A Fresh Start for Your Financials After Chapter 11

Business owners facing a Chapter 11 reorganization may feel that they've crossed a finish line when the bankruptcy court approves their reorganization plan. But companies face an additional set of accounting challenges once their plan is approved – applying the principles of fresh-start reporting to their freshly-restructured business.

Fresh-start reporting serves as a kind of "re-set" to a firm's financial statements, erasing previous accounting records and reflecting the reorganized company's new beginning.

Accounting Standards Codification Topic 852 (ASC 852), which governs Chapter 11 reorganizations, says that companies need to meet several criteria to utilize fresh-start reporting as they emerge from Chapter 11:

•Liabilities and claims must exceed assets at the time the reorganization plan is confirmed by the court. In other words, the company must be insolvent.
•Holders of existing shares must own less than 50 percent of the company after emergence. This is to ensure that the Chapter 11 process is a genuine reorganization, and not just a smokescreen allowing the old owners to continue business as usual.

Fresh-start reporting requires companies to use fair value concepts in determining the worth of the reorganized business and its assets and liabilities. The initial step is to determine the value of the overall business, based on its reorganization plan. At first glance this might seem straightforward, since reorganization plans typically include an assessment of the company's value. But determining an acceptable valuation can, in fact, be quite complicated.

To begin with, reorganization plans sometimes identify a range of values – say, $10 to $15 million – rather than a single number. And the value listed in the reorganization plan may differ from fair value. The figure cited in the plan is often based on negotiations or on a court determination, while fair value is based on what the market would pay for the entity. Finally, valuation can be a moving target – if enough time passes between creation and confirmation of a reorganization plan, there can be shifts in market conditions or business operations that affect the value of the company.

In determining the value of companies emerging from Chapter 11, appraisers generally use a discounted cash flow method, with market approaches as a secondary tool. Historical results are not necessarily a useful indicator of company value since so much may have changed with the reorganization. For instance:

•How will cash flow, margins, and growth rates be affected if facilities are closed or divisions sold off?
•Are there termination costs associated with operations that are being discontinued?
•How much income can be generated by the sale of assets?
•Will changes in management stemming from the reorganization restrict the company's ability to carry forward operating losses to offset taxes?

The second step in fresh start reporting involves allocating the company's new value to all its assets and liabilities. Appraisers need to review every asset and liability and determine its fair value, based primarily on its market value. They'll compare post-reorganization terms with market terms on things like leases and debt. And they may find significant differences: For instance, the landlord of a distressed company may have agreed to discount its lease rather than lose it as a tenant altogether. In cases like this, the favorable terms would result in recognition of an asset on the balance sheet.

Appraisers also must assign value to the company's intangible assets such as customer base, technology under development, brand names, and intellectual property. ASC 805 requires recognition of assets if they are:

•Separable, meaning they could be sold separately from the rest of the company (such as a database of customers), or
•Contractually or legally enforceable (such as a patent).

Again, there can be tricky differences between fair (market) value and how the company has traditionally valued some assets. For instance, a trademark might be assigned a high value based on the marketplace even if the company has no intention of using it. The residual value of the company - after recognizable assets and liabilities are taken into account – is considered goodwill.

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Fresh-start reporting after a Chapter 11 reorganization can be challenging. Big changes are happening with company operations; historical trends may no longer apply; and it's very possible that the company's financial records are in disarray. (Poor financial tracking may be partly how it ended up in bankruptcy proceedings to begin with.) All of this makes determining reliable numbers more difficult.

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But it's important that the fresh start also be an accurate start. If it isn't, you may end up with additional restatements and impairment charges down the line, accompanied by increased legal and accounting costs and damage to the company's reputation.

One key to a successful Chapter 11 reorganization is thinking about these fresh-start requirements while drafting the reorganization plan, and setting realistic expectations that are shared by all stakeholders.

The other key is retaining finance and legal professionals who have extensive experience with Chapter 11, the ASC 852 requirements, and fresh-start reporting. They need both the theoretical knowledge and hands-on experience to guide you through the process as smoothly as possible.

No one can make the reorganization process easy or painless – but with experienced, expert help, it can be a one-time experience that leaves your company on secure, stable ground and ready to move forward.

About Hemming Morse, LLP and the Author

Hemming Morse, LLP advises clients throughout the nation, with a strategic focus on financial and forensic consulting services. Founded in 1958 and headquartered in San Francisco, Hemming Morse has seven offices throughout California. For more information, please visit www.hemming.com.

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