

# FRESH START ACCOUNTING



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# FRESH START ACCOUNTING

Companies emerging from bankruptcy may be required to apply fresh start accounting. A&M provides a comprehensive suite of services, to advise and assist companies in adopting this non-routine area of accounting and reporting – allowing management to focus on the post-emergence business.



## PRE-EMERGENCE PLANNING

The process begins with determining if fresh start accounting applies. ASC 852 - Reorganizations requires that fresh start be applied if the company is balance sheet insolvent prior to emergence and a change in control occurs upon the court's confirmation of the plan of reorganization (Plan). If fresh start accounting applies, the company should start by reviewing its balance sheet and operating or legal structure with accounting and valuation experts in order to assess the level of effort that will be required to value and account for the company's emergence. In addition, it should evaluate its system capabilities, prepare an implementation timeline, and discuss its planning process with external auditors. Finally, the company should evaluate the income tax aspects of the reorganization, including the impact to its net operating losses (NOLs) and the impact of cancellation of indebtedness income (CODI) on the company's tax attributes.

## EMERGENCE

Emergence from bankruptcy occurs when the court confirms the Plan and all of the Plan's material conditions are resolved. This also marks the date a company should record the effects of Plan adjustments and adopt fresh start accounting. If the date of emergence is not within a few days of month end, it may prevent the company from using the month end as a convenience date. In that case, the company would be required to reflect emergence as of a non-traditional period end, likely necessitating additional effort to ensure that appropriate cut-off and other period-end reporting protocols are undertaken before accounting for emergence.

Immediately prior to emergence, the company must record adjustments to reflect (a) the effects of the Plan and (b) the impact of fresh start accounting. This is the last act as the pre-emergence, or predecessor, company for financial reporting purposes. The adjustments to reflect the effects of the Plan must consider the Plan's pre-petition liability settlement terms, exit financing structure, and the related funds flow. The company's adjustments to reflect the impact of fresh start accounting are similar to the acquisition method for business combinations under ASC 805, but with two distinct nuances. First, reorganization value, as opposed to purchase price, is used in allocating fair value to individual assets and liabilities. Reorganization value is the fair value of the company's assets before considering any liabilities. Second, the offsets to the balance sheet adjustments to individual assets and liabilities are recorded as a gain or loss in the predecessor income statement. The application of fresh start accounting frequently gives rise to the recognition of new intangible assets, including residual goodwill, similar to a business combination.

## POST-EMERGENCE

**Disclosure.** Bankruptcy-related disclosure under ASC 852 is comprehensive and impacts all aspects of a company's financial statements. Companies are required to provide a narrative description of the effects of the Plan and the impact of adopting fresh start accounting in the footnotes. This includes a discussion of how pre-petition liabilities were settled, how reorganization value was determined, and a schedule that quantifies the various balance sheet adjustments recorded, commonly known as the *four-column balance sheet*.

The four-column balance sheet becomes a roadmap to understanding the transformation that occurred at the emergence date. It bridges the final predecessor balance sheet to the opening balance sheet of the newly emerged company, known as the successor, separately showing the adjustments to reflect (a) the effects of the Plan and (b) the impact of fresh start accounting.

Footnotes to the four-column balance sheet provide insight into how each adjustment was developed and the fair value estimates and approaches used by company management. It also provides users with a reconciliation of the reorganization gain or loss recognized upon emergence, which is often a significant amount.

**Post-emergence reporting.** Following emergence, the fresh start accounting adjustments will have an impact on many of the company's financial performance measures. This includes the ongoing income statement impact of inventory step-ups, deferred revenue haircuts, amortization of identified intangibles, the revaluation of off-market operating leases, and depreciation of revalued long-lived assets among other things. The run-off of such adjustments can have a lasting impact on the post-emergence GAAP financial statements and make them difficult to compare to prior periods. Management often seeks the capability to isolate and quantify such effects in their accounting systems for purposes of discussing and analyzing post-emergence results on a non-GAAP basis.

In addition to financial reporting, fresh start accounting may affect other areas within an organization. The processes for budgeting and forecasting, income taxes and debt covenant compliance may all require adjustments due to the lingering effects of fresh start.

**Income taxes.** The U.S. Tax Code imposes certain limitations for an entity emerging from bankruptcy that require careful evaluation. Companies emerging from bankruptcy also frequently encounter issues related to CODI. While CODI is generally excluded from gross income if the cancellation is granted in a bankruptcy, the exclusion is limited to the amount of insolvency. Any CODI excluded from gross income under these exceptions is generally applied to reduce certain tax attributes (NOLs, general business credits, capital loss carryovers, minimum tax credits, basis in property, etc.).

## OUR PROFESSIONALS



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## A&M CAN HELP MANAGEMENT:

- Determine if fresh start accounting applies
- Manage the project and transition
- Coordinate approach and timeline with restructuring advisors, auditors, attorneys and other stakeholders
- Assess system capabilities
- Develop short- and long-term system solutions
- Evaluate income tax implications of the reorganization
- Perform or coordinate valuations of assets and liabilities
- Prepare final predecessor financial statements
- Prepare journal entries for the effects of the Plan and fresh start accounting
- Document accounting positions for all applicable technical accounting, income tax and reporting matters
- Draft bankruptcy and fresh start-related disclosures
- Provide audit-ready documentation
- Respond to requests from auditors and others
- Implement post-emergence reporting best practices
- Provide post-emergence support