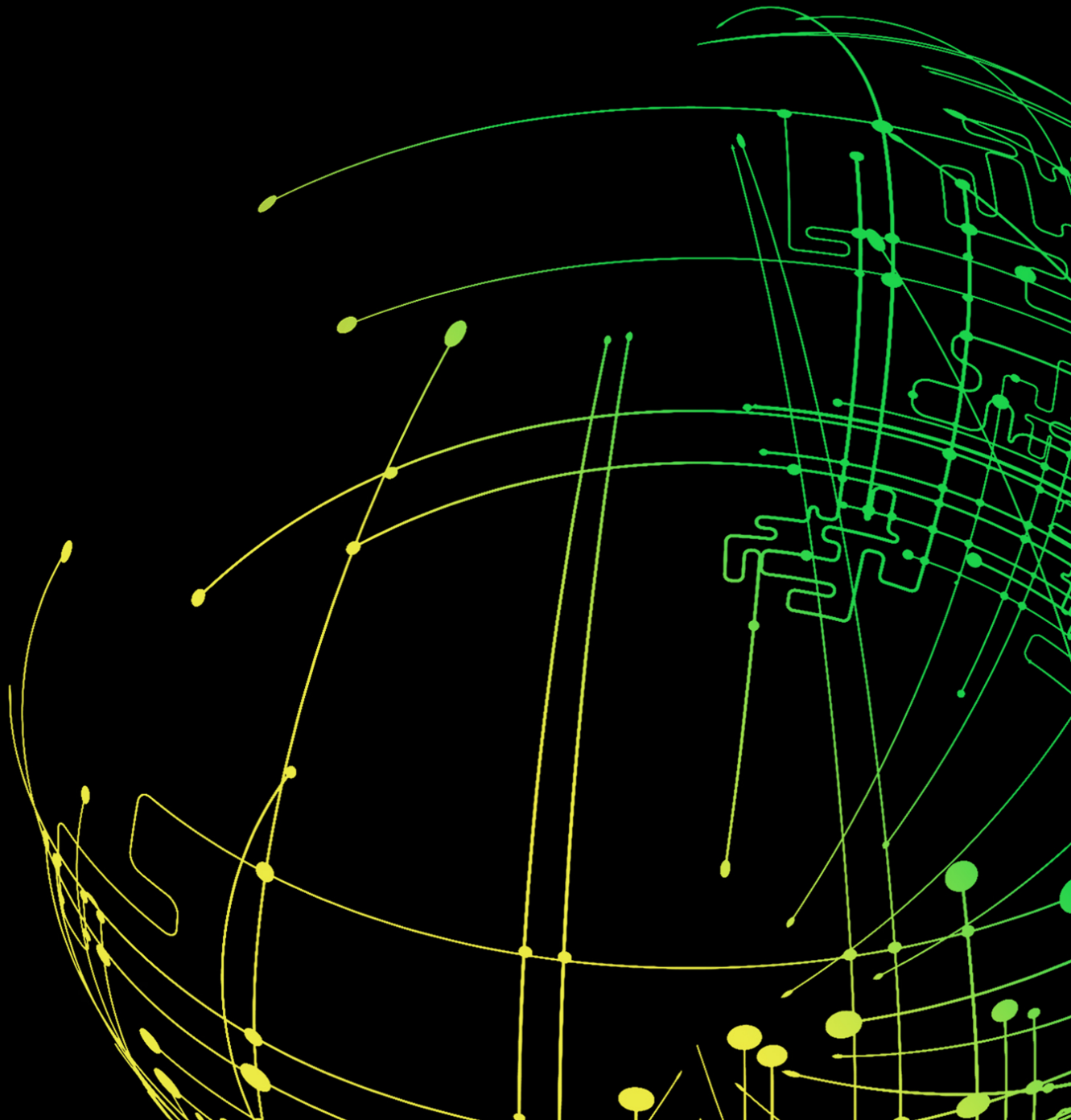


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Jump-start the revival journey

**Chapter 11 and Fresh Start reporting—
Part one of a two-part series**



Chapter 11 of the Bankruptcy Code has been an important tool to facilitate corporate reorganizations since 1978 (as amended in 2005), and Fresh Start reporting has been part of US GAAP reporting since 1990. Some things haven't changed. Chapter 11 continues to be an opportunity to reconstitute your business, extinguish old debts, and endeavor to make new fortunes. However, not all things stay the same. Here's a take on Fresh Start reporting to discuss the old and the new.

They say history repeats itself. Once again, the US economy is churning under stormy skies: Supply chain issues persist, food and energy costs are spiking, labor costs are increasing, interest rates are rising, and the number of companies filing for bankruptcy is growing. Experts predict that during the next few years, there will be a significant uptick in the number of companies seeking to reorganize under Chapter 11.

Small steps to meet the big ask

Managers whose organizations will be seeking Chapter 11 protection will face many challenges in the development, negotiation, and implementation of a plan of reorganization. There is also the prospect of these reorganizing companies being required to present new asset and liability values on their “emergence” balance sheets. As the period of exclusivity is generally limited to 18 months, coupled with recent trends for prepackaged or pre-negotiated reorganization plans, organizations contemplating a Chapter 11 filing often have a narrow time frame to address financial reporting requirements upon emergence. These accounting requirements are a part of Accounting Standards Codification (ASC) 852 Reorganizations (ASC 852). To minimize risks of error or delays in external reporting, planning early in the restructuring process to address the numerous and complex accounting requirements upon emergence needs to be a high priority.

A company that reorganizes under Chapter 11 bankruptcy protection is afforded an opportunity to reconstitute its business and extinguish pre-petition debt upon emergence. In addition, with Fresh Start reporting, it must remeasure its tangible and identifiable intangible assets and liabilities to their fair values. Any retained earnings, accumulated deficit balances, and other accumulated comprehensive income balances are reset to zero. In substance, this results in the emerged entity having a “fresh start,” with the ability to become a new company in many ways from both a legal and financial reporting perspective.

Planning, preparation, and readiness are paramount to gathering the proper information and developing the processes necessary to successfully implement Fresh Start reporting. It also requires a significant investment of time and resources by management and other company personnel. External financial reporting requirements, along with internal and other reporting obligations and deadlines, can be very tight, especially for publicly traded companies that are “accelerated filers” or “large accelerated filers” under the Securities Exchange Act of 1934.

Acting fast and seeking support when needed

Multinational organizations face additional challenges. It is not uncommon for companies operating in foreign jurisdictions to file financial statements, whether US GAAP or non-US GAAP, for local and other statutory reporting purposes. Maintaining historical basis records while also determining and maintaining the new basis of accounting values resulting from the adoption of Fresh Start reporting for US GAAP reporting can create many new challenges. Logistics, training, system modifications, reassessment of existing or development of new processes and controls, valuations, and extensive analysis are typical matters that must be considered and addressed to achieve the desired result. It is not uncommon for financial executives to find themselves stretched thin, running the day-to-day business while also being diverted by the many stringent and often unique reporting requirements that the emergent company must meet. Little or no time may be available to focus on planning for the successor entity’s financial reporting requirements during the pendency of the bankruptcy proceeding. Yet awareness of the challenges and upfront planning is just what a company in Chapter 11 needs to successfully navigate the many demanding hurdles in a timely manner. Often, executives seek help from experienced professionals to maneuver through the requirements and minimize distractions, thus enabling the company to truly start afresh as a better-prepared and more organized new entity while allowing management to focus more on its future and less on unresolved legacy accounting issues.

In this article, we discuss some of the issues, both strategic and tactical, that an entity planning on emerging from Chapter 11 should consider with respect to Fresh Start reporting, including the accounting and financial reporting for its plan of reorganization and the remeasurement of its assets and liabilities.

Fresh Start reporting and ASC 852

ASC 852 provides financial reporting guidance for entities that have filed for bankruptcy protection under Chapter 11 of the Bankruptcy Code and expect to reorganize as going concerns. This guidance covers financial reporting both for the period in bankruptcy and upon emergence from Chapter 11.

Upon emergence, the reporting entity needs to determine whether it must adopt Fresh Start reporting. As defined in ASC 852, a company (whether a parent or subsidiary) must adopt Fresh Start reporting if it meets two conditions:

1. Immediately prior to confirmation of its plan of reorganization, it should be “balance sheet insolvent”—that is, the reorganization value of its assets is less than the sum of its post-petition liabilities and allowed claims.
2. Holders of voting shares before the court confirms the bankruptcy plan receive less than 50% of the emerging company’s voting shares.

The accounting principles impacting the opening balance sheet of the successor entity upon adoption of Fresh Start reporting, as stated in ASC 852, are as follows:

- The reorganization value of the entity shall be allocated to the entity’s assets and liabilities using the business combination acquisition method principles in Business Combinations (ASC 805). If any portion of the reorganization value cannot be attributed to specific tangible or identified intangible assets of the emerging entity, such amounts should be reported as goodwill in accordance with paragraph 350-20-25-2 of Intangibles—Goodwill and Other (ASC 350).
- Deferred taxes shall be determined under the requirements of paragraph 852-740-45-1.

What is clear from a consideration of the accounting requirements and other guidance contained in ASC 852 and from the experience of the many companies that have come out of bankruptcy is that the managers of organizations in Chapter 11 have some complicated matters to orchestrate over a short time frame. Before dealing with accounting issues, the first and most obvious is to develop, negotiate, and confirm a reorganization plan. Then the accounting effort can be divided into two main categories: (1) recording the effects of the bankruptcy plan of reorganization and, if Fresh Start applies, (2) assigning new values to the assets and liabilities of the successor entity using the business acquisition principles of ASC 805-20. The latter generally involves recording the assets and liabilities of the emerged entity at fair value under the measurement principles of ASC 820 Fair Value Measurements.

At first blush, this may not seem much more onerous than accounting for any other acquisition. However, those who have been through the process have learned otherwise. As with any transaction, every Chapter 11 plan of reorganization is based on a unique set of facts that has been negotiated or litigated to a unique conclusion. Bankruptcy law and the resulting accounting implications, however, add complexities not seen in an acquisition or out-of-court restructuring. Many of the bankruptcy concepts impacting financial reporting are not well understood or, at times, are misunderstood by financial executives unfamiliar with the Chapter 11 process.

Out of the ordinary

One of the key differences between ordinary acquisition accounting and Fresh Start accounting relates to one of the underlying concepts of Fresh Start reporting, in which upon emergence, the consolidated entity is transferring ownership in exchange for the extinguishment of debt obligations, including (in many instances) the infusion of additional capital. In most bankruptcy cases, certain creditor groups of the highest priority that are not otherwise made whole upon emergence obtain ownership of the emerging entity, resulting in the company essentially being “purchased” by these creditors in exchange for their debt claims (along with new money contributions, in many cases). From the perspective of existing management, the remeasurement of assets and liabilities is not limited to an acquired business. More substantially, it is applied to the consolidated corporate enterprise in its entirety, including subsidiaries that may not have been part of the bankruptcy filing.

Another difference relates to the use of a measurement period. Acquisition accounting under ASC 805 provides a measurement period of up to one year after the closing date of acquisition. This allows the acquirer to record provisional amounts for the assets acquired and liabilities assumed and then adjust them during the measurement period. While there may be some limited circumstances under which recognizing provisional assets and liability amounts are allowed, the use of a measurement period is, in most cases, not permitted for Fresh Start accounting. The rationale for restricting the use of a measurement period is that the entity emerging from Chapter 11 has advanced access to all the information necessary to identify and measure its assets and liabilities. Some audit firms take an even more restrictive stance in that they believe the use of a measurement period is strictly prohibited.

Beware of the Section 363 sale

Many Chapter 11 cases are resolved through a court-supervised Section 363 sale of substantially all of a business’s operations and related assets, along with the acquirer’s assumption of certain operating liabilities. While one might expect the application of business combination accounting for an acquirer, recent trends have resulted in numerous loan-to-own strategies, in which lenders credit bid their secured debt positions in exchange for the equity of the successor entity. In many instances, there may not be a controlling shareholder within the new ownership group. The substance of some of these transactions may be viewed as a debt for equity exchange under the guise of a sale transaction, resulting in an emergence accounting outcome that is consistent with Fresh Start reporting. The assessments of these transactions can be complex and, at times, controversial as to what the appropriate accounting treatment (e.g., ASC 852 vs. ASC 805) should be. A thorough evaluation of the accounting consequences of such transactions should be part of the advanced planning process.



Other challenges

In addition to external reporting impacts, other reporting considerations may include internal, tax compliance, and operational reporting, where it is desirable to continue to capture cumulative results for the entire year. The loss of continuity in the reporting structure (due to a restructuring and a Fresh Start revaluation, creating a new reporting entity in the middle of the year, etc.) may make it difficult to manage budgets and measure performance. In addition, incentive compensation programs are typically impacted. Appropriate planning can ensure the process allows for the maintenance of necessary full-year data for management use, thereby avoiding the loss of continuity and allowing management to obtain needed internal reports to manage the business.

Effects of Fresh Start reporting on a successor entity's financial statements

The financial statements of the bankrupt predecessor company will likely look much different from those of the emerging successor entity. In addition to the settlement of liabilities subject to compromise and a reduction in the debt levels that a company will carry after emerging from Chapter 11, there will be other effects as well, such as these:

- Depreciation and amortization expense information, pre- and post-bankruptcy, will no longer be comparable, as the new entity will have a new basis in its assets as a result of remeasuring its assets and liabilities to fair value and identifying new intangible assets as of the Fresh Start reporting date and the establishment of new accounting lives for the amortization of the revalued or newly identified assets.
- Fair value adjustments (including those to deferred revenue accounts), favorable or unfavorable contracts, or changes in the carrying amounts of right of use assets and lease liabilities can have unanticipated impacts on revenue and earnings.

What this means for you

Fresh Start reporting allows organizations reorganized through Chapter 11 to continue business with a newly valued balance sheet, with less debt and the reset of its equity accounts (elimination of the accumulated deficit, etc.).

Coordinating all the elements that need to come together as of the Fresh Start reporting date is far more complex than even the most seasoned CFOs, controllers, and other senior managers would imagine, especially if they have had no prior experience working in a Chapter 11 environment. Time frames are often extremely tight, and unforeseen valuation, accounting, systems, tax, and reporting issues can make the process torturous. Assistance from an adviser with a broad understanding of the Chapter 11 bankruptcy process and deep experience in bankruptcy emergence accounting can significantly enhance an emerging company's ability to deliver timely and accurate financial statements.

This is part one of a two-part series. Also see <https://www2.deloitte.com/us/bankruptcy-advisory-services.html> for more of Chapter 11 and Fresh Start reporting.

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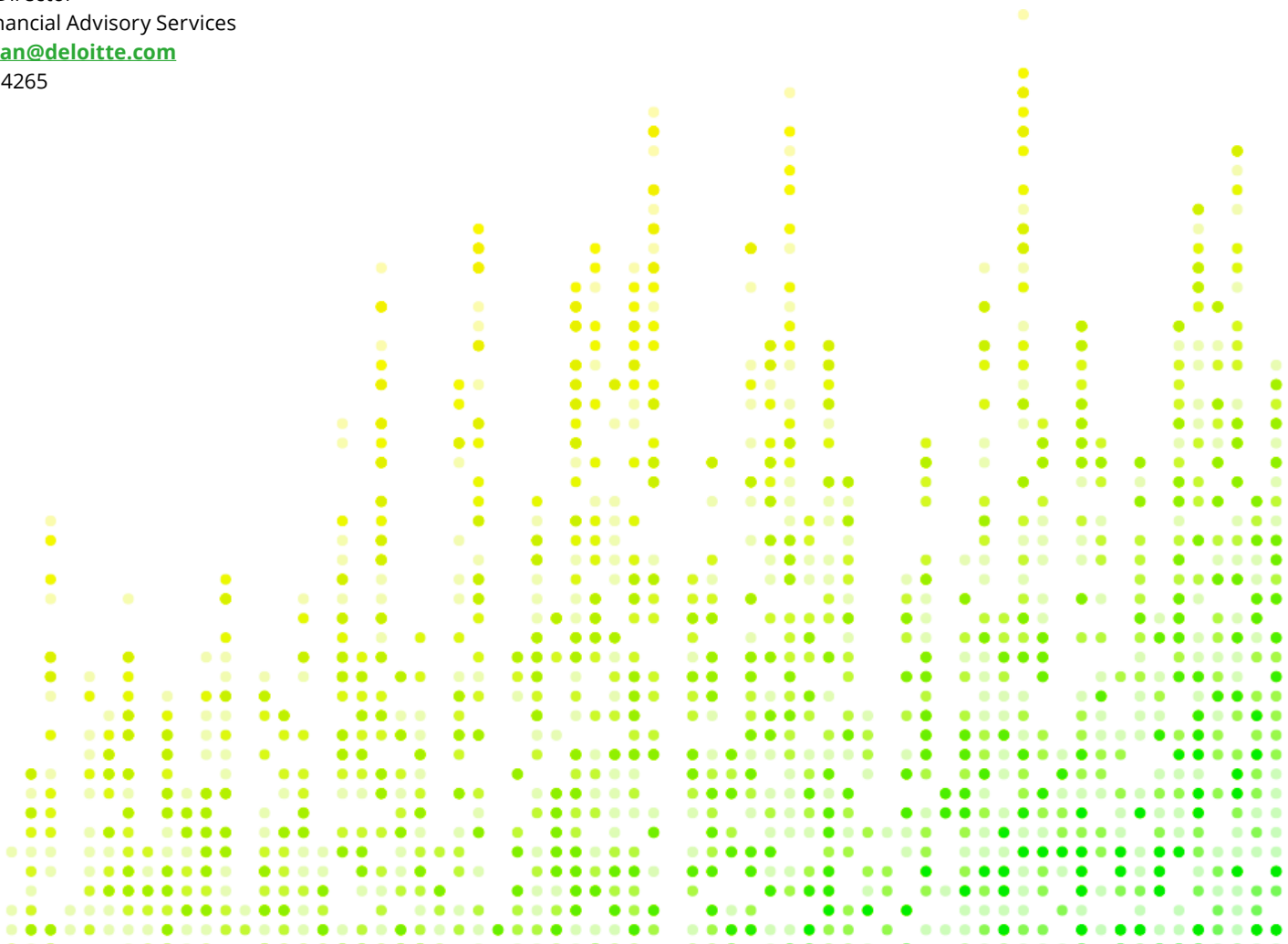
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