Fresh-Start Accounting Becomes Part of the Daily Financial Intake
Gary, Dan
American Bankruptcy Institute Journal; Feb 2010; 29, 1; ProQuest Central
pg. 30

Fresh-Start Accounting Becomes Part of the Daily Financial Intake

Written by:
Dan Gary[1]
KPMG LLP; Chicago
dgary@kpmg.com

Editor's Note: *Please see the Financial Statements column in the July/August 2009 issue of the* Journal *for an article discussing the requirements and criteria for fresh-start accounting and how to apply it. This article addresses the possible implications of fresh-start accounting.*

Chapter 11 bankruptcy filings have become part of nearly every major industry, including two of the Big Three auto manufacturers (General Motors and Chrysler), all tiers of their suppliers (Delphi, Visteon and Dana), most of the airline industry (United, Northwest, Delta and many smaller carriers), retailers (K-Mart and Winn-Dixie), telecommunication providers (WorldCom and Charter), basic energy (PG&E and NRG), financial institutions (Conseco and Refco), and the list goes on. Therefore, it becomes critical for both companies and investors to understand the "fresh-start" accounting that often applies to companies emerging from chapter 11. What is fresh-start accounting?

Fresh-start accounting resets nearly all amounts to fair value. The value of the reformed company is allocated to the assets and liabilities on a fair-value basis, with the residual amount being goodwill. Fresh-start accounting is required for companies emerging from chapter 11 when two conditions are met: its obligations exceed its assets prior to any special relief (balance-sheet insolvent), and the new equityholders own more than 50 percent of the company (change of control).

Examples

What are some specific differences between Company A, which is reporting on a fresh-start accounting basis, and Company B, which is not on a fresh-start accounting basis?

Previously unrecorded assets. Under fresh start, a company records all assets at fair value—even previously unrecorded assets. For example, Company A would record asset balances for its patents based on the current economic values, while Company B may have previously expensed the cost to develop and register patents over an extended period of time. This translates to a larger balance sheet and higher amortization expense for Company A. This dynamic is especially relevant to companies in the technology and pharmaceutical sectors that regularly incur significant costs to reach patented technologies or formulas, but end up accumulating little or no costs on the balance sheet.

Brands. Brands are developed over time through quality products, customer acceptance and effective advertising. This can add bulk to Company A's balance sheet, as brands are typically unrecorded assets that are recognized in fresh start. Although brand assets are often not amortized, the asset balance adds bulk to the balance sheet and translates to impairment risk. The value of a brand can be enormous for consumer goods producers.

In-Process Research and Development (IPR&D). Research and development efforts that are underway may have economic value, but do not otherwise qualify for capitalization. Fresh-start accounting requires that Company A's balance sheet bear these assets as well as either amortization upon successful development or a lump-sum expense when it is abandoned. Company B's earnings will likely show a smoother trend of research and development expense as incurred.

Possible Implications of Fresh-Start Accounting

We will see fresh-start more than ever before, as it has impacted market leaders as well as middle-market companies, so we will need to understand the key impacts. There are three areas to consider.

First, fair-value adjustments affect earnings in the periods following bankruptcy, making it difficult to analyze trends over pre- and post-chapter 11 periods. The impact is not easy to identify on the face of the income statement, and the note disclosures do not provide the details necessary to isolate the charges to establish level comparisons. Noncash fresh-start accounting adjustments are commingled with cash expenses across all captions of the income statement such as:

- *Cost of sales.* Inventory is often adjusted upward, translating to higher costs of sales and lower margins.
- *Operating expenses.* Intangible assets are amortized to nearly any caption within operating expenses.
- *Interest expense.* Fair-value adjustments to long-term obligations are often amortized to interest expense.

Even experienced analysts may have difficulty isolating the impact of fresh-start from reported results. Nevertheless, an understanding of which items are impacted by fresh-start and the likely direction of such impacts can prevent unfair comparisons.

Second, it may be unfair to compare a company's fresh-start accounting results to that of a peer reporting on its historical basis. Fresh-start typically impacts various income statement metrics in opposing ways, such as:

- *Higher net earnings.* Fresh-start accounting results benefit from an optimized capital structure with lower interest expense. Interest expense is classified "below" operating earnings, so there would be an increase to net earnings with no impact on operating earnings.
- *Lower operating earnings.* Fresh-start may add bulk in the form of higher asset values producing additional amortization expense. Amortization is classified as an operating expense, so it reduces operating earnings. Even if there

About the Author

Dan Gary is a partner in KPMG LLP's Transaction Services practice in Chicago.

[1] The views and opinions are those of the author and do not necessarily represent the views and opinions of KPMG LLP. All information provided is of a general nature and is not intended to address the circumstances of any particular individual or entity.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

are no fundamental changes to the company's actual operations, the bankruptcy and fresh-start accounting can translate to lower operating earnings. This may be mistaken as a decrease in true operating performance, as a simple trend of operating earnings would show a drop in periods subsequent to fresh start. As previously mentioned, it is difficult to isolate the incremental expense from fresh-start accounting adjustments as it is subsumed into the various line items on an income statement (cost of revenue, general and administrative expense, etc.).

Case in point: The negative impact on operating earnings is especially visible in financial restructurings, which are increasingly common in recent years. For example, a company with strong operating earnings is over-leveraged with debt, so despite strong operating earnings, the interest expense and principal cannot be paid. The company undergoes chapter 11 proceedings to reduce debt but makes virtually no changes to its operations. Upon applying fresh-start accounting, assets would likely be adjusted upward to fair value and previously unrecorded assets would be established (brands, contracts, etc.). These asset adjustments translate to additional amortization expense, which lowers operating earnings. In this example, operating earnings are negatively impacted by accounting adjustments, not substantive changes to operations. Conversely, the reduced debt load translates to significantly lower interest expense and improved net earnings. The company has a healthier earnings stream, as evidenced by improvement to the bottom line (net earnings), but a trend line on operating earnings might improperly imply deterioration of normal operations. Moreover, it could be construed that the company is less efficient than its peer group.

Third, it may be necessary to identify metrics that are not skewed by these factors. Such measures may be non-GAAP (not advocated by Generally Accepted Accounting Principles), such as earnings before interest, taxes and depreciation and amortization (EBITDA) or "normalized EBITDA" to remove other nonrecurring impacts of chapter 11. EBITDA would exclude both the impact of additional amortization expense and the reduction of interest expense.

While non-GAAP measures may be informative, the rules on presenting such metrics can be difficult to navigate. The Securities Exchange Commission looks carefully at the presentation of non-GAAP measures to ensure that they do not overshadow GAAP-basis information. While a non-GAAP measure may serve as a supplemental disclosure, it does not create a level comparison with equal prominence. Nevertheless, understanding the impact and identifying alternative measures may be critical in drawing a fair comparison between current and historical periods as well as among peers.

The frequency and size of bankruptcies are at unprecedented levels and it seems this trend may continue. Therefore, even companies that do not undergo a chapter 11 proceeding may find it necessary to consider the impact of other companies reporting on a fresh-start accounting basis for reasons such as:

Financial literacy. The concept of financial literacy has gained attention over recent years. Executives are required to understand and assume responsibility for internally and externally reported financial information. Boards are required to have financially literate directors. Business advisers of all types—attorneys, bankers, strategy consultants—are more effective when they understand their client's

continued on page 59

Bankruptcy Management Solutions provides the right tools to simplify your insolvency and post-confirmation responsibilities.

We specialize in:

- Automated ECF case retrieval and delivery
- Comprehensive document and asset management
- Integrated Web Portal service providing online communications to case constituents
- Online banking and disbursement services
- Access to extensive list of automated reports

See for yourself why Bankruptcy Management Solutions is the right resource for you.

DO YOU HAVE THE RIGHT RESOURCE WORKING FOR YOU?

PHONE: 800.634.7734
EMAIL: BMS@BMS11.COM
WEB: WWW.BMS11.COM

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

Trustee Talk: Can a Debtor Who Files Chapter 13 in Bad Faith Survive Dismissal?

from page 53

cases is particularly appropriate in light of the fact that lack of good faith in proposing a chapter 13 plan is an express statutory ground for denying plan confirmation. 11 U.S.C. §1325(a)(3). *See also In re Love*, 957 F.2d at 1356 ("because dismissal is harsh...the bankruptcy court should be more reluctant to dismiss a petition...for lack of good faith than to reject a plan for lack of good faith under section 1325(a).").[31]

[31] *Marrama*, 549 at 1112, n. 11.

Conclusion

Sometimes debtors do bad things. If the debtor's bad conduct relates to his honesty to the court, his compliance with orders of the court or his efforts to abuse the bankruptcy process, his conduct should result in "forfeiture of his right to proceed with a chapter 13 case."[32] Yet we should distinguish between pre- and postpetition conduct. Debtors who engage in bad conduct *prepetition* should be eligible to reorganize or rehabilitate. The test to survive in bankruptcy should be whether a debtor's conduct *postpetition* reflects a sincere effort for financial rehabilitation and does not involve false statements, concealment of assets, underreporting of income or manipulation of the Bankruptcy Code. Indeed, a bad person ultimately may be a good debtor. ■

[32] *Marrama*, 549 U.S. at 367 (Justice John Paul Stevens describes question presented to Court as whether debtor who acts in bad faith prior to or in course of filing chapter 13 petition "forfeits his right to obtain Chapter 13 relief" and goes on to acknowledge that federal courts are "virtually unanimous that prepetition bad faith conduct may cause a forfeiture of any right to proceed with a Chapter 13 case.").

Financial Statements: Fresh-Start Accounting Becomes Commonplace

from page 31

financial situation and the impact of their role on the financial results. This typically involves reading and understanding externally-reported financial information. When fresh-start accounting has been applied, a basic understanding of the impact is necessary to understand the reported results.

Covenants. Covenants are typically evaluated and re-evaluated during the chapter 11 process. The covenants on debtor-in-possession (DIP) financing and exit financing are often negotiated prior to final application of fresh-start accounting. This timing raises the risk that fresh start could trigger unforeseen debt covenant violations. To mitigate this risk, companies might draft covenants that specifically exclude the impact of subsequent fresh-start accounting adjustments or include a clause that covenant ratios will be reset upon final fresh-start accounting subject to certain tolerances.

Fresh-start can also become an issue with regard to covenants on debt that is not canceled during the chapter 11 process. For example, secured creditors may stand to survive the bankruptcy unimpaired, but they may desire to accelerate the recovery of their investment. This sentiment can surface when the secured creditors do not like the prospects of the emerged company but were not permitted to vote on the reorganization plan because they were not an impaired class. To accelerate recovery of their loans, they may seek to assert that the underlying covenants were violated in order to force acceleration of payment on their loans. It is likely that the financial metrics would be impacted by the fresh-start accounting adjustments and could result in covenant violations. Therefore, it may be necessary to proactively address covenants on surviving debt as well as new debt.

Trends and peer group analysis. Companies typically report trends over a continuum or on the basis of current versus comparable prior periods. Analysts use reported trends or even calculate their own trends as part of their research and ratings analyses. There is potential that fresh-start accounting causes confusion among the investment community. This makes it critical to isolate the impact of fresh-start accounting by selecting metrics that make pre- and post-fresh-start periods comparable. This issue is important to both the company reporting on a fresh-start accounting basis, as well as its competitors, to ensure that one entity does not have a perceived advantage. For example, given the pervasiveness of chapter 11 filings in the airline industry, it would be important for American Airlines to consider the impact of fresh-start accounting by United, Northwest, Delta and others—particularly the impact of assets and liabilities from lease contracts resulting from fresh-start.

Acquisitions. A recent application of fresh-start accounting provides an enterprise value, business unit values and individual asset values. This can be especially helpful to an acquirer during the due-diligence process in formulating a purchase price:

- *Sum of the parts vs. the whole.* The business unit values facilitate an analysis of whether to absorb the entire company or consider subsequent divestitures of certain business units. Moreover, individual asset values may suggest opportunities to divest items with high market value based on the more cost-efficient option of owning or leasing.
- *External validation.* The involvement of a financial adviser and voting process are external validations of the company value. Commonly, a financial adviser will determine the enterprise value by use of a discounted cash-flow model. Simply put, under a discounted cash-flow model, discount factors (based on selected rates of return) are applied to estimated future cash flows to determine a single fair-value amount. Companies emerging from bankruptcy will have such an analysis available, which can be extremely helpful in determining a purchase price pursuant to acquiring the company. This information is provided in the company's disclosure statement, which is publicly available and explicitly provided to the parties voting on the emergence plan. The voting classes of claimholders are implicitly accepting the enterprise value and underlying projected cash flows by voting in favor of emergence from bankruptcy.

Conclusion

Chapter 11 filings and fresh-start accounting will yield impacts on financial information for years to come. The pervasiveness of these effects makes it necessary to establish a more common understanding of fresh-start accounting, as well as a search for common grounds of comparison. ■

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.