sup>FN21</sup> 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.

<sup>FN21</sup> 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.

**Question 1:** May the company reclassify its capital accounts to eliminate the accumulated deficit without satisfying all of the conditions enumerated in Section 210<sup>FN22</sup> of the Codification of Financial Reporting Policies for a quasi-reorganization?

<sup>FN22</sup> ASR 25.

**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<sup>FN23</sup> for a quasi-reorganization are satisfied.<sup>FN24</sup>

<sup>FN23</sup> 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.

<sup>FN24</sup> In addition, FASB ASC Subtopic 852-20, Reorganizations–Quasi-Reorganizations, outlines procedures that must be followed in connection with and after a quasi-reorganization.

As discussed in ASC 852-20-S99-1, the SEC staff specified that all of the following additional conditions must be met to apply quasi-reorganization accounting:

- ▶ Retained earnings must be exhausted as of the date of the quasi-reorganization.
- ▶ Upon completion of the quasi-reorganization, no deficit exists in any (equity) surplus account.
- ▶ The registrant must notify all persons entitled to vote on matters of general corporate policy, and such persons must consent in advance to the transactions in accordance with the applicable laws and governing documents (e.g., the registrant must obtain approval from its board of directors) (see section 8.2.1, *Shareholder consent*).
- ▶ The registrant must restate its assets and liabilities.
- ▶ The registrant may not apply quasi-reorganization accounting repeatedly; rather quasi-reorganization accounting may be applied only when a reorganization or formation of a new corporation would be justified (see section 8.2.2, *Expectations of future profitability/losses*).

Before the SEC staff issued this guidance, some registrants eliminated an accumulated deficit against paid-in capital without restating assets or liabilities and referred to the procedure as a quasi-reorganization. However, the SEC staff emphasized in ASC 852-20-S99-1 that registrants cannot reclassify or eliminate a deficit in retained earnings unless they satisfy all the above conditions for a quasi-reorganization. It is rare that a registrant would meet the criteria to apply quasi-reorganization accounting, particularly when considering the specific conditions that must be met. We believe a privately held entity should also use these criteria when determining whether to apply quasi-reorganization accounting.

### 8.2.1 Shareholder consent

ASC 852-20-25-3 states that an entity must obtain shareholders' formal consent to the quasi-reorganization. In addition, the SEC requires entities to notify all persons entitled to vote on matters of general corporate policy and obtain the appropriate consents to the quasi-reorganization in advance, in accordance with the applicable law and charter provisions. Before applying quasi-reorganization accounting, management should consider obtaining a legal opinion on whether the entity meets these criteria. This determination likely depends on the corporate governance laws of the jurisdiction in which the entity is incorporated.

If the entity has debt outstanding at the date of the quasi-reorganization, management also should consider whether it is required to notify and receive approval from the lender to execute the quasi-reorganization.

### 8.2.2 Expectations of future profitability/losses

An entity cannot apply quasi-reorganization accounting until the conditions that resulted in the entity's deficit have been resolved and recurrence of a deficit is unlikely. The quasi-reorganization may correspond with, for example, infusing new capital, hiring new management or discontinuing loss operations (see our FRD, *Discontinued operations*, for additional guidance).

The requirement for an entity to be profitable after a quasi-reorganization stems from ASC 852-20-25-3, which states that as a condition to apply quasi-reorganization accounting, there should be no continuation of the circumstances that justify charges to additional paid-in capital. ASC 852-20-S99-1 states that an entity cannot apply quasi-reorganization accounting repeatedly. That is, an entity can do so only when a reorganization or formation of a new corporation would be justified.

The SEC staff stated that it would question an entity's ability to meet the criteria in ASC 852-20 if management does not expect the entity to be profitable on a US GAAP basis after the quasi-reorganization.<sup>21</sup> For example, an entity generally would not qualify for quasi-reorganization accounting if it expected to incur operating losses in the next interim period or year.

Predicting future earnings requires estimates and judgments of future events. The assumptions and projections used should not change based on the nature of the asset or accounting issue being analyzed. In other words, management should not use one set of projections for evaluating whether an entity will be profitable for assessing whether the criteria are met for quasi-reorganization accounting, while using different projections for evaluating impairment of goodwill or long-lived assets, or realizability of a deferred tax asset. The SEC staff questions entities that use projections for accounting that differ from those shared with analysts and investors, including in MD&A or other documents containing the financial statements. Management also should consider the effects of measurement adjustments that would result from quasi-reorganization (see section 8.3.2, *Adjustments to assets and liabilities*).

## 8.3 Recognition of quasi-reorganization accounting

If an entity meets the criteria for quasi-reorganization accounting, a new basis of accounting is established in the entity's financial statements using the following steps:

- ▶ Determine the effective date
- ▶ Determine the necessary readjustments to assets and liabilities
- ▶ Determine other readjustments (e.g., those resulting from a change in accounting principle)
- ▶ Record the resulting readjustments to equity accounts, including retained earnings and additional paid-in capital

### 8.3.1 Effective date of readjustment

#### Excerpt from Accounting Standards Codification

##### Reorganizations – Quasi-Reorganizations

##### *Recognition*

##### **852-20-25-5**

The effective date of the readjustment, from which the income of the entity is subsequently determined, shall be as near as practicable to the date on which formal consent of the stockholders is given, and shall ordinarily not be before the close of the last completed fiscal year. When the readjustment has been completed, the entity's accounting shall be substantially similar to that appropriate for a new entity.

<sup>21</sup> 19<sup>th</sup> Annual National Conference on Current SEC Developments – “Quasi-Reorganizations,” 1992.

## 8.3.2 Adjustments to assets and liabilities

### Excerpt from Accounting Standards Codification

#### Reorganizations – Quasi-Reorganizations

##### *Initial Measurement, General*

##### **852-20-30-2**

A write-down of assets below amounts that are likely to be subsequently realized, though it may result in conservatism in the balance sheet at the readjustment date, may also result in overstatement of earnings or of retained earnings when the assets are subsequently realized. Therefore, in general, assets shall 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 subsequently employed by the entity.

##### **852-20-30-3**

If the fair value of any asset is not readily determinable a conservative estimate may be made, but in that case the amount shall be described as an estimate. Paragraph 852-20-35-2 describes the subsequent accounting for any material difference arising through realization or otherwise and not attributable to events occurring or circumstances arising after that date.

##### **852-20-30-4**

Similarly, if potential losses or charges are known to have arisen before the date of readjustment but such amounts are then indeterminate, provision may properly be made to cover the maximum probable losses or charges.

##### *SEC Materials, SEC Staff Guidance*

##### *Staff Accounting Bulletins*

##### *SAB Topic 5.S, Quasi-Reorganization*

##### **852-20-S99-2**

The following is the text of SAB Topic 5.S, Quasi-Reorganization.

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.

In quasi-reorganization accounting, assets and liabilities are generally measured at fair value, subject to the limitation described below. Therefore, an entity would adjust the carrying amounts of assets or liabilities to fair value, if such adjustments are supportable. See our FRD, ***Fair value measurement***, for additional guidance on determining fair value and the required disclosures. It would be rare that the fair value of any asset is not readily determinable.

The adjustments for quasi-reorganization accounting to an entity's balance sheet generally incorporate many of the concepts applied in the accounting for business combinations (e.g., accounting for deferred revenue or contract liabilities to customers). See section 4 of our FRD, ***Business combinations***, for more discussion. However, quasi-reorganization accounting should not result in an increase of net assets.

Before the issuance of the guidance codified in ASC 852-20, some entities eliminated an accumulated deficit against paid-in capital without restating assets or liabilities and referred to the procedure as a quasi-reorganization. However, the SEC staff emphasized that entities need to determine whether any changes in the carrying amounts of assets and liabilities are necessary when applying quasi-reorganization accounting, and this guidance was codified in ASC 852-20-S99-2. That is, an entity cannot eliminate an accumulated deficit and call it a “quasi-reorganization” without appropriately considering whether any adjustments to assets or liabilities are needed.

Impairments of long-lived assets and goodwill or other adjustments that should be reflected in operating results are not quasi-reorganization adjustments. Quasi-reorganization accounting should not replace other US GAAP as it relates to the proper recording of impairments. See our FRD, *Impairment or disposal of long-lived assets*, for additional guidance.

Similarly, increases to a valuation allowance that should be reflected in the income tax provision prior to the quasi-reorganization are not quasi-reorganization adjustments. However, when recording adjustments to assets and liabilities that are a direct result from the quasi-reorganization, management should consider the effects on the differences between their tax basis and basis for financial reporting purposes. Any resulting adjustments to deferred tax assets or liabilities should be recorded as a part of the quasi-reorganization adjustment, including any resulting change in the valuation allowance. See section 16 of our FRD, *Income taxes*, for additional guidance.

See section 2, *Before bankruptcy or liquidation*, for other issues that may be applicable for an entity considering a quasi-reorganization. Any expenses recorded as a result of applying other US GAAP would generally be recorded through operations and not as quasi-reorganization adjustments.

See section 8.6, *Comprehensive example of quasi-reorganization accounting*, for an illustration of the issues discussed herein.

### 8.3.2.1

#### **Goodwill in a quasi-reorganization (updated March 2024)**

An entity applying quasi-reorganization accounting might have goodwill at the date of the readjustment. Economic and market conditions that cause a financial decline and poor performance often result in recording an impairment charge, which should precede quasi-reorganization accounting. See section 2.2, *Goodwill, intangible assets and long-lived assets*, and our FRD, *Intangibles – Goodwill and other*, for more guidance.

The question has arisen whether any goodwill remaining after impairment testing should survive the readjustment. The SEC staff noted that an entity applying quasi-reorganization accounting could have goodwill after the readjustment if the fair value of the business still justifies the amount recognized and all other assets and liabilities are stated at fair value.<sup>22</sup> However, an entity should not create goodwill because ASC 852-20 precludes a write-up of the book value of net assets. Therefore, if the fair value of net assets exceeds the book value of net assets at the date of the quasi-reorganization, the SEC staff believes that any excess should be eliminated by reducing (in the following order):

- ▶ Goodwill
- ▶ Other intangible assets
- ▶ Other noncurrent assets

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<sup>22</sup> Comments by Jeffrey A. Swormstedt, Professional Accounting Fellow, at the 1993 AICPA National Conference on SEC Developments.



See section 8.6, *Comprehensive example of quasi-reorganization accounting*, for an illustration of the issues discussed herein.

If goodwill remains after a quasi-reorganization, an entity would follow the guidance in ASC 350 to assign that goodwill to one or more reporting units as of the date of the quasi-reorganization and to test goodwill for impairment thereafter. The method used to assign goodwill to each reporting unit should be reasonable, supportable and consistently applied. The method should be consistent with the objectives of the process of assigning goodwill to reporting units in ASC 350-20-35-42 through 43 (see section 3.11 of our FRD, *Intangibles – Goodwill and other*).

### 8.3.2.2 Debt restructurings concurrent with a quasi-reorganization

#### Excerpt from Accounting Standards Codification

##### Debt – Troubled Debt Restructurings by Debtors

##### Scope and Scope Exceptions

##### 470-60-15-10

The guidance in this Subtopic shall be applied to all troubled debt restructurings including those consummated under reorganization, arrangement, or other provisions of the Federal Bankruptcy Act or other federal statutes related thereto. This Subtopic does not apply, however, if under provisions of those federal statutes or in a quasi-reorganization or corporate readjustment (see Topic 852) with which a troubled debt restructuring coincides, the debtor restates its liabilities generally, that is, if such restructurings or modifications accomplished under purview of the bankruptcy court encompass most of the amount of the debtor's liabilities.

The accounting for a modification or extinguishment of debt concurrent with a quasi-reorganization should be evaluated under ASC 470-50 (not ASC 470-60). See section 2.5.1 and 2.6.2 of our FRDs, *Issuer's accounting for debt and equity financings (before the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)*, or *Issuer's accounting for debt and equity financings (after the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)*, as applicable, for additional guidance.

The SEC staff has stated that any income statement effects of a debt restructuring should be recorded in the statement of operations prior to the quasi-reorganization (in the predecessor's financial statements).<sup>23</sup>

The SEC staff has interpreted the prohibition in ASC 852-20 against a write-up of net assets to apply to the valuation adjustments required to restate assets and liabilities to fair value, and not to the effect of concurrent transactions, such as a debt restructuring. As a result, the accounting for a concurrent debt restructuring could increase net assets, whereas any other adjustments to assets and liabilities pursuant to quasi-reorganization accounting should not increase net assets.

### 8.3.2.3 Pension/OPEB in a quasi-reorganization

ASC 715 provides guidance on the accounting for pension and other postretirement benefits. This guidance continues to apply if an entity modifies or terminates a pension or other postretirement benefit plan in a quasi-reorganization. Any adjustments resulting from applying ASC 715 would be recorded in the operations of the entity prior to the quasi-reorganization.

<sup>23</sup> 19<sup>th</sup> Annual National Conference on Current SEC Developments – “Quasi-Reorganizations, 1992.

ASC 852-20 generally requires an entity to record assets and liabilities at fair value, following many of the same principles that are applied in ASC 805 in accounting for business combinations. Employee benefits that are in the scope of ASC 715 are exceptions to the recognition and measurement criteria of ASC 805 and are accounted for in accordance with the applicable standards (see section 4.3.1 of our FRD, *Business combinations*). Application of ASC 715 generally would result in the elimination of any previously unrecognized prior service cost, and actuarial gains or losses remaining in accumulated other comprehensive income in a business combination. We believe the exceptions in ASC 805 likewise would apply to employee benefits in a quasi-reorganization. That is, we believe an entity would account for employee benefits under ASC 715 in a quasi-reorganization rather than at fair value as otherwise would be required by ASC 852-20.

### 8.3.3 Accounting policy and principle changes

#### Excerpt from Accounting Standards Codification

##### Reorganizations – Quasi-Reorganizations

##### *SEC Materials, SEC Staff Guidance*

##### *Staff Accounting Bulletins*

##### *SAB Topic 5.S, Quasi-Reorganization*

##### *852-20-S99-2*

The following is the text of SAB Topic 5.S, 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 GAAP with respect to the change. <sup>FN25</sup>

<sup>FN25</sup> FASB ASC Topic 250 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.

FASB ASC paragraph 852-20-25-5 (Reorganizations Topic) indicates that, following a quasi-reorganization, an “entity’s accounting shall be substantially similar to that appropriate for a new entity.” 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. <sup>FN26</sup> FASB ASC paragraph 852-20-30-2 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 subsequently employed by the entity.*” (emphasis added)

<sup>FN26</sup> 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. <sup>FN27</sup>

<sup>FN27</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.

The SEC staff stated in SAB Topic 5.S that any anticipated discretionary accounting changes must be recorded prior to, or as part of, the quasi-reorganization (not after). In addition, newly issued accounting standards that allow early adoption also should be adopted as part of the quasi-reorganization. The SEC staff stated that entities that intend to adopt such new standards or other discretionary accounting changes within 12 months following the quasi-reorganization should adopt the new accounting prior to or as part of the quasi-reorganization. Discretionary accounting changes are subject to ASC 250. We believe this guidance also should be applied by private entities.

### 8.3.4

## Adjustments to equity accounts

### Excerpt from Accounting Standards Codification

#### Reorganizations – Quasi-Reorganizations

##### *Recognition*

##### **852-20-25-4**

When the amounts to be written off in a readjustment have been determined, they shall be charged first against retained earnings to the full extent of such retained earnings; any balance may then be charged against additional paid-in capital. An entity that has subsidiaries shall apply this rule in such a way that no consolidated retained earnings survive a readjustment in which any part of losses has been charged to additional paid-in capital. If the retained earnings of any subsidiaries cannot be applied against the losses before application against additional paid-in capital, the parent entity's interest in such retained earnings shall be regarded as capitalized by the readjustment just as retained earnings at the date of acquisition is capitalized, so far as the parent is concerned.

##### **852-20-25-6**

Additional paid-in capital originating in such a readjustment is restricted in the same manner as that of a new corporation; charges against it shall be only those which may properly be made against the additional paid-in capital of a new corporation.

#### Equity – Overall

##### *Recognition*

##### **505-10-25-2**

All of the following shall be excluded from the determination of net income or the results of operations under all circumstances...

c. Adjustments made pursuant to a quasi-reorganization (see Subtopic 852-20 for information concerning quasi-reorganizations).

After the entity records all required charges in operations (that is, those that would be otherwise required by US GAAP), quasi-reorganization adjustments are recorded as follows:

- ▶ First, against retained earnings, to the extent it exists (which is unlikely, since ASC 852-20-S99-2 requires retained earnings to be exhausted for quasi-reorganization accounting to be applicable)
- ▶ Next, against additional paid-in capital

- ▶ Finally, to common stock
- ▶ Adjustments made under a quasi-reorganization are not recorded in net income or the results of operations.
- ▶ Entities should not record any additional paid-in capital as a result of the quasi-reorganization; charges against additional paid-in capital are limited to those that would be recorded for a new entity. Shareholders' equity in total, and in each component therein, must be positive after the quasi-reorganization accounting.
- ▶ An entity eliminates the accumulated other comprehensive income (loss) in equity as part of the quasi-reorganization adjustments, since a new entity would not have any amounts accumulated in equity. For example, this would include unrealized gains or losses on available-for-sale securities, foreign currency translation adjustments and pension obligations. Since the accumulated translation adjustment account is reset on the date of the quasi-reorganization, the exchange rate on that date becomes the new exchange rate for remeasuring the entity's financial statements to its functional currency. See section 3.2 of our FRD, *Foreign currency matters*, for additional guidance on remeasurement. See section 8.6, *Comprehensive example of quasi-reorganization accounting*, for an illustration of the issues discussed herein.

### 8.3.4.1

#### Consolidated groups

##### Excerpt from Accounting Standards Codification

##### Reorganizations – Quasi Reorganizations

##### SEC Materials

##### 852-20-S99-1

The following is the text of FRR 210. Quasi-reorganization.

ASR 25: (5/29/41)

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.

Parent entities should adjust equity so that no consolidated retained earnings survive a readjustment in which any losses were charged to additional paid-in capital. If the retained earnings of any subsidiaries cannot be applied against the losses before being applied against additional paid-in capital, the parent's interest in the subsidiary's retained earnings should be treated as if it were capitalized by the readjustment in the consolidated financial statements.

When a parent in a consolidated group applies quasi-reorganization accounting, the parent accounts for its controlled subsidiaries as if they were acquired on the effective date of the quasi-reorganization. That is, the parent applies the concepts in the accounting for business combinations to those subsidiaries. See section 4 of our FRD, *Business combinations*, for more guidance. As a result of applying business combination accounting, the retained earnings of a subsidiary are eliminated as of the date of the readjustment in the consolidated balance sheet. The quasi-reorganization accounting would be pushed down to the separate financial statements of any subsidiaries, since the quasi-reorganization is a new basis event.

## 8.4 Subsequent measurement

### Excerpt from Accounting Standards Codification

#### Reorganizations – Quasi-Reorganizations

##### *Initial Measurement, General*

##### **852-20-35-2**

If the fair value of any asset was not readily determinable and a conservative estimate was made at the date of the readjustment, any material difference arising through realization or otherwise and not attributable to events occurring or circumstances arising after that date shall not be carried to income or retained earnings. Similarly, if provisions for losses or charges established at the date of readjustment are subsequently found to have been excessive or insufficient, the difference shall not be carried to retained earnings nor used to offset losses or gains originating after the readjustment, but shall be recorded as additional paid-in capital.

In a quasi-reorganization, assets and liabilities are adjusted to fair value at the date of readjustment (see section 8.3.2, *Adjustments to assets and liabilities*). It would be rare for fair value not to be readily determinable. See our FRD, *Fair value measurement*, for guidance on determining fair value.

Any material difference between the amount recorded in the quasi-reorganization and the amount realized that is attributable to events occurring or circumstances arising before the readjustment date is recorded to additional paid-in capital, and not through income. Judgment is required to evaluate subsequent events under ASC 855, including determining whether the events provide evidence about conditions that existed at the date of quasi-reorganization, or evidence of conditions that arose after. See section 8.6, *Comprehensive example of quasi-reorganization accounting*, for an illustration.

### 8.4.1 Unwinding a quasi-reorganization

### Excerpt from Accounting Standards Codification

#### Reorganizations – Quasi-Reorganizations

##### *SEC Materials, SEC Staff Guidance*

##### *Staff Accounting Bulletins*

##### *SAB Topic 5.S, Quasi-Reorganization*

##### **852-20-S99-2**

The following is the text of SAB Topic 5.S, Quasi-Reorganization.

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 FASB ASC 250, Accounting Changes and Error Corrections, would preclude such a change in accounting. It states: “a method of accounting that was previously adopted for a type of transaction or event that is being terminated or that was a single, nonrecurring event in the past shall not be changed.”<sup>FN33</sup> (emphasis added.)

<sup>FN33</sup> FASB ASC paragraph 250-10-45-12.

An entity that applies quasi-reorganization accounting cannot reverse it later, regardless of the magnitude (or lack) of adjustments recorded. ASC 250 states that an entity cannot change the accounting method used for a single, nonrecurring event.

## 8.4.2 Income tax adjustments

See section 6 of our FRD, *Income taxes*, for guidance on recording a valuation allowance on deferred tax assets prior to a quasi-reorganization. See section 16 of our FRD, *Income taxes*, for guidance on accounting for income taxes in, or subsequent to, a quasi-reorganization.

## 8.5 Presentation and disclosure

Quasi-reorganization accounting changes an entity's financial statement presentation. Since quasi-reorganization accounting results in a new basis of accounting in the entity's financial statements, it is as if the old reporting entity were terminated and a new one was created. Therefore, it would not be appropriate to combine the periods before and after the quasi-reorganization, generally referred to as the "predecessor" (or "pre-reorganization") and "successor" (or "post-reorganization") periods, or something similar.

To emphasize this change in reporting entity, a black line should separate the successor and predecessor periods. For example, if the quasi-reorganization were effective on 30 September 2010, the successor entity's 31 December 2010 statements of operations, comprehensive income, cash flows and changes in shareholders' equity should include a nine-month predecessor period and a three-month successor period, separated by a black line. In addition, disclosures should be separated for the predecessor and the successor periods. See section 8.6, *Comprehensive example of quasi-reorganization accounting*, for an illustration of these issues.

The financial statements also should clearly disclose that the basis of presentation reflects quasi-reorganization accounting. They also should disclose the facts and circumstances of the quasi-reorganization, the adjustments recorded and the judgments and estimates made.

Entities that apply quasi-reorganization accounting would continue to apply other US GAAP that is not contrary to ASC 852-20. While ASC 852-20 provides specific measurement requirements, other US GAAP continues to apply, including requirements related to presentation and disclosure. For example, entities should consider the disclosure requirements of ASC 820. See our FRD, *Fair value measurement*, for additional guidance.

### 8.5.1 Dating of equity

#### Excerpt from Accounting Standards Codification

##### Reorganizations, Quasi-Reorganizations

###### Disclosure

###### 852-20-50-2

After such a readjustment, retained earnings previously accumulated cannot properly be carried forward under that title. A new retained earnings account shall be established, dated to show that it runs from the effective date of the readjustment, and this dating shall be disclosed in financial statements until such time as the effective date is no longer deemed to possess any special significance. The dating of retained earnings following a quasi-reorganization would rarely, if ever, be of significance after a period of 10 years. There may be exceptional circumstances in which the discontinuance of the dating of retained earnings could be justified at the conclusion of a period less than 10 years.

After a quasi-reorganization, the retained earnings accumulated prior to the readjustment date cannot be carried forward. The entity establishes a new retained earnings account dated to show that it runs from the effective date of the readjustment. ASC 852-20 states that the entity should continue to date retained earnings until the effective date no longer carries any special significance, which would rarely be longer than 10 years. In addition, ASC 852-20 states that there may be exceptional circumstances under which the dating of retained earnings may stop in fewer than 10 years.

However, Regulation S-X 210.5-02 paragraph 30(b) requires a registrant to date retained earnings for at least 10 years. In addition, for at least three years, a registrant is required to disclose the deficit eliminated on the face of the balance sheet.

For investment companies regulated under the Investment Company Act of 1940, special guidance applies for the calculation and disclosure of accumulated undistributed net income and accumulated undistributed net profits from the sale of securities or other properties, after a quasi-reorganization.<sup>24</sup>

## 8.5.2 SEC reporting in a quasi-reorganization

In advance of completing a quasi-reorganization, a registrant might need to seek the approval of its shareholders, which might require filing proxy statements. The SEC staff has asked registrants to disclose the following:

- ▶ Reasons the quasi-reorganization would be in the best interest of the registrant and its stockholders (e.g., reasons why the quasi-reorganization will mitigate prior issues faced by the registrant and the benefits that will result from this quasi-reorganization)
- ▶ Expected effects that a quasi-reorganization could have on future periods
- ▶ Reasons the registrant expects to be profitable in future periods

In addition, pro forma financial information reflecting quasi-reorganization accounting may be required in a Form 8-K, SEC registration statements and proxy statements. Article 11 requires registrants to provide pro forma financial information if material events or transactions have occurred or are probable of occurring and if disclosure of pro forma financial information would be material to investors, which could include a quasi-reorganization. The Article 11 requirements apply to all registrants, although smaller reporting companies can condense the information in accordance with Regulation S-X 8-03(a).

Pro forma financial information prepared in accordance with Article 11 generally includes a condensed income statement for the latest year and subsequent year-to-date interim period, a condensed balance sheet as of the end of the latest period presented, and accompanying explanatory notes.

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<sup>24</sup> Investment Company Act of 1940, Rule 270.19a-1(c)

## 8.6 Comprehensive example of quasi-reorganization accounting

The following is a comprehensive example illustrating a quasi-reorganization in which the fair value of the net assets exceeds the book value of the net assets at the date of the quasi-reorganization.

### Illustration 8-1: Comprehensive example of quasi-reorganization accounting

An entity determines that it meets all of the requirements for quasi-reorganization accounting on 31 December 20X0. The following worksheet illustrates the adjustments recorded by the entity, excluding the effect of income taxes.

| (in thousands)                              | (1)<br>Before the<br>quasi-<br>reorganization | (2)<br>Adjustments<br>recorded in<br>operations of<br>the predecessor | (3)<br>Quasi-<br>reorganization<br>adjustments | (4) = (1+2+3)<br>After quasi-<br>reorganization |
|---|---|---|--|---|
| <b>Assets</b>                               |   |   |  |   |
| Cash and cash equivalents                   | \$ 600  | \$ -  | \$ -   | \$ 600  |
| Accounts receivable, net                    | 1,000   | (10) (a)  | -  | 990   |
| Inventories                                 | 2,000   | (40) (b)  | -  | 1,960   |
| Other current assets                        | 700   | -   | -  | 700   |
| Total current assets                        | <u>4,300</u>                                  | <u>(50)</u>   | <u>-</u>                                       | <u>4,250</u>                                    |
| Property and equipment, net                 | 2,500   | (200) (c)   | -  | 2,300   |
| Intangible assets, net                      | 900   | -   | 1,800 (g)                                      | 2,700   |
| Goodwill                                    | 1,300   | -   | (1,300) (g)                                    | -   |
| Total assets                                | <u>\$ 9,000</u>                               | <u>\$ (250)</u>   | <u>\$ 500</u>                                  | <u>\$ 9,250</u>                                 |
| <b>Liabilities and shareholders' equity</b> |   |   |  |   |
| Accounts payable                            | \$ 1,300                                      | \$ -  | \$ -   | \$ 1,300  |
| Notes payable                               | 2,900   | -   | -  | 2,900   |
| Total current liabilities                   | <u>4,200</u>                                  | <u>-</u>  | <u>-</u>                                       | <u>4,200</u>                                    |
| Long-term debt                              | 3,300   | -   | 500 (f)  | 3,800   |
| Total liabilities                           | <u>7,500</u>                                  | <u>-</u>  | <u>500</u>                                     | <u>8,000</u>                                    |
| Common stock                                | 600   | -   | -  | 600   |
| Additional paid-in capital                  | 2,150   | -   | (1,500) (h)                                    | 650   |
| Retained earnings (deficit)                 | (1,250)                                       | (250) (e)   | 1,500 (h)                                      | -   |
| Total equity                                | <u>1,500</u>                                  | <u>(250)</u>  | <u>-</u>                                       | <u>1,250</u>                                    |
| Total liabilities and shareholders' equity  | <u>\$ 9,000</u>                               | <u>\$ (250)</u>   | <u>\$ 500</u>                                  | <u>\$ 9,250</u>                                 |

<sup>(a)</sup> Immediately before the quasi-reorganization, management determined that accounts receivable of \$10 were uncollectible. The entity recorded bad debt expense of \$10, which is included in loss from operations (net loss) in the predecessor financial statements.

<sup>(b)</sup> Immediately before the quasi-reorganization, management determined that write-downs were needed to measure inventory at the lower of cost or market. The entity recorded an expense of \$40, which is included in loss from operations (net loss) in the predecessor financial statements.

<sup>(c)</sup> Immediately before the quasi-reorganization, management tested property and equipment for impairment and determined that its fair value was \$2,300. The entity recorded an impairment charge of \$200 (\$2,500 less \$2,300) related to certain equipment, which is included in loss from operations (net loss) in the predecessor financial statements.

<sup>(d)</sup> The entity also tested goodwill and intangible assets for impairment under ASC 350, but determined that no impairment charge was necessary.

<sup>(e)</sup> As a result of the expenses recorded in entries (a) – (d), the entity records a net loss of \$250, which is reflected in the accumulated deficit in the predecessor financial statements.

<sup>(f)</sup> The entity determined that the fair value of the long-term debt is \$3,800. As a result, management increased the long-term debt by \$500 (\$3,800 less \$3,300), primarily due to changes in interest rates.



<sup>(g)</sup> Management determined the adjustments to intangible assets and goodwill by first determining the carrying amount of the net assets prior to quasi-reorganization, which reflects the following:

|   |          |
|---|----------|
| Total assets (Column 1)                                     | \$ 9,000 |
| Total liabilities (Column 1)                                | (7,500)  |
| Adjustments recorded in operations (Column 2)               | (250)    |
| Carrying amount of net assets prior to quasi-reorganization | \$ 1,250 |

The excess of the fair value of the net assets over the carrying amount of the net assets prior to the quasi-reorganization is calculated as follows:

|  |          |
|--|----------|
| Fair values (as determined by management):                       |          |
| Current assets (\$4,300 less \$10 less \$40, as per (a) and (b)) | \$ 4,250 |
| Property and equipment (c)                                       | 2,300    |
| Intangible assets  | 3,000    |
| Current liabilities (see Column 1)                               | (4,200)  |
| Long-term liabilities (f)  | (3,800)  |
| Estimated fair value of net assets                               | 1,550    |
| Carrying amount of net assets prior to quasi-reorganization      | 1,250    |
| Excess   | \$ 300   |

Since the fair value of the net assets exceed their carrying amount by \$300, and a net write-up of assets is prohibited in a quasi-reorganization, the assets cannot be written up to their full fair value. Based on the hierarchy described in section 8.3.2.1, *Goodwill in a quasi-reorganization*, the excess is deducted from the fair value of the intangible assets (goodwill is not reflected in the table above, and is therefore eliminated in its entirety, even though no impairment existed under ASC 350). The \$300 excess is allocated as a pro rata reduction to the intangible assets. The intangible assets are increased by \$1,800 (fair value of \$3,000 less allocated excess of \$300 less carrying amount of \$900).

| (amounts in thousands)  | Carrying amount<br>prior to quasi-<br>reorganization | Fair value | % of fair<br>value | Allocated<br>amount | Amount allocated<br>after quasi-<br>reorganization | Net<br>write-up |
|-------------------------|--|------------|--------------------|---------------------|--|-----------------|
| Contractual rights      | \$ 400   | \$ 900     | 30%                | \$ (90)             | \$ 810   | \$ 410          |
| Patents                 | 300  | 1,500      | 50%                | (150)               | 1,350  | 1,050           |
| Customer relationships  | 200  | 600        | 20%                | (60)                | 540  | 340             |
| Total intangible assets | \$ 900   | \$ 3,000   |                    | \$ (300)            | \$ 2,700   | \$1,800         |

<sup>(h)</sup> The entity recorded the resulting adjustments to eliminate the deficit against additional paid-in capital.

The ending net assets of \$1,250 is the same as the net assets before the quasi-reorganization after recording the charges in operations (\$1,500 less \$250). The quasi-reorganization adjustments do not increase net assets.

Assume that the entity earned \$100 in 20X1 after the quasi-reorganization, which was completed 31 December 20X0. An excerpt of the entity's consolidated balance sheets follows:

| (amounts in thousands)  | Predecessor      | Successor        |
|---|------------------|------------------|
|   | 31 December 20X0 | 31 December 20X1 |
| Common stock  | \$ 600           | \$ 600           |
| Additional paid-in capital  | 2,150            | 650              |
| Retained earnings since 1 January 20X1, in connection with quasi-reorganization | -                | 100              |
| Accumulated deficit (before the quasi-reorganization)                           | (1,500)          | -                |
| Total stockholder's equity  | \$ 1,250         | \$ 1,350         |

The following illustrates a fact pattern in which the goodwill remains after the quasi-reorganization.

**Illustration 8-2: Comprehensive example of quasi-reorganization accounting – goodwill remaining**

An entity determines that it meets all of the requirements for quasi-reorganization accounting. The following worksheet illustrates the adjustments recorded by the entity, excluding the effect of income taxes.

| (in thousands)                                | Before the<br>quasi-<br>reorganization | Adjustments<br>recorded in<br>operations of<br>the predecessor | Quasi-<br>reorganization<br>adjustments | After quasi-<br>reorganization |
|---|--|--|---|--------------------------------|
| <b>Assets</b>                                 |  |  |   |                                |
| Cash and cash equivalents                     | \$ 600                                 | \$ -   | \$ -                                    | \$ 600                         |
| Accounts receivable, net                      | 1,000                                  | (10) (a)   | -                                       | 990                            |
| Inventories                                   | 2,000                                  | (40) (b)   | -                                       | 1,960                          |
| Other current assets                          | 700                                    | -  | -                                       | 700                            |
| Total current assets                          | <u>4,300</u>                           | <u>(50)</u>  | <u>-</u>                                | <u>4,250</u>                   |
| Property and equipment, net                   | 2,500                                  | (200) (c)  | -                                       | 2,300                          |
| Intangible assets, net                        | 900                                    | -  | -                                       | 900 (g)                        |
| Goodwill                                      | 1,300                                  | -  | (400) (d)                               | 900 (g)                        |
| Total assets                                  | <u>\$ 9,000</u>                        | <u>\$ (250)</u>  | <u>\$ (400)</u>                         | <u>\$ 8,350</u>                |
| <b>Liabilities and shareholders' equity</b>   |  |  |   |                                |
| Accounts payable                              | \$ 1,300                               | \$ -   | \$ -                                    | \$ 1,300                       |
| Notes payable                                 | 2,900                                  | -  | -                                       | 2,900                          |
| Total current liabilities                     | <u>4,200</u>                           | <u>-</u>   | <u>-</u>                                | <u>4,200</u>                   |
| Long-term debt                                | 3,300                                  | -  | (400) (f)                               | 2,900                          |
| Total liabilities                             | <u>7,500</u>                           | <u>-</u>   | <u>(400)</u>                            | <u>7,100</u>                   |
| Common stock                                  | 600                                    | -  | -                                       | 600                            |
| Additional paid-in capital                    | 2,150                                  | -  | (1,500) (h)                             | 650                            |
| Retained earnings (deficit)                   | (1,250)                                | (250) (e)  | 1,500 (h)                               | -                              |
| Total equity                                  | <u>1,500</u>                           | <u>(250)</u>   | <u>-</u>                                | <u>1,250</u>                   |
| Total liabilities and<br>shareholders' equity | <u>\$ 9,000</u>                        | <u>\$ (250)</u>  | <u>\$ (400)</u>                         | <u>\$ 8,350</u>                |

Entries (a) to (e) are the same as in Illustration 8-1.

<sup>(f)</sup> The entity determined that the fair value of the long-term debt is \$2,900. As a result, management decreased to the carrying amount of the long-term debt by \$400 (\$2,900 less \$3,300). The decrease in the fair value of the long-term debt is primarily due to changes in interest rates.

<sup>(g)</sup> After considering whether all intangible assets were identified and recognized at their current fair values, management determined the fair value of the long-lived assets approximated their carrying amounts. Therefore, since liabilities decreased by \$400, assets must decrease by the same amount so that there is no write-up of net assets. Accordingly, goodwill is also reduced by \$400, leaving \$900 of goodwill. Management believes that the fair value of the business exceeds the fair value of the identifiable net assets of \$1,250, and thus the goodwill is supportable.

The carrying amount of the net assets before the quasi-reorganization reflects the following:

|   |                 |
|---|-----------------|
| Total assets  | \$ 9,000        |
| Total liabilities   | (7,500)         |
| Adjustments recorded in operations <sup>(e)</sup>           | (250)           |
| Carrying amount of net assets prior to quasi-reorganization | <u>\$ 1,250</u> |

<sup>(h)</sup> The entity recorded the resulting adjustments to eliminate the deficit against additional paid-in capital.

The ending net assets of \$1,250 (\$8,350 less \$7,100) is the same as the net assets prior to quasi-reorganization, after recording the charges in operations (\$1,500 less \$250). The quasi-reorganization adjustments do not increase net assets.

**Illustration 8-3: Subsequent measurement**

At the date of a quasi-reorganization, management identified a contingent loss related to an event that occurred prior to the quasi-reorganization, for which the range of probable loss was \$0 to \$1 million. Before the quasi-reorganization, management was unable to determine any point within that range that represented its best estimate. Accordingly, the entity previously accrued the low end of the range of \$0, in accordance with ASC 450. Upon applying quasi-reorganization accounting, management continued to believe that \$0 was the best estimate of the loss, and therefore nothing was accrued in quasi-reorganization accounting.

After the quasi-reorganization, the entity determines that the contingency will be settled for \$1 million. Management concludes that the change is not due to changes in facts and circumstances after the readjustment, and that the difference would be material to the entity's financial statements.

Therefore, the credit would be recorded to additional paid-in capital rather than as an expense.

# A **Summary of important changes**

The following highlights important changes to this publication since the April 2023 edition:

- ▶ Sections 2.4.2 and 3.8.1 were updated to reflect the adoption of ASU 2016-13.
- ▶ Sections 2.16, 3.9.9 and 4.4.1 were updated to reflect the adoption of 2016-02.
- ▶ Sections 3.9.1 and 8.3.2.1 were updated to reflect the adoption of 2017-04.

# B Abbreviations used in this publication

Entities operating in bankruptcy continue to apply US GAAP. Accounting and financial reporting guidance specific to periods subsequent to filing for bankruptcy protection is provided in the following authoritative sources.

| <b>Abbreviation</b> | <b>FASB Accounting Standard Codification</b>   |
|---------------------|--|
| ASC 205             | FASB ASC Topic 205, Presentation of Financial Statements                                     |
| ASC 205-20          | FASB ASC Topic 205-20, Presentation of Financial Statements, Discontinued Operations         |
| ASC 205-30          | FASB ASC Topic 205-30, Presentation of Financial Statements, Liquidation basis of accounting |
| ASC 205-40          | FASB ASC Topic 205-40, Presentation of Financial Statements, Going Concern                   |
| ASC 210             | FASB ASC Topic 210, Balance Sheet  |
| ASC 220             | FASB ASC Topic 220, Income Statement – Reporting Comprehensive Income                        |
| ASC 230             | FASB ASC Topic 230, Statement of Cash Flows  |
| ASC 250             | FASB ASC Topic 250, Accounting Changes and Error Corrections                                 |
| ASC 260             | FASB ASC Topic 260, Earnings Per Share   |
| ASC 275             | FASB ASC Topic 275, Risks and Uncertainties  |
| ASC 280             | FASB ASC Topic 280, Segment Reporting  |
| ASC 310             | FASB ASC Topic 310, Receivables  |
| ASC 321             | FASB ASC Topic 321, Investments – Equity Securities  |
| ASC 323             | FASB ASC Topic 323, Investments – Equity Method and Joint Ventures                           |
| ASC 326             | FASB ASC Topic 326, Financial Instruments – Credit Losses                                    |
| ASC 350             | FASB ASC Topic 350, Intangibles – Goodwill and Other   |
| ASC 360             | FASB ASC Topic 360, Property, Plant, and Equipment   |
| ASC 405             | FASB ASC Topic 405, Liabilities  |
| ASC 420             | FASB ASC Topic 420, Exit or Disposal Cost Obligations  |
| ASC 450             | FASB ASC Topic 450, Contingencies  |
| ASC 460             | FASB ASC Topic 460, Guarantees   |
| ASC 470             | FASB ASC Topic 470, Debt   |
| ASC 480             | FASB ASC Topic 480, Distinguishing Liabilities from Equity                                   |
| ASC 505             | FASB ASC Topic 505, Equity   |
| ASC 606             | FASB ASC Topic 606, Revenue from Contracts with Customers                                    |
| ASC 715             | FASB ASC Topic 715, Compensation – Retirement Benefits                                       |
| ASC 718             | FASB ASC Topic 718, Compensation – Stock Compensation  |
| ASC 740             | FASB ASC Topic 740, Income Taxes   |
| ASC 805             | FASB ASC Topic 805, Business Combinations  |
| ASC 810             | FASB ASC Topic 810, Consolidation  |
| ASC 815             | FASB ASC Topic 815, Derivatives and Hedging  |
| ASC 820             | FASB ASC Topic 820, Fair Value Measurements and Disclosures                                  |
| ASC 825             | FASB ASC Topic 825, Financial Instruments  |
| ASC 830             | FASB ASC Topic 830, Foreign Currency Matters   |

| <b>Abbreviation</b> | <b>FASB Accounting Standard Codification</b>                        |
|---------------------|---|
| ASC 835-30          | FASB ASC Topic 835-30, Interest, Imputation of Interest             |
| ASC 842             | FASB ASC Topic 842, Leases  |
| ASC 845             | FASB ASC Topic 845, Nonmonetary Transactions                        |
| ASC 852             | FASB ASC Topic 852, Reorganizations                                 |
| ASC 852-20          | FASB ASC Topic 852, Reorganizations, Quasi-reorganizations          |
| ASC 855             | FASB ASC Topic 855, Subsequent Events                               |
| ASC 946             | FASB ASC Topic 946, Financial Services – Investment Companies       |
| ASC 960             | FASB ASC Topic 960, Plan Accounting – Defined Benefit Pension Plans |

| <b>Abbreviation</b> | <b>Other Authoritative Standards</b>  |
|---------------------|---|
| ASU 2013-07         | Accounting Standards Update, Presentation of Financial Statements (Topic 205): Liquidation Basis of Accounting  |
| ASU 2016-13         | Accounting Standards Update, Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments                 |
| ASU 2022-02         | Accounting Standards Update, Financial Instruments – Credit Losses (Topic 326): Troubled Debt Restructurings and Vintage Disclosures                  |
| ASU 2021-08         | Accounting Standards Update, Business Combinations (Topic 805): Accounting for Contract Assets and Contract Liabilities from Contracts with Customers |

| <b>Abbreviation</b> | <b>Non-Authoritative Standards</b>  |
|---------------------|---|
| PB 11               | AICPA Practice Bulletin 11, Accounting for Preconfirmation Contingencies in Fresh-Start Reporting                 |
| SAB Topic 5.S       | SEC Staff Accounting Bulletin Topic 5.S, <i>Quasi-Reorganization</i>  |
| SOP 90-7            | AICPA Statement of Position No. 90-7, Financial Reporting by Entities in Reorganization Under the Bankruptcy Code |
| Statement 141       | FASB Statement 141, Business Combinations   |

# C Index of ASC references in this publication

| ASC paragraph | Section |  |
|---------------|---------|--|
| 205           | 3.3.2   | Liabilities subject to compromise when an entity is discontinuing an operation |
| 205-20        | 1.1     | Types of bankruptcies  |
| 205-20        | 2.9     | Restructurings, disposal or exit activities and discontinued operations        |
| 205-20        | 3.4.1   | Reorganization items related to discontinued operations                        |
| 205-20        | 4.4.12  | Discontinued operations upon emergence in fresh-start accounting               |
| 205-30        | 3.1.1   | Plans of liquidation   |
| 205-30        | 6.2     | When to apply the liquidation basis of accounting                              |
| 205-30        | 6.2.5   | Convenience date   |
| 205-30        | 6.3     | Applying liquidation basis accounting  |
| 205-30        | 6.3.5   | Change in accounting principles  |
| 205-30        | 6.3.8   | Foreign currency considerations  |
| 205-30-05-1   | 6.1     | Introduction   |
| 205-30-15-1   | 6.2.1   | Investment companies registered under the 1940 Act                             |
| 205-30-20     | 6.1     | Introduction   |
| 205-30-20     | 6.2.6   | Liquidation of an entity (including acquisitions, mergers and spin-offs)       |
| 205-30-20     | 6.4     | Financial statement presentation   |
| 205-30-20     | D       | Glossary   |
| 205-30-25-1   | 6.2.2   | Liquidation plan established at inception                                      |
| 205-30-25-2   | 6.2.4   | Determining when liquidation is imminent                                       |
| 205-30-25-3   | 6.2.3   | Following a liquidation plan   |
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| 855                  | 8.4            | Subsequent measurement  |
| 946                  | 6.2.1          | Investment companies registered under the 1940 Act                  |
| 960                  | 6.3.2          | Initial recognition and measurement of liabilities                  |

# D

## Glossary

It is important to understand the key terms used in bankruptcy and liquidation because many of the accounting and reporting issues are determined by (1) the stage of bankruptcy and (2) how certain liabilities are expected to be settled as part of the bankruptcy. The following selected definitions are relevant to the bankruptcy and liquidation processes:

### Excerpt from Accounting Standards Codification

#### Presentation of Financial Statements – Liquidation Basis of Accounting

##### *Glossary*

##### *205-30-20*

**Fair value** – The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

**Liquidation** – The process by which an entity converts its assets to cash or other assets and settles its obligations with creditors in anticipation of the entity ceasing all activities. Upon cessation of the entity's activities, any remaining cash or other assets are distributed to the entity's investors or other claimants (albeit sometimes indirectly). Liquidation may be compulsory or voluntary. Dissolution of an entity as a result of that entity being acquired by another entity or merged into another entity in its entirety and with the expectation of continuing its business does not qualify as liquidation.

**Market Participants** – Buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics:

- a. They are independent of each other, that is, they are not related parties, although the price in a related-party transaction may be used as an input to a fair value measurement if the reporting entity has evidence that the transaction was entered into at market terms
- b. They are knowledgeable, having a reasonable understanding about the asset or liability and the transaction using all available information, including information that might be obtained through due diligence efforts that are usual and customary
- c. They are able to enter into a transaction for the asset or liability
- d. They are willing to enter into a transaction for the asset or liability, that is, they are motivated but not forced or otherwise compelled to do so.

**Orderly Transaction** – A transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale).

**Remote** – The chance of the future event or events occurring is slight.

**Statement of Changes in Net Assets in Liquidation** – A statement that presents the changes during the period in net assets available for distribution to investors and other claimants during liquidation.

**Statement of Net Assets in Liquidation** – A statement that presents a liquidating entity's net assets available for distribution to investors and other claimants as of the end of the reporting period.



## Debt – Troubled Debt Restructurings by Debtors

### *Glossary*

#### **470-60-20**

**Troubled Debt Restructuring** – A restructuring of a debt constitutes a troubled debt restructuring if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider.

### **Reorganizations – Overall**

### *Glossary*

#### **852-10-20**

**Absolute Priority Doctrine** – A doctrine that provides that if an impaired class does not vote in favor of a plan, the court may nevertheless confirm the plan under the cram-down provisions of the Bankruptcy Code. The absolute priority doctrine is triggered when the cram-down provisions apply. The doctrine states that all members of the senior class of creditors and equity interests must be satisfied in full before the members of the second senior class of creditors can receive anything, and the full satisfaction of that class must occur before the third senior class of creditors may be satisfied, and so on.

**Administrative Expenses** – Claims that receive priority over all other unsecured claims in a bankruptcy case. Administrative expenses (sometimes referred to as administrative claims) include the actual, necessary costs and expenses of preserving the estate, including wages, salaries, or commissions for services rendered after the commencement of the case. Fees paid to professionals for services rendered after the petition is filed are considered administrative expenses.

**Allowed Claim** – The amount allowed by the Bankruptcy Court as a claim against the estate. This amount may differ from the actual settlement amount.

**Automatic Stay Provisions** – Provisions causing the filing of a petition under the Bankruptcy Code to automatically stay virtually all actions of creditors to collect prepetition debts. As a result of the stay, no party, with minor exceptions, having a security or adverse interest in the debtor's property can take any action that will interfere with the debtor or the debtor's property, regardless of where the property is located or who has possession, until the stay is modified or removed.

**Bankruptcy Code** – A federal statute, enacted October 1, 1979, as title 11 of the United States Code by the Bankruptcy Reform Act of 1978, that applies to all cases filed on or after its enactment and that provides the basis for the current federal bankruptcy system.

**Bankruptcy Court** – The United States Bankruptcy Court is an adjunct of the United States District Courts. Under the jurisdiction of the District Court, the Bankruptcy Court is generally responsible for cases filed under Chapters 7, 11, 12, and 13 of the Bankruptcy Code.

**Chapter 11** – A reorganization action, either voluntarily or involuntarily initiated under the provisions of the Bankruptcy Code, that provides for a reorganization of the debt and equity structure of the business and allows the business to continue operations. A debtor may also file a plan of liquidation under Chapter 11.

**Chapter 7** – A liquidation, voluntarily or involuntarily initiated under the provisions of the Bankruptcy Code, that provides for liquidation of the business or the debtor's estate.

**Claim** – As defined by Section 101(4) of the Bankruptcy Code, a right to payment, regardless of whether the right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, secured, or unsecured, or a right to an equitable remedy for breach of performance if such breach results in a right to payment, regardless of whether the right is reduced to a fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured right.

**Confirmed Plan** – An official approval by the court of a plan of reorganization under a Chapter 11 proceeding that makes the plan binding on the debtors and creditors. Before a plan is confirmed, it must satisfy 11 requirements in section 1129(a) of the Bankruptcy Code.

**Consenting Classes** – Classes of creditors or stockholders that approve the proposed plan.

**Cram-Down Provisions** – Provisions requiring that for a plan to be confirmed, a class of claims or interests must either accept the plan or not be impaired. However, the Bankruptcy Code allows the Bankruptcy Court under certain conditions to confirm a plan even though an impaired class has not accepted the plan. To do so, the plan must not discriminate unfairly and must be fair and equitable to each class of claims or interests impaired under the plan that have not accepted it. The Bankruptcy Code states examples of conditions for secured claims, unsecured claims, and stockholder interests in the fair and equitable requirement.

**Debtor-in-Possession** – Existing management continuing to operate an entity that has filed a petition under Chapter 11. The debtor-in-possession is allowed to operate the business in all Chapter 11 cases unless the court, for cause, authorizes the appointment of a trustee.

**Disclosure Statement** – A written statement containing information approved as adequate by the court. It is required to be presented by a party before soliciting the acceptance or rejection of a plan of reorganization from creditors and stockholders affected by the plan. Adequate information means information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor's records, that would enable a hypothetical reasonable investor typical of holders of claims or interests of the relevant class to make an informed judgment about the plan.

**Emerging Entity** – An entity (sometimes referred to as the reorganized entity), that has had its plan confirmed and begins to operate as a new entity.

**Impaired Claims** – In determining which class of creditors' claims or stockholders' interests must approve the plan, it is first necessary to determine if the class is impaired. A class of creditors' claims or stockholders' interests under a plan is not impaired if the plan leaves unaltered the legal, equitable, and contractual right of a class, cures defaults that lead to acceleration of debt or equity interest, or pays in cash the full amount of the claim, or for equity interests, the greater of the fixed liquidation preference or redemption price.

**Nonconsenting Class** – A class of creditors or stockholders that does not approve the proposed plan.

**Obligations Subject to Compromise** – Includes all prepetition liabilities (claims) except those that will not be impaired under the plan, such as claims in which the value of the security interest is greater than the claim.

**Petition** – A document filed in a court of bankruptcy, initiating proceedings under the Bankruptcy Code.

**Plan of Reorganization** – An agreement formulated in Chapter 11 proceedings under the supervision of the Bankruptcy Court that enables the debtor to continue in business. The plan, once confirmed, may affect the rights of undersecured creditors, secured creditors, and stockholders as well as those of unsecured creditors. Before a plan is confirmed by the Bankruptcy Court, it must comply with general provisions of the Bankruptcy Code. Those provisions mandate, for example, that the plan is feasible, the plan is in the best interest of the creditors, and, if an impaired class does not accept the plan, the plan must be determined to be fair and equitable before it can be confirmed.

**Postpetition Liabilities** – Liabilities incurred after the filing of a petition that are not associated with prebankruptcy events. Thus, these liabilities are not considered prepetition liabilities.

**Prepetition Liabilities** – Liabilities that were incurred by an entity before its filing of a petition for protection under the Bankruptcy Code including those considered by the Bankruptcy Court to be prepetition claims, such as a rejection of a lease for real property.

**Reorganization Items** – Items of income, expense, gain, or loss that are realized or incurred by an entity because it is in reorganization.

**Reorganization Proceeding** – A Chapter 11 case from the time at which the petition is filed until the plan is confirmed.

**Reorganization Value** – The value attributed to the reconstituted entity, as well as the expected net realizable value of those assets that will be disposed of before reconstitution occurs. Therefore, this value is viewed as the value of the entity before considering liabilities and approximates the amount a willing buyer would pay for the assets of the entity immediately after the restructuring.

**Secured Claim** – A liability that is secured by collateral. A fully secured claim is one in which the value of the collateral is greater than the amount of the claim.

**Terminal Value** – A component of reorganization value. Reorganization value calculated based on the discounting of cash flows normally consists of three parts; the discounted cash flows determined for the forecast period, the residual value or terminal value, and the current value of any excess working capital or other assets that are not needed in reorganization. Terminal or residual value represents the present value of the business attributable to the period beyond the forecast period.

**Trustee** – A person appointed by the Bankruptcy Court in certain situations based on the facts of the case, not related to the size of the entity or the amount of unsecured debt outstanding, at the request of a party in interest after a notice and hearing.

**Undersecured Claim** – A secured claim whose collateral is worth less than the amount of the claim. Sometimes referred to as an undersecured claim liability.

**Unsecured Claim** – A liability that is not secured by collateral. In the case of an undersecured creditor, the excess of the secured claim over the value of the collateral is an unsecured claim, unless the debtor elects in a Chapter 11 proceeding to have the entire claim considered secured. The term is generally used in bankruptcy to refer to unsecured claims that do not receive priority under the Bankruptcy Code. Sometimes referred to as an unsecured claim liability.

#### Other definitions used in this publication:

**Distressed liquidation value** – The value an entity expects to receive for its assets, considering there may be insufficient time for adequate market exposure or considering that the assets may be only marketed to a single market participant.

**Fresh-start accounting** – An accounting methodology applied if certain criteria are met when an entity emerges from Chapter 11 bankruptcy, which results changing the historical book basis of the assets and liabilities of the emerging entity to a new basis of accounting (following the principles in ASC 805, generally to fair value).

**Liabilities not subject to compromise** – Includes (1) liabilities that are fully secured and are expected to be repaid at their full amount under their original terms and (2) liabilities incurred subsequent to the filing of the petition that are not associated with the pre-bankruptcy events (i.e., postpetition liabilities).

**Liabilities subject to compromise** – Includes liabilities incurred before the entity filed for Chapter 11, or that became known after the petition was filed. The liabilities are either undersecured or unsecured, and will likely not be repaid at their full amount and/or under their original payment terms.

**Orderly liquidation value** – The value an entity expects to receive for an asset sold given sufficient time to market the asset in a customary manner to multiple potential buyers; generally, this amount equals fair value, however, it may not, for example, when it does not reflect the time value of money.

**Quasi-reorganization** – A corporate readjustment procedure in which, without the creation of a new corporate entity and without the intervention of formal court proceedings, an entity restates its balance sheet to fair value. This procedure eliminates an accumulated deficit and/or prevents future charges from being recorded in the income statement that otherwise would be recorded.

**Stalking horse** – The initial prospective acquirer willing to set forth a specific price and terms for the acquisition of the entity's asset(s). The prospective acquirer usually negotiates for payment of a "break-up fee" or "topping fee" if it does not become the approved acquirer to ensure that any competing bid is meaningfully more valuable to the entity.

# E Comparison of IFRS and US GAAP

The following table compares certain aspects of US GAAP and IFRS relevant to the topics discussed in this publication.

| Topic  | US GAAP  | IFRS   |
|--|--|--|
| <b>Basis of accounting when there is substantial doubt about an entity being a going concern</b> | <p>The financial statement presentation is not affected (i.e., the measurement and classification of assets and liabilities) unless the financial statements are prepared under a basis other than the going concern basis. If the financial statements are prepared under another accounting basis, such as the liquidation basis, that fact and the reasons leading to that decision must be disclosed.</p>  | <p>The same as US GAAP.</p>  |
| <b>Liquidation basis of accounting</b>   | <p>When liquidation is imminent, an entity applies the liquidation basis of accounting in accordance with ASC 205-30, unless one of the scope exceptions or recognition exceptions is met. Liquidation is imminent when either of the following occurs:</p> <ul style="list-style-type: none"> <li>▶ The party or parties with the authority to approve a liquidation plan do so, and the likelihood is remote that (1) the plan will be blocked and (2) the entity will return from liquidation.</li> <li>▶ Other forces (e.g., involuntary bankruptcy) impose a plan for liquidation, and the likelihood that the entity will return from liquidation is remote.</li> </ul> <p>US GAAP contains specific accounting requirements for the application of the liquidation basis of accounting.</p> | <p>An entity is prohibited from preparing its financial statements on a going concern basis if management determines during or after the reporting period either that (1) it intends to liquidate the entity or to cease trading or (2) that it has no realistic alternative to doing so.</p> <p>IFRS does not prescribe specific requirements for a liquidation basis of accounting. An entity continues to follow the requirements of International Accounting Standards (IAS) 1 <i>Presentation of Financial Statements</i> regarding the classification and presentation of assets and liabilities on the balance sheet, and income and expenses within the statement of operations after emergence from bankruptcy. IAS 8 <i>Accounting Policies, Changes in Accounting Estimates and Errors</i> requires clear disclosure of accounting policies selected.</p> |

| Topic  | US GAAP  | IFRS   |
|--|--|--|
| <b>Reorganization in bankruptcy</b>                  | <p>When an entity files a petition for Chapter 11 bankruptcy (reorganization), it applies ASC 852-10 in addition to other applicable US GAAP.</p> <p>The balance sheet distinguishes between (1) prepetition liabilities subject to compromise (2) prepetition liabilities not subject to compromise and (3) postpetition liabilities. The statement of operations distinguishes between income and expenses resulting from the reorganization and those resulting from the ongoing operations of the business, except for income and expenses reported as discontinued operations.</p> <p>Prepetition liabilities subject to compromise are measured at the amounts expected to be allowed by the Bankruptcy Court, even if they may be settled for lesser amounts, and even if this amount differs from the amount that would otherwise be required under US GAAP. An entity discloses the status of the reorganization proceedings.</p>   | <p>IFRS does not contain any specific accounting requirements when an entity is reorganizing under bankruptcy proceedings.</p> <p>Therefore, an entity should continue to follow the requirements of IAS 1 <i>Presentation of Financial Statements</i> regarding the classification and presentation of assets and liabilities in the balance sheet, and income and expenses within the statement of operations after filing for reorganization. An entity would also apply IFRS 5 <i>Non-current Assets Held for Sale and Discontinued Operations</i>, if applicable.</p> <p>An entity continues to follow other applicable IFRS (e.g., IAS 37 <i>Provisions, Contingent Liabilities and Contingent Assets</i>, or IFRS 9 <i>Financial Instruments</i>) when measuring its liabilities during a reorganization in bankruptcy. IAS 8 <i>Accounting Policies, Changes in Accounting Estimates and Errors</i> requires clear disclosure of accounting policies selected. An entity discloses the status of the reorganization proceedings.</p>   |
| <b>Emergency from a reorganization in bankruptcy</b> | <p>When an entity emerges from a reorganization in bankruptcy, it must determine whether it qualifies for fresh-start accounting under ASC 852-10. Fresh-start accounting can be used only if both of the following criteria are met:</p> <ul style="list-style-type: none"> <li>▶ The reorganization value of the assets is less than the postpetition liabilities and allowed claims.</li> <li>▶ There is a change in control.</li> </ul> <p>If an entity emerging from bankruptcy under Chapter 11 qualifies for fresh-start accounting, the reorganization value of the emerging entity is assigned to the emerging entity's assets and liabilities as if it were the consideration transferred in a business combination, and the principles of ASC 805 are applied.</p> <p>If the entity does not qualify for fresh-start accounting, the postpetition liabilities and allowed claims existing upon emergence from bankruptcy are measured at the present value of the amounts to be paid.</p> | <p>IFRS does not contain the concept of fresh-start accounting upon emerging from a reorganization in bankruptcy. Therefore, the application of fresh-start accounting and adjustments or revaluations to an entity's financial statements would generally be prohibited, unless otherwise permitted under IFRS (e.g., revaluations in accordance with IAS 16 <i>Property, Plant and Equipment</i>). Modifications or extinguishments of an entity's liabilities and debts would be accounted for under the applicable IFRS (e.g., IAS 37 <i>Provisions, Contingent Liabilities and Contingent Assets</i>, or IFRS 9 <i>Financial Instruments</i>).</p> <p>An entity continues to follow the requirements of IAS 1 <i>Presentation of Financial Statements</i> regarding the classification and presentation of assets and liabilities in the balance sheet, and income and expenses within the statement of operations after emergence from bankruptcy. IAS 8 <i>Accounting Policies, Changes in Accounting Estimates and Errors</i> requires clear disclosure of accounting policies selected.</p> |

| Topic                        | US GAAP  | IFRS  |
|------------------------------|--|---|
| <b>Quasi-reorganizations</b> | <p>Under limited circumstances, an entity that encounters significant financial difficulties may choose not to file for bankruptcy but may instead undergo a quasi-reorganization. A quasi-reorganization is a corporate readjustment procedure in which an entity restates its balance sheet to fair value without first creating a new corporate entity and completing formal court proceedings. The adjustments to restate the balance sheet to fair value are first recorded against retained earnings (if it exists) and then against additional paid-in capital. Retained earnings/accumulated deficit is then reset to zero as of the effective date of the quasi-reorganization.</p> | <p>IFRS does not contain the concept of a quasi-reorganization. Adjustments or revaluations to an entity's financial statements would generally be prohibited, unless otherwise permitted under IFRS (e.g., revaluations in accordance with IAS 16 <i>Property, Plant and Equipment</i>). Modifications or extinguishments of an entity's equity would be accounted for under IFRS 9 <i>Financial Instruments</i>.</p> <p>An entity continues to follow the requirements of IAS 1 <i>Presentation of Financial Statements</i>, regarding the classification and presentation of assets and liabilities on the balance sheet, and income and expenses within the statement of operations after emergence from bankruptcy. IAS 8 <i>Accounting Policies, Changes in Accounting Estimates and Errors</i>, requires clear disclosure of accounting policies selected.</p> |

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