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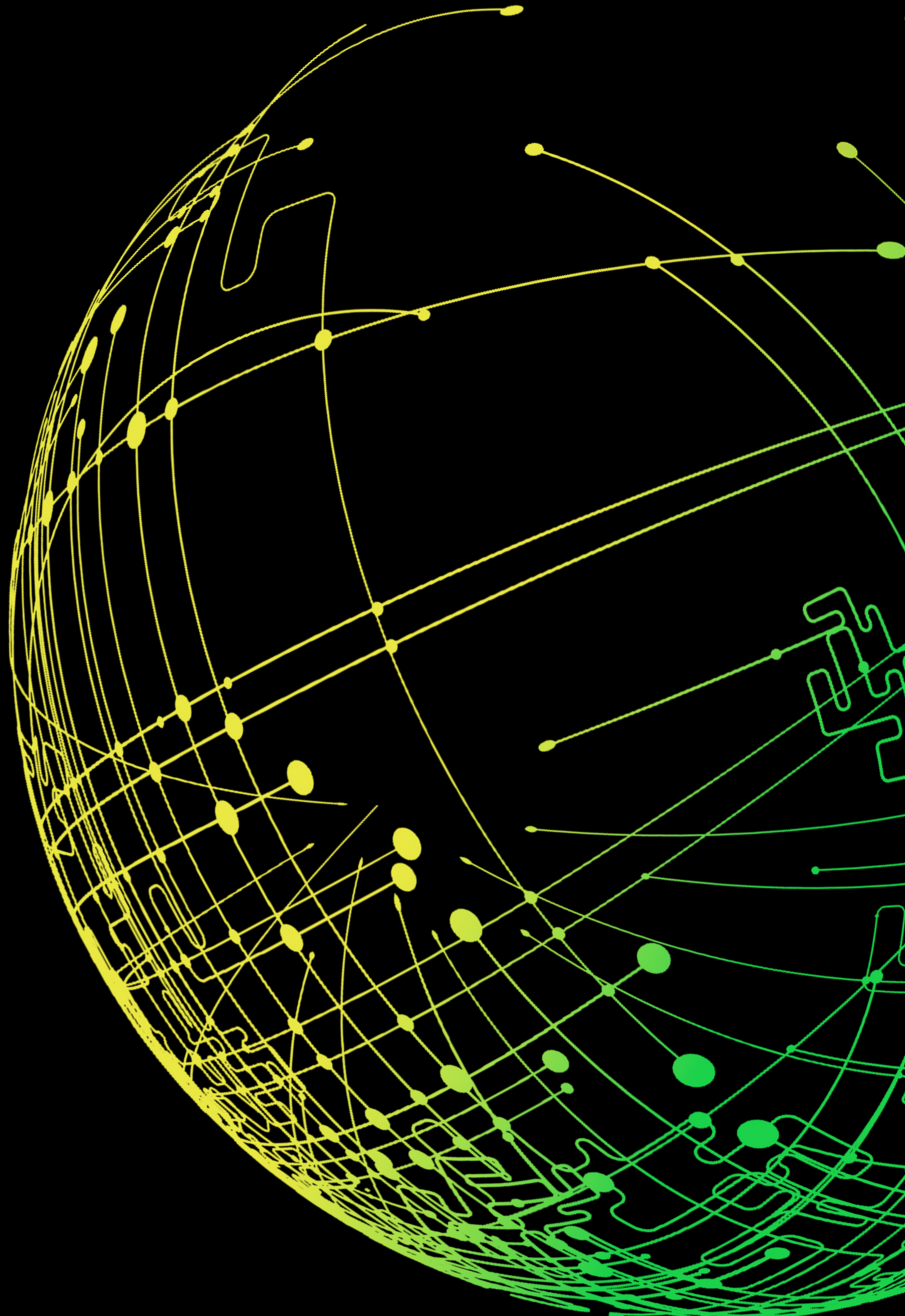

Making a fresh start and seven steps to get there

**Chapter 11 and Fresh Start Reporting—
Part Two of a two-part series**

In Part One of this two-part series, we presented an overview of the requirements and challenges associated with the application of Fresh Start Reporting (Read Part One **here**.) In Part Two below, we have provided a more detailed description of the major steps and other complexities often encountered in executing a Fresh Start implementation.

Complex mechanics of preparing for Fresh Start

The following are several items that management must consider when preparing for the emergence from Chapter 11 and applying the requirements of Fresh Start Reporting. This is not an exhaustive list; but for this article, we have boiled our approach down to seven key steps, which typically need to be addressed concurrently.

1. **Selection of a reporting date:**
   Internal accounting, tax reporting, and external reporting personnel should communicate and carefully assess the implications of the Fresh Start Reporting date. Ideally, the Fresh Start Reporting date will coincide with a company's month-end or year-end reporting process. While ASC 852 *Reorganizations* states that the reporting date is as of the confirmation date (subject to satisfaction of outstanding material conditions), material conditions to the effectiveness of a plan of reorganization such as financing generally occur on the date of emergence. In most cases, this results in the reporting date technically being required as of the plan effective date. That being said, it is not unusual for companies to seek to establish a convenience date for accounting purposes. To the extent that the Fresh Start Reporting date does not occur on the date of an accounting period close, the use of a convenience date for applying Fresh Start Reporting will eliminate the need for the company to close its books twice in the same month. The preferred convenience date will typically be as of the beginning or end of an accounting period subsequent to plan confirmation and prior to or as of the effective date of the plan of reorganization. The motivation is to avoid mid-month manual close procedures, allowing for a natural cutoff process to occur, to leverage the company's normal month-end close processes, and to significantly reduce the burden related to system modifications necessary to establish a new reporting entity.

   In years past, it was not uncommon for companies to adopt a convenience date where the plan effective date was within 10 or so days from the beginning or end of an accounting period. Based on our experience over the years, including comments made by the SEC, such a large number of days to allow for convenience may result in a material distortion to the financial statements of the predecessor or successor entity upon adoption of Fresh Start Reporting. Accordingly, the benchmark is now materiality.

   Materiality considerations should include an assessment of both quantitative metrics and qualitative factors as well as the effects of other errors in the financial statements. As a result, it is now more important than ever to plan for and manage this issue through consultation with counsel, external auditors, and general planning. Communications regarding this topic must occur early enough in the process to allow counsel to plan for court hearings and advantageous dates. Obviously, a debtor will be subject to the court's calendar, but advance planning can sometimes make a big difference in targeting an emergence date as close as possible to the end of an accounting period. In any event, some level of planning for a mid-month close is typically required, as the actual emergence date is not known with certainty until it occurs. In larger and more complex organizations, planning for a mid-month close may need to be quite extensive. It is also important to note that the effects of Fresh Start Reporting cannot be recognized in a reporting period before the entity's plan of reorganization is confirmed and all material conditions to effectiveness are satisfied and, most importantly, may not cross reporting periods.

2. **Final predecessor accounting—closing 'old' books:**
   Internal accounting, tax reporting, and external reporting should closely coordinate how to close the company's books as of the Fresh Start Reporting date. For starters, amounts of all liabilities subject to compromise should be carefully analyzed and adjusted to best estimates of allowed claims. Typically, this means recording estimates for those claims that remain contingent, unliquidated, or disputed. While accruals for claim estimates should be recorded throughout the Chapter 11 proceeding, we typically see much more emphasis on resolving asserted claims toward the end of a case, as part of preparing for the implementation of the plan of reorganization. Part of the reason for this is the Fresh Start Reporting date is an audited cutoff of the final operating results of the predecessor entity, which naturally garners increased scrutiny as part of the overall audit process. Having a well-vetted claims reconciliation process integrated with the accounting function will provide the basis for recording the proper estimates. Too often, we see a lack of communication between various functions resulting in a frenzy of last-minute efforts to reconcile the books. To the extent that asserted claim amounts will remain on the balance sheet of the emerged entity (e.g., administrative, secured, or priority claim amounts), these estimates should be fine-tuned to minimize future earnings impacts for any subsequent changes in estimates that would otherwise have to be recorded as part of the operating results of the successor company.

3. Determining and recording accounting impacts of the reorganization plan:

Calculating distributions to creditors is done on a plan class basis and, in many cases, at the legal entity level. This can be a challenge for a company given that liabilities are rarely recorded in the general ledger on a plan class basis. Typically, obligations by plan class are commingled within various general ledger accounts. Allowed claims by plan class will need to be identified to determine the proper recoveries and resulting gains from the extinguishment of debt. Financial advisers are typically hired to manage the claims process outside of the company's accounting processes and systems. Syncing up such third-party claims databases and analyses with the company's books and records is important to avoid any potential misstatement within the financial statements.

In addition, a thorough evaluation of the plan of reorganization can help identify the major components of the population of accounting events to be analyzed, journalized, and recorded. This should include a comprehensive plan to calculate the estimated recoveries to claimants, including working with third-party financial advisers where appropriate. Distributions to creditors are often complex—in the form of cash, new debt, and new common stock. Other equity instruments such as options and warrants also add to the accounting complexities in many plans. New money raises, backstop agreements, and complex fee structures, most commonly negotiated with existing creditors, add to the "fun." Systems and processing matters also need to be assessed to record plan distributions, eliminate pre-petition balances, and maintain unresolved claims, often long beyond emergence. Capturing additional information needed for other financial disclosures should also be an important consideration in the planning process.

4. Valuation of assets and liabilities:

As stated in Part One of this two-part series, Fresh Start Reporting requires substantially all assets and liabilities be remeasured to their "fair value" as of the Fresh Start Reporting date. This can be a significant challenge for companies as this requirement may impact all legal or reporting entities in the organization whether domestic/foreign or a debtor/non-debtor. For each entity, companies will need to perform a detailed review of each line item on the balance sheet (and the underlying general ledger accounts) to identify accounts where balances will be revalued. In addition, some intangibles, such as customer relationships, intellectual property, or above- and below-market contracts, often do not exist on the company's historical balance sheet. Accordingly, management will need to undertake a process to identify its intangible assets, and to the extent required, create new asset categories in accordance with ASC 805 *Business Combinations*. Proper attention to segments and reporting units is also critical in allocating value, to minimize future impairment impacts that could result from a company's annual assessments under ASC 350 *Intangibles – Goodwill and Other* and ASC 360 *Property, Plant, and Equipment*. Further allocations to certain tax jurisdictions may also be important to avoid unintended tax consequences. In addition to paying close attention to the allocation of reorganization value to various assets (and liabilities) and legal entities within the organization, management should also focus on how future net income will be impacted by changes in depreciable basis and useful lives resulting from Fresh Start Reporting. Additionally, assets may also be moved between legal entities as a result of tax planning, legal entity merger activity, or the reorganization of new stand-alone reporting groups, adding to the complexity of the process.

5. Modifying back-office systems (as necessary):

Companies emerging from Chapter 11 will need to address the impacts of this event on their accounting systems. Capturing stub period information, recording transactions to the sub-ledgers, and establishing new reporting entities are a few of the challenges. The IT department will need to understand how the accounting entries related to the plan of reorganization and the remeasurement of assets and liabilities will be recorded to determine the modifications that may be required. Examples could include:

a. Clearing pre-petition vouchers and unpaid invoices in the accounts payable sub-ledger that are extinguished or otherwise settled outside the normal accounts payable process.

b. Decisions on whether asset revaluation adjustments will be recorded at the asset record level or ledger account level. The answers will often depend on the nature of the adjustment and the needs of the company. Establishing new asset values and restarting depreciation within subsystems can be a complex event. This can include considerations related to statutory reporting in foreign jurisdictions and tax books. Legacy accounting systems may lack the flexibility to include more than one value (tax, new book, historical) or values as of more than one date (original purchase date vs. "Fresh Start" date). How will transactions be recorded to capture necessary information for various and differing reporting purposes?

c. Segregation of plan transactions and revaluation adjustments from normal operations is also necessary for compiling the accounting information needed for footnote disclosures discussed in item 7 below.

6. Preparing stub period financial statements:

A Fresh Start Reporting date occurring during a fiscal year (as opposed to a company's year-end) will require financial statement information to be presented for both predecessor and successor stub periods. For the predecessor entity, this will be on a historical basis from the beginning of the fiscal year to the date of implementation of Fresh Start Accounting (the final "Predecessor" period) and—for the "Successor" entity—separately on a new basis of accounting for the post-Fresh Start period. From the Fresh Start date forward, the fresh start event will result in a loss of comparability between the Predecessor and Successor reporting periods. That means additional disclosure requirements for pre- and post-emergence activity as well as capturing plan effects and Fresh Start information.

7. Determining and developing required disclosures:

The accounting for the plan treatments and the remeasurement of assets and liabilities is typically reflected in the notes to the financial statement in a columnar balance sheet roll-forward presentation. This footnote reflects the final closing balances of the old entity in the first column followed by separate plan effects and Fresh Start adjustment columns, with the final fourth column representing the opening balance sheet for the reorganized entity. All adjustments within this columnar presentation are supported by accompanying explanatory descriptions.

We are hopeful that this summary of key aspects of the work effort required to achieve a successful Fresh Start implementation resonates, in that the effort is substantially greater than a normal year-end close and significantly more complex than an acquisition in a non-bankruptcy setting.

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