Fresh Start Accounting – A Path Forward

by Jamie Sieman, ASA, Principal

Companies that find themselves in financial distress have limited options for survival. While a down round equity raise, new debt financing or a sale of the company are a solution for some, many companies pursue a reorganization, filing for bankruptcy protection under Chapter 11 of the US Bankruptcy Code.

FRESH START ACCOUNTING

If a Chapter 11 Bankruptcy is pursued, the fair value of all underlying assets and liabilities may be required as a critical component of the new opening day balance sheet, in compliance with **Fresh Start Accounting**, as governed by the Financial Accounting Standards Board's Accounting Standards Codification (ASC) 852 - *Reorganizations* and ASC 820 – *Fair Value Measurements*.

Fresh Start Accounting provides guidance for companies emerging from bankruptcy, including the requirement that the balance sheet and related assets of a company emerging from bankruptcy be restated at fair value. **Fair value** is defined in ASC 820 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*."

Fair value is often described as an "exit value" because the definition is based solely upon the price one would receive if they were to sell the asset, there is no consideration as to the seller's perspective, as opposed to the Fair Market Value standard, which includes the point of view of both the "willing buyer and willing seller." One can see where an "exit value" perspective makes sense in a reorganization.

Balance sheet adjustments to reflect the impact of Fresh Start Accounting are similar to accounting for mergers and acquisitions under ASC 805 - *Business Combinations*. However, in the case of Fresh Start Accounting, the company's reorganization value is the basis for the allocation, as opposed to the total transaction consideration being the basis in a business combination (change in control transactions).

While an entity that emerges from Chapter 11 is considered a new legal entity, it does not always qualify for Fresh Start Accounting (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**:

1. The reorganization value of the assets immediately before the date of confirmation is less than the post-petition liabilities and allowed claims, AND

2. Control changes (i.e., the pre-petition shareholders lose control of the emerging entity by receiving less than 50% of the voting shares of the emerging entity).

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.

Reorganization Value

ASC 852 defines reorganization value as:

> *"The value attributable to the reconstituted entity, as well as the expected net realizable value of those assets that will be disposed of before reconstitution occurs. 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 restructuring."*

Reorganization value is often determined during the bankruptcy process and is the basis for the company's Fresh Start Accounting exercise. This reorganization (fresh start) value is often measured utilizing a discounted cash flow approach based on the company's new cash flow projections included in the reorganization plan.

Once the reorganization value had been established, the emerging entity follows similar guidelines in accounting for the fair value of its assets and liabilities as though it were a new acquisition. The reorganization value is allocated in accordance with the procedures set forth in ASC 805. This requires a valuation of the assets including any underlying real property, tangible assets and recognized intangible assets including assets that may not have been capitalized prior to the reorganization, such as trademark and tradename. Any value not allocated as a result of the analysis is reported as goodwill.

Summary

Obviously, accounting for bankruptcy transactions involves an in depth understanding of specific financial reporting requirements. Fresh Start Accounting rules require that valuation professionals in every discipline (financial, equipment, and real estate) have an understanding of valuation principles and methodologies. An independent multidisciplinary valuation firm with in-depth experience in similar engagements is a key component in a complex plan to assist companies as they emerge from bankruptcy.

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