



Accounting for bankruptcies

Handbook

US GAAP

May 2026

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A difficult time

Nobody enjoys going through Chapter 11 bankruptcy. The process of filing for bankruptcy and successfully emerging from bankruptcy is time-consuming and challenging. Bankruptcy takes a toll on resources as a business navigates the interests of the Court, creditors, lawyers and advisors, and employees.

Subtopic 852-10 provides specific accounting and financial statement presentation requirements for entities in Chapter 11 bankruptcy. These requirements bring their own challenges, and in some cases it may be difficult to understand how the guidance intersects with the broad US GAAP requirements that continue to apply to entities in Chapter 11 bankruptcy.

This Handbook addresses some of the key accounting and presentation issues facing companies moving through the various stages of Chapter 11 bankruptcy: as they approach a bankruptcy filing, once they are in bankruptcy, and as they emerge from bankruptcy.

We hope this Handbook will help take your mind off the accounting to focus on what's important – getting your business back on track.

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About this publication

The purpose of this Handbook is to enhance your understanding of the accounting and financial reporting considerations an entity may encounter as it enters Chapter 11 bankruptcy, during the Chapter 11 bankruptcy, and as it emerges from Chapter 11 bankruptcy. An entity in Chapter 11 bankruptcy is subject to the guidance in Subtopic 852-10, Reorganizations.

Scope of this Handbook

Federal law governs bankruptcy in the United States and allows individuals and businesses to eliminate or reorganize debt in a structured, orderly manner. Title 11 of the United States Code was enacted by the Bankruptcy Reform Act of 1978 (the Code) and provides the basis for the current federal bankruptcy system.

This Handbook focuses on entities that are contemplating filing for bankruptcy, operating during Chapter 11 bankruptcy and/or emerging from Chapter 11 bankruptcy. This Handbook considers the application of Subtopic 852-10, Reorganizations, and the effects of the Code. Laws in other jurisdictions, which are not considered in this Handbook, may have different accounting consequences.

This Handbook does not address instances in which an entity is preparing financial statements on a liquidation basis under Subtopic 205-30 or has executed a quasi-reorganization under Subtopic 852-20.

In addition to Subtopic 852-10, other US GAAP will likely apply to an entity during the aforementioned period. These other accounting and financial reporting considerations are discussed throughout this Handbook. Where applicable, links to other KPMG publications are included.

Organization of the text

Each chapter of this Handbook includes excerpts from the *FASB Accounting Standards Codification*[®] and overviews of the relevant requirements. Our in-depth guidance is explained through Q&As that reflect the questions we encounter in practice. We include examples to explain key concepts.

Our commentary is referenced to the Codification and to other literature, where applicable. The following are examples:

- 852-10-15-1 is paragraph 15-1 of ASC Subtopic 852-10
- FAS 141.44 is paragraph 44 of FASB Statement No. 141, Business Combinations
- SAB Topic 5.P is paragraph P of SEC Accounting Bulletins Topic 5.P as codified in ASC 420-10-S99
- 2002 AICPA Conf is the 2002 AICPA National Conference on Current SEC Developments

- SEC SLB No. 2 is SEC Staff Legal Bulletin No. 2
- SEC FRM 9510.3 is section 9510.3 of the SEC Financial Reporting Manual
- PB 11.08 is paragraph 8 of AICPA Practice Bulletin No. 11
- REG S-K Item 303 is SEC Regulation S-K Item 303
- SOP 90-7.43 is paragraph 43 of AICPA Statement of Position of 90-7, Financial Reporting by Entities in Reorganization Under the Bankruptcy Code
- FSP SOP 90-7-1.6 is paragraph 6 of FASB Staff Position Statement of Position 90-7-1, An Amendment of AICPA Statement of Position 90-7
- SEC Regs Comm 04/2004 is the April 2004 minutes of the SEC Regulations Committee
- ASU 2017-07.BC25 is paragraph 25 of the basis for conclusions of ASU 2017-07, Compensation—Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost

May 2026 edition

This edition of our Handbook has minor updates. Compared to the May 2025 edition, items that have been updated or revised are identified with #. The [Index of changes](#) identifies all significant changes.

Pending content

This edition of our Handbook incorporates amendments to the FASB Codification from ASU 2025-12, Codification Improvements. The amendments in this ASU are effective for annual and interim periods in fiscal years beginning after December 15, 2026, with early adoption permitted.

The Codification excerpts containing the amendments for this ASU are reproduced as if the pending content were currently effective for all entities – i.e. the amendments are not labeled as pending content.

Abbreviations

We use the following abbreviations in this Handbook:

AOCI	Accumulated other comprehensive income
DIP	Debtor-in-possession
VIE	Variable interest entity

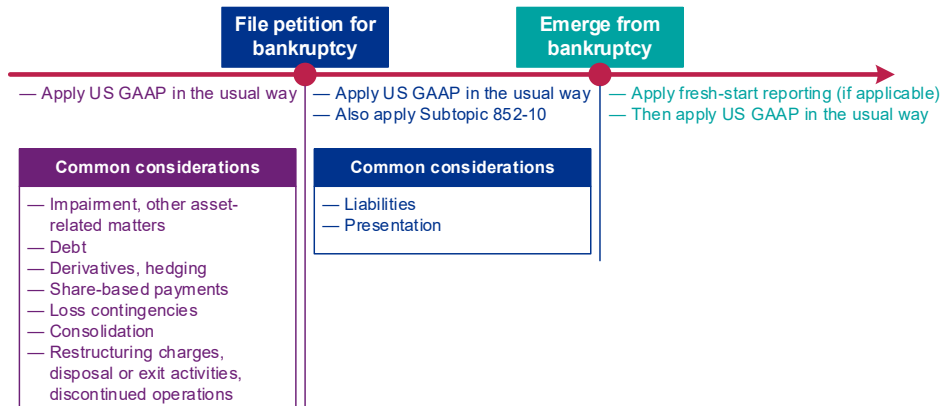
1. Executive summary

Scope

Federal law governs bankruptcy in the United States and allows individuals and businesses to eliminate or reorganize debt in a structured, orderly manner. Title 11 of the United States Code was enacted by the Bankruptcy Reform Act of 1978 (the Code) and provides the basis for the current federal bankruptcy system.

Chapter 11 is the focus of this Handbook. It is one of the most common types of bankruptcy filing for businesses. It provides for a reorganization of an entity's financial affairs through a court-approved plan to modify, reduce or eliminate the entity's debt and other liabilities – all while continuing to conduct business operations.

The following diagram depicts the accounting and financial reporting considerations at the different stages of a Chapter 11 bankruptcy. Subtopic 852-10 provides targeted guidance in certain areas to complement other guidance in US GAAP but is not designed as a comprehensive framework for entities in bankruptcy.



Before bankruptcy

In the period preceding bankruptcy, there are no 'special' accounting requirements, and an entity continues to apply US GAAP in the usual way. However, the facts and circumstances causing the entity to contemplate bankruptcy may trigger incremental accounting considerations given the entity's financial standing.

Examples of accounting issues that may take on increased importance ahead of bankruptcy include the impairment of goodwill, long-lived assets, investments and inventory; changes in the allowance for credit losses for contract assets, accounts receivable and loans receivable; the classification of debt, troubled

debt restructurings, debt extinguishments and modifications; the criteria for applying hedge accounting; and loss contingencies.

Read more: [Chapter 3](#)

During Chapter 11 bankruptcy

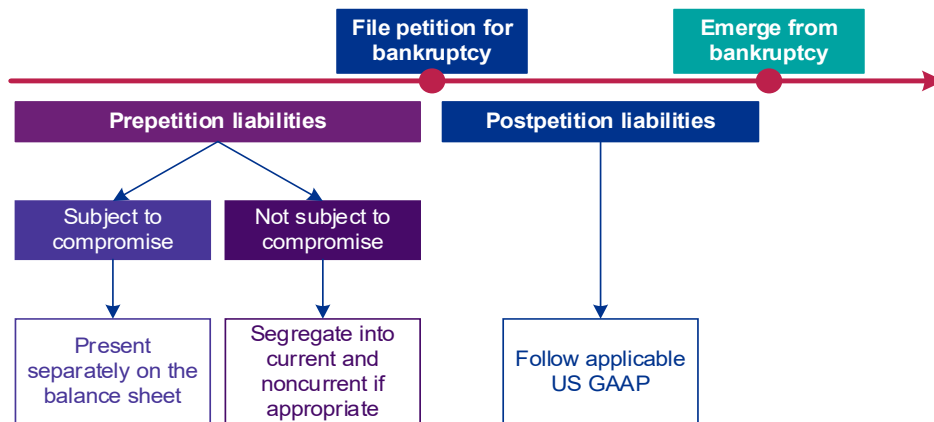
The financial statements of an entity reporting under Subtopic 852-10 are in many ways similar to those the entity would ordinarily prepare. An entity continues to follow US GAAP applicable to a going concern unless liquidation becomes imminent.

However, during bankruptcy the needs of the financial statement users change. Subtopic 852-10 attempts to meet those needs with incremental requirements related to the classification and accounting for certain liabilities and the presentation of the statement of operations.

Liabilities

The following diagram highlights how Subtopic 852-10 distinguishes between different liabilities. Liabilities incurred by the entity before filing for bankruptcy are prepetition liabilities, and those incurred after are postpetition liabilities.

Prepetition liabilities can be either subject to compromise or not subject to compromise. A prepetition liability is subject to compromise if it is impaired from the creditor's perspective – i.e. the creditor might not recover the full amount owed. This may be the case if, for example, a claim is unsecured or the value of any security is less than the creditor's claim. In contrast, postpetition liabilities are not subject to compromise.



When an entity files for bankruptcy, prepetition liabilities subject to compromise are measured at the amount that is expected to be allowed for the claim. Changes in that carrying amount are recognized separately in the statement of operations – within 'reorganization' items.

Statement of operations

An entity in bankruptcy distinguishes transactions and events that are directly associated with the bankruptcy proceedings from its ongoing, normal operations. To accomplish this, expenses, gains and losses resulting from bankruptcy proceedings are reported as reorganization items separately in the statement of operations.

The following are examples of items that are typically considered reorganization items:

- Changes to liabilities and related accounts resulting from the application of Subtopic 852-10.
- Gains/losses from adjusting the carrying amount of debt to the amount of the allowed claim.
- Losses from rejecting or modifying executory contracts.
- Other expenses directly related to bankruptcy proceedings.

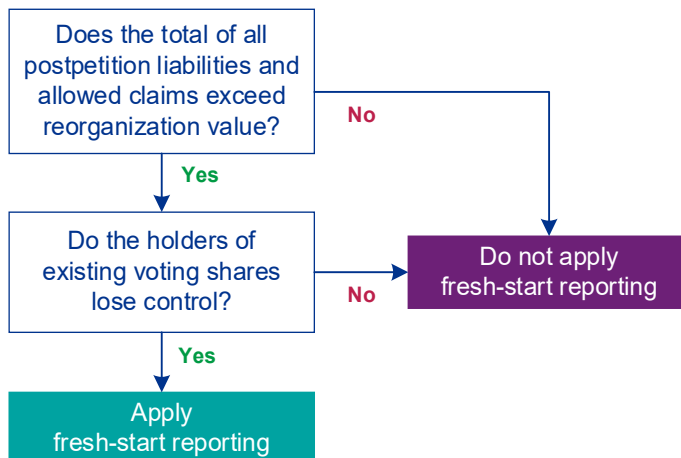
Read more: [Chapter 4](#)

Emerging from Chapter 11 bankruptcy

An entity emerges from Chapter 11 bankruptcy when the Court has confirmed the plan of reorganization and conditions precedent (if any) are met. Once confirmed by the Court, the plan is binding on the entity (the debtor) and creditors.

If an entity qualifies for fresh-start reporting under Subtopic 852-10, its reorganization value (i.e. the aggregate value of the emerging entity's assets before considering liabilities) is assigned to its assets, liabilities and equity. Assigning value to its assets and liabilities is performed using the acquisition method principles followed in a business combination. From an accounting and financial reporting perspective, the emerging entity is considered a new reporting entity separate from the pre-emergence (or predecessor entity).

The diagram highlights the criteria that need to be met for an entity to qualify for fresh-start reporting.



An entity that does not qualify for fresh-start reporting continues to apply other US GAAP.

Read more: [Chapter 5](#)

2. Overview of bankruptcy

Detailed contents

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2.1 Introduction

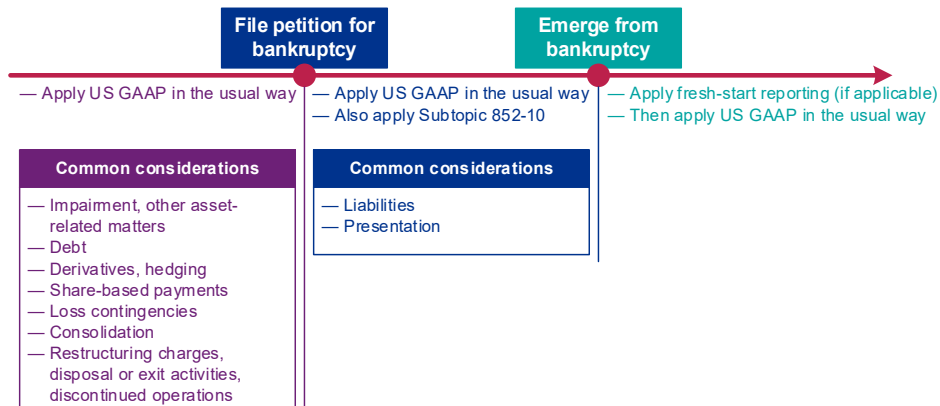
Federal law governs bankruptcy in the United States and allows individuals and businesses to eliminate or reorganize debt in a structured, orderly manner. Title 11 of the United States **Bankruptcy Code** was enacted by the Bankruptcy Reform Act of 1978 (the Code) and provides the basis for the current federal bankruptcy system.

This chapter provides an overview of the types of bankruptcies available to businesses and the process followed during bankruptcy proceedings. Later chapters explain:

- accounting and financial reporting considerations before filing for bankruptcy (see [chapter 3](#))
- accounting and financial reporting during **Chapter 11** bankruptcy (see [chapter 4](#))
- accounting and financial reporting upon emergence from Chapter 11 bankruptcy (see [chapter 5](#)).

Chapter 11 is one of the most common types of bankruptcy filing for businesses. It allows an entity to reorganize its financial affairs while continuing to conduct business operations. This Handbook focuses on entities that are contemplating filing for bankruptcy, operating during Chapter 11 bankruptcy and emerging from Chapter 11.

The following diagram depicts the accounting and financial reporting considerations at the different stages. Subtopic 852-10 provides targeted guidance in certain areas to complement other guidance in US GAAP but is not designed as a comprehensive framework for an entity in bankruptcy.



This Handbook does not address instances in which an entity is preparing financial statements on a liquidation basis under Subtopic 205-30 or has executed a quasi-reorganization under Subtopic 852-20.

In this chapter, terms that are defined in the [Subtopic 852-10 glossary](#) are highlighted.

2.2 Types of bankruptcies

The US Bankruptcy Court (the Court) is an adjunct of the US District Courts. Under the jurisdiction of the District Court, the Bankruptcy Court is generally responsible for cases filed under the Code.

There are six types of bankruptcies under the Code. They are identified by the chapters within the Code that describe them. The following table provides a description of each type of bankruptcy, as well as the types of entities permitted to use them.

Type	Applicability	Description
Chapter 7	Individuals and businesses	Provides for the appointment of a panel trustee for orderly liquidation of the assets of the entity to satisfy some or all of its liabilities to its creditors. See section 2.4 .
Chapter 9	Municipalities	Allows reorganization similar to Chapter 11 for an entity that meets the Code's definition of a municipality. See section 2.5 .
Chapter 11	Individuals and businesses	Provides for a reorganization of an entity's financial affairs through a court-approved plan to modify, reduce or eliminate the entity's debt and other liabilities; allows business operations to continue during proceedings. See section 2.3 .
Chapter 12	Farmers	Provides debt relief to family farmers with regular annual income.
Chapter 13	Individuals and qualifying businesses	Provides debt relief to individuals with regular annual income and qualifying small businesses.
Chapter 15	Ancillary and other cross-border cases	Provides mechanisms for dealing with cross-border insolvency cases. See section 2.6 .

Chapter 7, Chapter 11 and Chapter 13 are the most common types of bankruptcies. Chapter 11 is the focus of this Handbook. Subtopic 852-10 discusses the accounting and financial reporting for this type of bankruptcy. A unique aspect of this guidance is the requirement to use 'fresh-start' reporting on emerging from bankruptcy if certain conditions are met.

2.3 The Chapter 11 bankruptcy process

2.3.10 Overview

Excerpt from ASC 852-10

05-2 This Subtopic addresses the accounting and financial statement disclosure for entities that have filed petitions with the **Bankruptcy Court** and expect to reorganize as going concerns under Chapter 11 of the **Bankruptcy**

Code. This Subtopic necessarily contains many references to provisions of the Bankruptcy Code; however, the material in this Subtopic should not be relied upon as definitive interpretations of the law for any purposes. The accounting and reporting guidance in this Subtopic is incremental to guidance that otherwise applies to an entity.

05-3 An entity enters reorganization under **Chapter 11** by filing a **petition** with the Bankruptcy Court, an adjunct of the United States District Courts. The filing of the petition starts the **reorganization proceeding**. The goal of the proceeding is to maximize recovery by creditors and shareholders by preserving it as a viable entity with a going concern value. For that purpose, the entity prepares a **plan of reorganization** intended to be confirmed by the court. The plan provides for treatment of all the assets and liabilities of the debtor, which might result in forgiveness of indebtedness. For the plan to be confirmed and the reorganization proceedings thereby concluded, the consideration to be received by parties in interest under the plan must exceed the consideration they would otherwise receive on liquidation of the entity under Chapter 7 of the Bankruptcy Code. The court may confirm a plan even if some classes of creditors or some of the stockholders have not accepted it, provided that it meets standards of fairness required by Chapter 11 to the dissenting class of creditors or the dissenting stockholders.

05-4 The plan is the heart of every Chapter 11 reorganization. The provisions of the plan specify the treatment of all creditors and equity holders upon its approval by the Bankruptcy Court. Moreover, the plan shapes the financial structure of the entity that emerges.

05-5 Chapter 11 provides that, unless a **trustee** is appointed, the debtor has the exclusive right to file a plan for the first 120 days of the case, or such longer or shorter time as the Bankruptcy Court decrees, for cause. If a plan is filed within the exclusive period, additional time is provided to allow the debtor to obtain plan acceptance. The appointment of the trustee immediately terminates the debtor's exclusive right to file a plan, and any party in interest may then do so.

05-6 Except to the extent that specific debts are determined by the Bankruptcy Court not to be discharged by the plan, the provisions of a **confirmed plan** bind the debtor, any entity issuing securities under the plan, any entity acquiring assets under the plan, and any creditor, equity security holder, or general partner in the debtor, regardless of whether the **claim** is impaired under the plan and whether such creditor, equity security holder, or general partner has accepted the plan. A claim is impaired if, subject to certain rights to cure defaults, its legal rights are affected adversely by the plan.

05-7 In general, except as provided in the plan or in the order confirming the plan, confirmation of the plan discharges the debtor from all preconfirmation claims and terminates all rights and interest of equity security holders or general partners as provided for in the plan.

05-8 The Bankruptcy Court confirms a plan if it finds all of the following:

- a. The plan and the plan proponent have complied with various technical requirements of the Bankruptcy Code.

- b. Disclosures made in soliciting acceptance of the plan have been adequate.
- c. Dissenting members of **consenting classes** of **impaired claims** would receive under the plan at least the amount they would have received under a **Chapter 7** proceeding.
- d. Claims entitled to priority under the Bankruptcy Code will be paid in cash.
- e. Confirmation of the plan is not likely to be followed by liquidation or further reorganization.
- f. At least one class of impaired claims, apart from insiders, has accepted the plan.
- g. The plan proponent has obtained the consent of all impaired classes of claims or equity securities, or the plan proponent can comply with the **cram-down provisions** of the Bankruptcy Code. Under the cram-down provisions, the court may confirm a plan even if one or more classes of holders of impaired claims or equity securities do not accept it, as long as the court finds the plan does not discriminate unfairly and is fair and equitable to each **nonconsenting class** impaired by the plan.

05-9 In general, a **secured claim** is deemed to be treated fairly and equitably if it remains adequately collateralized and will receive a stream of payments whose discounted value equals the amount of the secured claim on the effective date of the plan. In general, an **unsecured claim** is deemed to be treated fairly and equitably if it receives assets whose discounted value equals the allowed amount of the claim, or if the holder of any claim or equity security interest that is junior to the dissenting class will not receive or retain any assets under the plan. Similarly, an equity security interest is deemed fairly and equitably treated if that interest receives assets whose discounted value equals the greatest of any fixed liquidation preference, any fixed redemption price, or the value of such interest, or if no junior equity security interest will receive any assets under the plan.

> Reorganization Value

05-10 An important part of the process of developing a plan is the determination of the **reorganization value** of the entity that emerges from bankruptcy. Reorganization value generally approximates fair value of the entity before considering liabilities and approximates the amount a willing buyer would pay for the assets of the entity immediately after the restructuring. The reorganization value of an entity is the amount of resources available and to become available for the satisfaction of **postpetition liabilities** and **allowed claims** and interest, as negotiated or litigated between the **debtor-in-possession** or trustee, the creditors, and the holders of equity interests. Reorganization value includes the sum of the value attributed to the reconstituted entity and other assets of the debtor that will not be included in the reconstituted entity. Reorganization value and the terms of the plan are determined only after extensive arm's-length negotiations or litigation between the interested parties. Before the negotiations, the debtor-in-possession, creditors, and equity holders develop their own ideas on the reorganization value of the entity that will emerge from Chapter 11. Several methods are used to determine the reorganization value; however, generally it is determined by discounting future cash flows for the reconstituted business that will emerge from Chapter 11 and from expected proceeds or collections from assets not required in the reconstituted business, at rates reflecting the business and financial risks involved.

> The Disclosure Statement

05-11 A **disclosure statement** approved by the court is transmitted to all parties entitled to vote on the plan at or before the time their acceptance of the plan is solicited. The disclosure statement provides information that enables them to make informed judgments about the plan.

05-12 No postpetition solicitation of acceptance of a plan may be made unless by the time of the solicitation a disclosure statement previously approved by the Bankruptcy Court has been sent to those whose acceptance is required. The disclosure statement must contain adequate information, which is defined in the Bankruptcy Code as information that would enable a hypothetical reasonable investor typical of holders of claims or interests of the relevant class to make an informed judgment about the plan, as far as it is reasonably practicable to provide in light of the nature and history of the **emerging entity** and the condition of the emerging entity's records. Examples of the kinds of items that may be included in disclosure statements to provide such information include a summary of the reorganization plan, historical and prospective financial information, and a pro forma balance sheet reporting the reorganization value and the capital structure of the emerging entity.

05-13 What constitutes adequate information depends on the circumstances of the entity in Chapter 11, the nature of the plan, and the sophistication of the various classes whose acceptance is required. Although a valuation is not required for a Bankruptcy Court's approval of a disclosure statement, the instances in which valuations are not made are generally restricted to those in which the reorganization value of the emerging entity is greater than the liabilities or in which holders of existing voting shares retain more than 50 percent of the emerging entity's voting shares when the entity emerges from reorganization.

05-14 After reorganization proceedings have started, acceptances of a plan may not be solicited by any person without a disclosure statement approved by the court, but acceptances obtained before the proceedings started may be counted if they were solicited in compliance with applicable nonbankruptcy law governing the adequacy of disclosure or there is not any applicable nonbankruptcy law but there was in fact adequate information provided at the time of the prebankruptcy solicitation of acceptances of the plan.

05-15 While the court determines the adequacy of the disclosure statement, entities that expect to adopt fresh-start reporting (see Section 852-10-45 for guidance on what is referred to as fresh-start reporting) should report information about the reorganization value in the disclosure statement, so that creditors and stockholders can make an informed judgment about the plan. The most likely place to report the reorganization value is in the pro forma balance sheet that is commonly part of the disclosure statement. Because reorganization value may not have been allocated to individual assets concurrently with the preparation of the pro forma balance sheet included in the disclosure statement in some cases, it may be necessary to include in the pro forma balance sheet a separate line item to reflect the difference of the total reorganization value of the emerging entity over recorded amounts. When possible, reorganization value should be segregated into major categories.

> The Financial Reporting Consequences of the Absolute Priority Doctrine

05-16 Under the **absolute priority doctrine** of the Bankruptcy Code, if the amount of postpetition liabilities and allowed claims exceeds the reorganization value of the emerging entity, existing shareholders lose their legal right to any economic interest without the consent of creditors. Therefore, any equity interest in the emerging entity ultimately held by existing shareholders is given to them by the creditors. Among the reasons the creditors might give such shareholders equity interests in the emerging entity are to avoid the expensive and time-consuming legal proceedings necessary to implement the cram-down provisions of the Bankruptcy Code or to preserve continuity of management. Consequently, in this situation, if all of the conditions stated in paragraph 852-10-45-19 are met, then upon an entity's emergence from Chapter 11, this Subtopic requires the entity to adopt fresh-start reporting.

05-17 The following terms are widely used when addressing reorganizations, yet are not included in the text of the standards:

- a. **Administrative expenses**
- b. **Obligations subject to compromise**
- c. **Undersecured claim.**

A Chapter 11 bankruptcy under the Code is often called a reorganization proceeding. An entity that files for bankruptcy under Chapter 11 seeks to continue its business and restructure its debt. There is no limit on the amount of debt that can be restructured.

The Chapter 11 bankruptcy process is iterative. Once an entity files for bankruptcy, it works with the **Bankruptcy Court** and its advisors to manage and administer claims, while continuing to manage the operations of the business. The first step to initiating a bankruptcy proceeding is to file a bankruptcy petition with the Court.

2.3.20 Filing for Chapter 11

An entity can voluntarily file for bankruptcy by filing a **petition** with the Court, or its creditors can initiate involuntary bankruptcy proceedings under Chapter 11 if certain criteria are met. A bankruptcy petition is filed by each legal entity seeking bankruptcy protection. For example, a consolidated group that includes ten subsidiaries, a holding company and the parent entity must file a petition for each of these 12 entities to obtain bankruptcy protection for each entity.

An entity that is seeking or has been forced into reorganization under Chapter 11 is also referred to as a debtor.

The Court accepts the bankruptcy petition and rules on the proceedings. As the bankruptcy progresses, the Court either confirms the plan of reorganization or approves alternative actions to close the proceedings. The Court must also approve all attorneys, accountants and other professionals engaged by the debtor to assist with the proceedings.

Reorganization proceedings begin once a petition has been filed with the Court. The debtor is also required to file the following:

- a list of creditors;
- the following documents (unless the Court orders them not to be filed):
 - a schedule of assets and liabilities;
 - a schedule of current income and expenses;
 - a schedule of executory contracts and unexpired leases; and
 - a statement of financial affairs.

Upon filing a voluntary petition, the debtor becomes a **debtor-in-possession**. This means its board of directors and managers – as opposed to an independent trustee – continue to manage the business and bankruptcy proceedings.

In some cases, the Court may assign an independent **trustee** to serve in the management role. The trustee monitors the debtor's compliance with the applicable reporting requirements, bankruptcy laws and procedures. The Code only assigns a trustee in limited circumstances, the most common being when there is alleged fraud or mismanagement at an entity that files for bankruptcy.

An examiner may also be appointed by the Court to investigate a certain issue associated with the bankruptcy, or to assist in other aspects when management continues to run the business as debtor-in-possession. An examiner is generally not appointed if a trustee has been assigned.

Involuntary bankruptcy

Involuntary bankruptcy is rare. Unlike a voluntary petition, a debtor is not immediately placed in bankruptcy by the Court when creditors file an involuntary petition for bankruptcy. The Court serves the debtor with the involuntary petition and a summons. The debtor must respond to the summons within a specified period, typically by proposing to either:

- pay or otherwise resolve its outstanding debts with the creditor(s) that filed the petition and have the petition dismissed; or
- convert the petition from an involuntary case to a voluntary one.

Once the debtor responds to the summons, the Court schedules a hearing and determines whether the bankruptcy should proceed. If the Court rules in favor of the debtor, the case is dismissed. If the debtor fails to respond to the summons within the time allowed, or if the Court rules in favor of the creditors, the debtor is placed into involuntary bankruptcy.

Debtor protections

When a debtor files a petition for bankruptcy, it is immediately provided some important protections, most notably under the **automatic stay** provisions. These provisions prohibit enforcement actions against the debtor, including acts to control property of the debtor and its estate; efforts to collect, assess or recover claims; initiation or continuation of lawsuits; creation or enforcement of liens; or perfecting a lien so it can remain effective in the event the debtor defaults. These provisions also protect the creditors as a group by prohibiting actions by individual creditors to have their claims satisfied at the expense of other creditors.

First-day motions

These statutory protections come with restrictions limiting a debtor’s discretion to operate without Court approval. Because of this, debtor’s counsel (or independent trustee if one has been appointed) typically files a number of ‘first-day motions’ at the beginning of the bankruptcy proceedings.

For example, the Code generally prohibits a debtor from paying any obligations that arose before the bankruptcy filing. However, a debtor may file a motion seeking permission to pay prepetition employee wages or claims of critical trade vendors – i.e. obligations that need to be satisfied to continue normal business operations.

Avoidance powers

The purpose of avoidance powers is to recover unfair payments of prepetition liabilities at the expense of other creditors because the payments returned to the debtor can then be used to pay creditors in accordance with the priority rules of the Code. During bankruptcy proceedings, the debtor may exercise avoidance powers to cancel transactions that occurred up to 90 days before the bankruptcy, or up to one year if the creditor is an insider of the debtor.

The Code defines an insider as:

- a director of the debtor (or a relative of a director);
- an officer of the debtor (or a relative of an officer);
- a person in control of the debtor (or a relative of a person in control);
- a partnership in which the debtor is a general partner; or
- a general partner of the debtor (or a relative of a general partner).

When a debtor exercises its avoidance powers to cancel a transaction and force repayment, it is referred to as an avoidable transfer and the amount the counterparty is forced to return to the debtor is referred to as a preferential payment. The counterparty is entitled to file an unsecured claim for the amount that it was forced to return to the debtor.

Adversary proceedings

An adversary proceeding is a lawsuit filed separately within a bankruptcy case by filing a complaint with the Court. A debtor may initiate an adversary proceeding to recover money or property from an avoidable transfer. An adversary proceeding may also be initiated by creditors.

Creditor involvement

There are generally four classes of creditors, as follows (in priority order).

Type claim	Description
Secured creditor	A creditor is secured if it has a claim that is secured by collateral. A fully secured claim is when the value of the collateral is equal to or greater than the claim, and an undersecured claim is when the value of the collateral is less than the claim. For example, if a revolving line of credit is fully collateralized by an asset, the creditor is secured.

Type claim	Description
Administrative creditor	An administrative creditor holds an administrative claim. An administrative claim is a debt incurred postpetition, which represents the actual, necessary costs and expenses to continue to run the business in the debtor's ordinary course. These claims generally include salaries, certain taxes (e.g. income taxes) and compensation for certain professional services received.
Priority unsecured creditor	A priority unsecured creditor has an unsecured claim that is entitled to be paid ahead of other general unsecured claims , pursuant to the Code. For example, employees that have filed claims are usually priority unsecured creditors.
Unsecured creditor	A general unsecured creditor has a claim for any other unsecured prepetition debt owed to a creditor. These include (among other things) counterparties to trade payables and other accruals and contingency claims.

The **absolute priority doctrine** stipulates that no payments are made to subordinate classes unless the prior classes have been paid in full or settled in an equitable manner as determined by the Court. The debtor's equity holders at the time of the bankruptcy filing are entitled to any remaining residual interest in the debtor. The equity holders' interest may be reduced or eliminated during the bankruptcy proceedings.

The regional US Trustee will generally appoint a creditors' committee shortly after the bankruptcy filing. The creditors' committee comprises representatives from a range of unsecured creditors, including some unsecured creditors that are owed larger amounts by the debtor. Sometimes other committees are also appointed if necessary, to represent the interests of creditors and/or other stakeholders.

Obtaining cash to operate

Some debtors may not need additional cash to operate during bankruptcy because they have enough unencumbered cash. Other debtors may need to rely on cash collateral that is subject to a lender's security interest. To use this cash collateral, the secured party must agree to its use, or the Court may be required to authorize its use.

If the debtor cannot continue to operate even with the use of cash collateral, it may need to obtain a line of credit or another form of postpetition financing. The Code permits a debtor to borrow funds referred to as debtor-in-possession (DIP) financing and offers protections and priorities to induce lenders to make these loans. [Section 4.4.20](#) discusses accounting considerations related to DIP financing.

2.3.30 Operations during bankruptcy proceedings

A few weeks after a bankruptcy filing, Chapter 11 activities may slow down, and operations return to 'business as usual'. However, in addition to running its

business, the debtor must continue to comply with the various obligations and deadlines imposed by the Code. This can include, but is not limited to:

- filing monthly operating reports;
- paying quarterly fees to the US Trustee;
- filing tax returns by the IRS deadlines; and
- continuing to comply with SEC filing requirements, as applicable.

During this time, the debtor has a chance to evaluate its business and legal strategies. From a business perspective, the debtor may evaluate issues such as whether to sell or shut down certain locations or business lines, whether to reduce workforce and how to reduce expenses. From a legal perspective, it may evaluate issues such as whether to assume, assign or reject certain executory contracts, as well as exercise its avoidance powers. There may also be ongoing negotiations or litigation involving various stakeholders and other parties to the proceedings.

Claims administration

The administration of bankruptcy claims is an important process during bankruptcy proceedings. The Code defines a **claim** as either a right to payment or a right to an equitable remedy for breach of performance if the breach results in a right to payment.

A claim can be impaired or unimpaired. An **impaired claim** is a claim where the creditor's rights are expected to be altered as a result of bankruptcy. In contrast, an unimpaired claim is one that is expected to be settled in full, without any alterations.

In addition to being either impaired or unimpaired, there are four broad classes of claims, which correlate to the creditors classes discussed under [Creditor involvement](#):

- secured claims;
- administrative expense claims;
- priority unsecured claims; and
- general unsecured claims.

A claims agent generally collects claims filed by creditors and maintains the list of claims. Once the deadline for filing a timely filed claim (the 'bar date') has passed and there is a complete list of all possible claims, the debtor has the opportunity to analyze and object to claims.

Claims administration also involves ensuring that claims are classified appropriately. This is important as voting on a plan of reorganization is done on a plan class basis (see [section 2.3.40](#)).

Executory contracts during bankruptcy proceedings

An executory contract is a contract under which performance remains due, either by the debtor or by the creditor (e.g. a lease). The Code allows a debtor the following options on each executory contract, subject to the Court's approval.

- **Assume the contract** and continue performing without modification. If a contract is assumed, it must be assumed in its entirety. Its terms cannot be modified, nor can only part of the contract be assumed.

Additionally, there are some limits to a debtor's ability to assume a contract. For example, if a contract is in default, the debtor can only assume it if certain requirements of the Code are met. Such stipulations include the debtor's requirement to cure pre- and postpetition defaults, reimburse the counterparty for reasonable amounts resulting from the debtor's defaults (which may be in the form of legal fees) and provide adequate assurance that the debtor will fulfill the contract's future obligations.

- **Modify the contract's** terms and conditions.
- **Assign the contract** to a third party. A contract may be assigned if there is adequate assurance that the assignee will continue to perform under the contract.
- **Reject the contract**, relieving all parties from further obligations. If a debtor rejects a contract, it is protected from the counterparty seeking remedies by the automatic stay provisions (see [section 2.3.20](#)). Instead, when a debtor rejects a contract, the counterparty will generally file a claim for breach of contract. Similar to assumed contracts, the debtor must reject a contract in its entirety. It cannot reject only part of the contract and assume, modify or assign the rest.

The debtor is allowed a reasonable amount of time (as determined by the Court based on circumstances) to decide what action it will take on each executory contract. The Code allows a debtor to assume or reject an executory contract (other than a lease for nonresidential real property) any time before confirmation. However, if the counterparty to the contract asks the Court to require an earlier decision on the part of the debtor, the Court has the authority to do so.

Additionally, the Code limits the amount of time a debtor has to assume or reject a nonresidential real property lease. If the debtor does not assume or reject such a lease by the earlier of either confirmation of its plan of reorganization or 120 days after filing for bankruptcy, the contract is deemed to be rejected and the debtor must surrender the property to the lessor immediately.

2.3.40 Plan development, acceptance and confirmation

During bankruptcy proceedings, the debtor prepares a **plan of reorganization**, which must be approved by the Court for the debtor to emerge from Chapter 11 bankruptcy. The goal of the plan is to treat the debtor's assets and liabilities in a manner that maximizes the recovery of the debtor's creditors and shareholders. This frequently results in the reduction, modification or elimination of the debtor's debt.

The debtor has an exclusive right to file a plan of reorganization for a 120-day period after filing the petition, which may be extended or reduced by the Court. The Court may grant an extension of the exclusive period for up to 18 months after the petition date. After this exclusivity period ends, a creditor or the

independent trustee, if there is one, may file a plan. This process can extend bankruptcy proceedings, possibly for many years.

Disclosure statement

A written **disclosure statement** must be filed with and approved by the Court before the plan of reorganization can be voted on. The disclosure statement is a document that provides sufficient detail so that creditors can make an informed judgment about the plan. The document is written in plain English and generally provides the following information (not exhaustive):

- background of the case;
- history of the entity;
- treatment of claims;
- expected recovery of claims;
- valuation and liquidation analyses; and
- prospective financial information.

Information provided to creditors

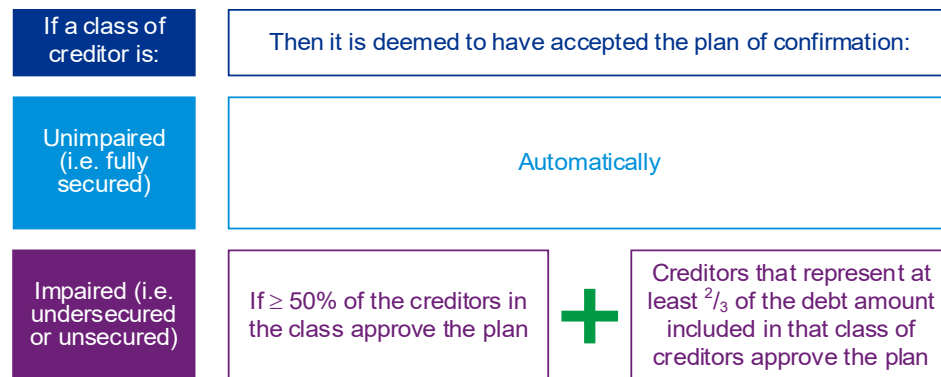
Once the disclosure statement is approved, the debtor must provide all creditors and equity security holders with the following (among other things when necessary):

- the plan of reorganization, or a court-approved summary of the plan;
- the court-approved disclosure statement;
- notice of the period within which acceptances and rejections of the plan may be filed;
- notice of time period for filing objections;
- notice of the date and time of the confirmation hearing; and
- a ballot to accept or reject the plan.

Creditor voting

The debtor has 180 days after the petition date to obtain acceptances of its plan. Similar to the timeline for filing the plan of reorganization, this period may be extended for cause.

The following diagram summarizes the requirements, by class of creditor, to consider the plan of confirmation to be accepted.



Impaired creditors are generally separated into multiple classes that share similar claims or interests. Voting to approve the plan of reorganization is performed separately for each class of impaired creditors. To obtain approval, each class of impaired creditor must receive approval from at least 50% of the creditors in the class and those creditors must represent at least 2/3 of the debt amount in that class.

The plan is approved if each class of impaired creditors vote to approve the plan. If at least one, but not all, of the classes of impaired creditors votes to accept the plan (**consenting classes**), then the debtor may seek to apply the **cram-down provisions** on the classes that rejected the plan (**nonconsenting class**). Under the cram-down provisions, the plan can be confirmed despite rejection of an impaired class if the Court determines that the plan's treatment of the rejecting (or dissenting) class is fair and equitable.

Plan confirmation

Once the debtor has received the necessary plan acceptances, it requests that the Court confirm the plan at the confirmation hearing. The Code requires the Court to make a number of specific findings to have a **confirmed plan** and make it binding on all parties. These include determining that the plan complies with all applicable law, that it has been proposed in good faith and that it is feasible. If applicable, the Court must determine whether the cram-down provisions are appropriate and whether the plan passes the 'best interest of creditors' test. The best interest of creditors test requires that each claim holder must either accept the plan or receive at least what it would receive in a Chapter 7 liquidation, including interest on any payment stream.

Post-confirmation

Confirmation of a plan of reorganization does not mean the bankruptcy case is over. Instead, it signifies that the requirements have been met and the Court approves the terms of the plan. Generally, a number of required actions remain in the post-confirmation period, including settling claims, raising capital, divesting certain assets and executing other agreed upon transactions, and litigating adversary proceedings. The Court issues a final decree once it determines that the plan has been fully consummated.

2.3.50 Prearranged plans and prepackaged bankruptcies

A debtor may execute some of the requirements of a Chapter 11 bankruptcy before filing a bankruptcy petition, which has a number of advantages. For example, if the debtor spends less time in bankruptcy it will generally incur lower professional fees. In addition, a debtor is exposed to less negative publicity associated with bankruptcy if it can do as much of the work as possible before formally entering into bankruptcy proceedings.

Depending on the extent of preparation before filing a petition, these types of bankruptcies are referred to as either prearranged or prepackaged. The legal requirements of prearranged and prepackaged bankruptcy filings are no different from a standard bankruptcy filing. Therefore, these transactions are in the scope of Subtopic 852-10.

Prearranged plan

A prearranged plan is simply one in which at least *some* of the work has been done before filing a petition with the Court. Usually, the petition is filed after a restructuring has been negotiated with at least one class of creditors that is expected to be impaired. The key terms of the restructuring are approved by representatives of these creditors. Only after the petition has been filed and the Court approves the disclosure statement does the debtor formally solicit creditor approval of the plan.

Prepackaged bankruptcy

In a prepackaged plan, not only have the terms of the reorganization been negotiated, but the debtor has developed its disclosure statement and plan of reorganization and has obtained the required approval of the plan from its major stakeholders. Once sufficient votes are received to confirm the plan, the debtor files a bankruptcy petition, along with the disclosure statement, plan of reorganization and voting ballots. Ideally, all that is left once a petition is filed is to obtain approval of the disclosure statement and confirmation of the plan from the Court.

2.3.60 Alternative endings for Chapter 11 cases

Chapter 11 cases do not always end in a reorganization of the entity. Such cases sometimes end with the debtor's liquidation or a sale of the debtor's assets. Sometimes, a debtor's plan of reorganization may require that another party acquire the debtor.

Liquidation

Although Chapter 11 is used to reorganize an entity, debtors sometimes use Chapter 11 as a forum for an orderly liquidation. Unlike a Chapter 7 liquidation, a liquidating plan under Chapter 11 allows management to remain in place during the bankruptcy process. Also, once the assets of a business are substantially liquidated, typically the debtor, or the debtor jointly with the creditors' committee, proposes a plan to make distributions to creditors. This permits the creditors to take a more active role in arranging for the liquidation of assets and the distribution of the proceeds than in a Chapter 7 case.

Other times, Chapter 11 cases begin as intended reorganizations, but ultimately become going-out-of-business liquidations. This can occur if a debtor is unsuccessful in obtaining DIP financing or does not have the liquidity to fulfill the shortened terms, high fees and high interest rates that these instruments sometimes carry. Also, in a lengthy Chapter 11 bankruptcy case, a debtor incurs high **administrative expenses** that must be satisfied before distributing a return to general unsecured creditors.

A Chapter 11 reorganization may be converted to a Chapter 7 liquidation to avoid these high expenses, particularly if the debtor is under pressure from creditors for a quick resolution. Further, a conversion into Chapter 7 liquidation can occur if the debtor does not have sufficient funds to pay administrative priority creditors in full and is therefore 'administratively insolvent'. The Code

prohibits a Chapter 11 liquidation plan from being confirmed when the debtor is administratively insolvent. In those situations, the case is typically converted to a Chapter 7 liquidation plan.

Section 363 sale

Section 363 of the Code allows a debtor to sell substantially all of its assets free and clear of liens and encumbrances. The liens are instead attached to proceeds of the sale, and the proceeds are later paid to the appropriate parties. Sometimes a debtor will elect a Section 363 sale to quickly realize maximum value for its assets – avoiding the erosion of asset values due to continued operating losses.

A Section 363 sale may be initiated by a debtor entering into an agreement with a third party ‘stalking horse’ before an auction of the debtor’s assets. The stalking horse is often a financial- or private equity-based purchaser.

The stalking horse’s bid represents the opening bid for the auction. The agreement between the stalking horse and debtor generally provides the stalking horse with compensation (e.g. breakup fee and reimbursement of related expenses) in the event another entity wins the auction.

Although the entity may have sold all or a portion of its assets, it remains under bankruptcy protection and Subtopic 852-10 continues to apply until the Court has approved the plan of reorganization or an alternative option.

Merger or stock acquisition

Sometimes a debtor is acquired in a business combination while it is in bankruptcy. In such a transaction, many of the debtor’s creditors and equity holders typically receive equity interests in the acquirer (or in the new entity that results from the merger). Among other things, an advantage of acquiring an entity in bankruptcy is the relative ease with which the acquirer can bind dissatisfied creditors to the plan of reorganization without approval. This is because the cram-down provisions of the Code allow for the plan of reorganization (which may include the acquisition of the debtor) to be forced on any disapproving creditors, as long as it is approved by the other creditors and the Court (see [section 2.3.40](#)).

An unsecured creditor can also sell its claim to another entity (a purchaser). This will sometimes result in the purchaser gaining control of the bankrupt entity by obtaining sufficient unsecured claims in the debtor that are expected to be converted to a controlling financial interest in the reorganized entity.

2.4 Chapter 7 bankruptcy

Chapter 7 bankruptcy is also known as liquidation. In a Chapter 7 bankruptcy case, a panel trustee is appointed at the beginning of the case. The trustee may, with Court approval, continue to operate the business of the debtor, but it typically closes the business as quickly as possible to avoid any unnecessary administrative expenses. The role of the trustee is to liquidate the assets of the entity as efficiently as possible and distribute the proceeds to creditors in accordance with the Code.

A company liquidating under Chapter 7 applies the guidance in Subtopic 205-30 (liquidation basis accounting).

2.5 Chapter 9 bankruptcy

Chapter 9 of the Code allows a financially distressed municipality protection from creditors while it negotiates a plan to reorganize its debt. The Code broadly defines a municipality as a 'political subdivision or public agency or instrumentality of a State'.

Unlike other forms of bankruptcy, Chapter 9 limits the Court's involvement in a case due to provisions of the Tenth Amendment to the Constitution, which limits the Federal government's ability to interfere with states' rights. Because of this, there is no provision in Chapter 9 for liquidating the assets of the municipality and distributing the proceeds to creditors. However, for practical reasons a municipality may agree to give the Court jurisdiction over many of the traditional areas of judicial oversight in a bankruptcy case, to obtain the protection of court orders and expedite the proceedings.

An entity that meets the Code's definition of a municipality and is filing for reorganization under Chapter 9 applies the guidance in GASB Codification Section Bn5, Bankruptcies.

2.6 Chapter 15 bankruptcy

Chapter 15 of the Code provides mechanisms for dealing with cross-border bankruptcy proceedings. When a debtor files a bankruptcy proceeding in another country, it often files an ancillary proceeding in the United States under Chapter 15. However, it could also file a Chapter 7 or Chapter 11 case in the United States if it wants its US assets and liabilities to be liquidated or reorganized under US bankruptcy law.

To begin an ancillary proceeding, a foreign representative files a petition under Chapter 15, along with documents proving existence of the foreign proceeding. The Court then issues an order recognizing the foreign proceeding as either a foreign main proceeding (a proceeding pending in a country where the debtor's center of main interests is located) or a foreign non-main proceeding (a proceeding pending in a country where the debtor has an establishment, but not its center of main interests). Immediately upon the recognition of a foreign main proceeding, certain provisions under the Code take effect in the United States.

The accounting treatment of a Chapter 15 bankruptcy depends on whether an entity is filing for a reorganization or a liquidation in a foreign country and is outside the scope of this Handbook.

3. Before bankruptcy

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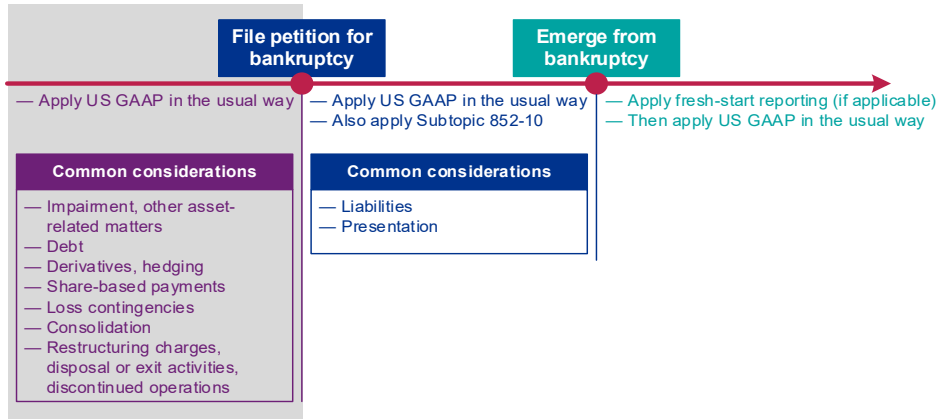
3.13 Bankruptcy as a subsequent event

Question

Question 3.13.10 Is the filing of a petition for Chapter 11 bankruptcy after the reporting date a recognized subsequent event?

3.1 How the standards work

This chapter discusses the potential accounting consequences to financial statements prepared under US GAAP in the period before entering bankruptcy.



In the period preceding bankruptcy, an entity continues to follow applicable US GAAP when preparing its financial statements. However, the facts and circumstances causing the entity to contemplate bankruptcy may trigger incremental accounting considerations given its financial standing (e.g. asset impairments).

Some of the common causes of bankruptcy that also trigger pre-bankruptcy accounting consequences include:

- deteriorating conditions in an entity’s industry or overall economy;
- prolonged or increasing operating losses and negative cash flow; and
- significant unforeseen events requiring immediate cash outflows.

3.2 Professional fees in advance of bankruptcy filing

An entity typically incurs professional fees in advance of filing for bankruptcy. These fees are not in the scope of Subtopic 852-10 because that Subtopic applies to bankruptcy-related fees incurred only after an entity has filed a petition with the Court. Instead, the entity accounts for and presents these pre-filing expenses in accordance with other applicable US GAAP, which generally requires these costs to be expensed as incurred.

Professional fees incurred after the filing related to bankruptcy are presented as reorganization items in the statement of operations (see [section 4.9.10](#)).

3.3 Impairment and other assets

Events and circumstances leading to bankruptcy can also lead to the impairment of, and other accounting impacts on, an entity's assets. This section discusses common accounting considerations for an entity having financial difficulties. However, *any* asset held by an entity may be adversely affected by events and circumstances that can lead to bankruptcy.

Asset	Accounting considerations	Section
Goodwill and indefinite-lived intangible assets	Impairment	3.3.10
Long-lived assets	Impairment, held-for-sale designation	3.3.20
Inventories	Recoverability	3.3.30
Investments	Impairment, classification	3.3.40
Accounts receivable	Credit losses	3.3.50

3.3.10 Goodwill and indefinite-lived intangible assets

Topic 350 requires that goodwill and indefinite-lived intangible assets be tested for impairment. Although important differences exist between the two impairment tests, the general premise is that the asset is tested for impairment at least annually, but more frequently if a triggering event is identified that indicates it is more likely than not (i.e. greater than 50%) that the fair value of the reporting unit or indefinite-lived intangible asset is less than its carrying amount. [[350-20-35-28](#), [35-30](#), [350-30-35-18](#)]

The events and circumstances leading up to a bankruptcy often constitute triggering events, and interim impairment tests are often necessary in the period shortly before an entity files for bankruptcy.

If an entity has elected the Private Company Council (PCC) alternative for the subsequent accounting for goodwill, it tests goodwill for impairment only on a triggering event. The PCC alternative test does not change the requirement to test indefinite-lived intangible assets for impairment at least annually. [[350-20-05-5](#), [350-30-35-18](#)]

Goodwill

Topic 350 provides examples (not exhaustive) of events or circumstances that suggest a possible impairment of goodwill. [\[350-20-35-3C\]](#)

Macroeconomic conditions	Deterioration in general economic conditions; limitations on accessing capital; fluctuations in foreign exchange rates; other developments in equity and credit markets.
Industry and market considerations	Deterioration in the environment in which an entity operates; an increased competitive environment; a decline in market-dependent multiples or metrics (absolute terms and/or relative to peers); a change in the market for an entity's products or services; a regulatory or political development.
Cost factors	Increases in raw materials, labor or other costs that have a negative effect on earnings and cash flows.
Financial performance	Negative or declining cash flows or a decline in actual or planned revenue or earnings compared with actual and projected results of relevant prior periods.
Entity-specific events	Changes in management, key personnel, strategy or customers; contemplation of bankruptcy; litigation.
Events affecting a reporting unit	Changes in the composition or carrying amount of its net assets; a more-likely-than-not expectation of selling or disposing of all, or a portion, of a reporting unit; the testing for recoverability of a significant asset group within a reporting unit; recognition of a goodwill impairment loss in the financial statements of a component subsidiary.
Share price	A sustained decrease in share price (absolute terms and/or relative to peers).

Goodwill is tested for impairment at a level of reporting referred to as a reporting unit. A reporting unit is an operating segment or one level below an operating segment (also known as a component). Entities that have elected the PCC alternative to goodwill impairment testing are permitted to elect to test goodwill for impairment at the entity level, rather than at the reporting unit level. [\[350-20-35-1, 350-20 Glossary, 350-20-35-65\]](#)

Before testing goodwill for impairment, an entity needs to evaluate whether any indefinite-lived intangible assets or other long-lived assets in the same reporting unit have been impaired. The carrying amounts of such assets are decreased for any impairment losses, with a corresponding adjustment to the carrying amount of the reporting unit in which those assets reside. Goodwill impairment testing is then performed based on the adjusted carrying amount of the reporting unit. [\[350-20-35-31\]](#)

The required sequencing is:

- other assets (e.g. accounts receivable, inventory) and indefinite-lived assets.
- long-lived assets (asset group).
- goodwill.

Goodwill impairment is measured by calculating the difference between the carrying amount and the fair value of the reporting unit. For a discussion of

testing goodwill for impairment, see KPMG Handbook, [Impairment of nonfinancial assets](#).

Question 3.3.10 Can an entity contemplating bankruptcy elect to apply Step 0 in an impairment analysis?

Background: An entity has the option of performing a qualitative evaluation of whether it is more likely than not that a reporting unit's fair value is less than its carrying amount (Step 0 evaluation). If it is more likely than not that the goodwill is impaired, the entity must move on to the quantitative test. If it is not, the entity need not perform the quantitative test. [350-20-35-3A – 35-3B]

Interpretive response: Theoretically yes, but we believe it would be unusual. Because an entity contemplating bankruptcy is likely already experiencing many of the indicators that a reporting unit's fair value may be less than its carrying amount, we generally believe that an entity in this situation should not invest time performing a qualitative analysis and instead should move directly to a quantitative test.

Question 3.3.20 How can restructuring done to avoid bankruptcy affect the allocation of goodwill to reporting units for impairment testing?

Background: Goodwill is allocated to an entity's reporting units based on the extent to which the reporting unit will benefit from the synergies realized as a result of a business combination. A reporting unit may be an operating segment (as defined by Topic 280). However, a component of an operating segment (i.e. a level below the operating segment level) is considered a reporting unit if: [350-20-35-34]

- the component constitutes a business for which discrete financial information is available; and
- segment management regularly reviews the operating results of the component.

Further, an entity aggregates two or more components of an operating segment into a single reporting unit if the components have similar economic characteristics. [350-20-35-34 – 35-35]

A key factor in determining an entity's reporting units is the approach that management takes to organize the business for making operating decisions and assessing performance.

Interpretive response: An entity restructuring its operations may need to reevaluate its operating segments, reporting units or both. If an entity concludes that the composition of its reporting units has changed, goodwill is reassigned to the affected reporting units on a relative fair value basis.

For example, an entity experiencing financial distress might eliminate an unsuccessful operating segment by reallocating all of its operations to other operating segments; or an entity might change its structure from being

organized primarily geographically to being organized primarily by product line. As a result, its reporting units change and goodwill must be reallocated.

Question 3.3.25 In assessing the recoverability of long-lived assets, how are future cash flows estimated if the entity is contemplating a bankruptcy filing?

Interpretive response: In the period preceding bankruptcy, an entity continues to follow applicable US GAAP when preparing its financial statements. Therefore, Topic 360 is applied in the usual way and the forecast period is not limited to the potential timing of a bankruptcy filing.

The general requirement in Topic 360 is for the entity to consider all available evidence, and for the underlying assumptions to be consistent with those used for other estimates. Further, the likelihood of the different outcomes needs to be considered if: [\[360-10-35-30\]](#)

- the entity is considering alternative courses of action for the operation or disposition of the asset group; and/or
- there is a range of possible future cash flows.

The estimated future cash flows should take into account the factors that have led to the potential bankruptcy filing, including the possible scenarios that might arise following the filing. While an entity could use either a single best estimate or probability-weighted cash flows, the relevance of using probability-weighted cash flows will be heightened when the entity is considering alternative courses of action for an asset group.

For an in-depth discussion of the relevant accounting considerations when estimating cash flows used for a Topic 360 impairment test before bankruptcy, see KPMG Handbook, [Impairment of nonfinancial assets](#).

Indefinite-lived intangible assets

Subtopic 350-30 includes subsequent measurement guidance for indefinite-lived intangible assets. Indefinite-lived intangible assets are periodically evaluated to determine: [\[350-30-35-18, 35-16\]](#)

- if the assets have been impaired; and
- if the assets still have indefinite useful lives.

For reasons similar to goodwill, indefinite-lived intangible assets of an entity in financial distress should be carefully analyzed to determine whether they have been impaired. Additionally, contemplation of restructuring or otherwise significantly changing the entity's operations to alleviate financial distress can potentially affect the conclusion that an intangible asset has an indefinite life or that it is not impaired. For further discussion, see KPMG Handbook, [Impairment of nonfinancial assets](#).

3.3.20 Long-lived assets

When an entity experiences financial difficulties, its long-lived tangible and intangible assets may become impaired. Also, the entity may sell both tangible and intangible long-lived assets to increase liquidity.

Long-lived asset impairments

The guidance for an impairment test of long-lived assets (both tangible and intangible) subject to depreciation or amortization is under Subtopic 360-10. Long-lived assets intended to be held and used are tested for impairment whenever a triggering event is identified. The likelihood that a triggering event has occurred, and an asset is impaired increases in the period preceding a bankruptcy. [350-30-35-14, 360-10-35-21]

The triggering events for long-lived assets are similar to those identified for goodwill (see [section 3.3.10](#)), focusing on the effect of events on the significant inputs used to determine the fair values of such assets. The following are indicators of when a long-lived asset (asset group) should be tested for impairment (not exhaustive). [360-10-35-21]

Market price	A significant decrease in the market price of a long-lived asset (asset group).
Changes in asset use	A significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or in its physical condition.
Changes in legal factors/business climate	A significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset (asset group), including an adverse action or assessment by a regulator.
Cost factors	An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset (asset group).
Financial performance	A current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset (asset group).
Events affecting an asset's use	A current expectation that, more likely than not, a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life.

The Topic 360 impairment test for held-and-used assets is performed at the asset group level, which is the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities. [360-10 Glossary, 360-10-35-17]

When performing this impairment test, an entity first compares the carrying amount of the asset (or asset group) to the sum of the estimated undiscounted future cash flows from its use and eventual disposal. If the estimated undiscounted future cash flows are less than the carrying amount, the entity determines the fair value (e.g. discounted cash flows) of the asset (or asset

group) and recognizes an impairment charge to the extent the carrying amount exceeds fair value. [360-10-35-17]

When a long-lived asset (or asset group) is tested for impairment, it is likely necessary to review the useful life and salvage value estimates. In such cases, an entity recognizes an impairment loss before revising depreciation estimates. An entity cannot avoid an impairment charge by prospectively adjusting an asset's useful life or salvage value. [250-10-45-17, 360-10-35-22]

Question 3.3.30 Could an entity contemplating bankruptcy conclude that its long-lived assets classified as held-and-used are not impaired?

Interpretive response: Yes, because the first step of the impairment test for assets that are held-and-used involves comparing the carrying amount of the asset (or asset group) to its entity-specific *undiscounted* future cash flows (recoverability test). Even if an entity is contemplating bankruptcy, it may be able to conclude that the carrying amount of specific assets (or asset groups) is recoverable through future cash flows and therefore no impairment charge is required. [360-10-35-17, 35-29 – 35-35]

Long-lived assets held-for-sale

Long-lived assets classified as held-for-sale are measured at the lower of carrying amount or fair value less cost to sell. [360-10-45-14]

Often, an entity intends to dispose of assets that are held-for-sale (and any liabilities directly associated with those assets) as a group, referred to as a disposal group. For example, the assets and liabilities associated with operations of an entity that are being disposed of may be included in a single disposal group. [360-10 Glossary]

The assets and liabilities of a disposal group are presented separately in the asset and liability sections of the balance sheet. Different presentation guidance applies if the disposal group qualifies as a discontinued operation (see [section 3.11.10](#)). [360-10-45-14]

To classify an asset (or disposal group) as held-for-sale, all of the following criteria must be met: [360-10-45-9]

- management, having the authority to approve the action, commits to a plan to sell the asset;
- the asset is available for immediate sale in its present condition, subject only to terms that are usual and customary for sales of such assets;
- an active program to locate a buyer and other actions required to complete the plan to sell the asset have been initiated;
- the sale of the asset is probable, and transfer of the asset is expected to qualify for recognition as a completed sale within one year (with exceptions for certain events beyond the entity's control);

- the asset is being actively marketed for sale at a price that is reasonable in relation to its current fair value; and
- actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made, or that the plan will be withdrawn.

If an entity intends to dispose of an asset (disposal group) by means other than sale (e.g. abandonment), it continues to classify it as held-and-used until it is disposed of. The guidance on assets held-and-used (such as evaluating the salvage value, useful life and recoverability) continues to apply until the asset is disposed of. [360-10-45-15]

For further discussion about the accounting for discontinued operations, see KPMG Handbook, [Discontinued operations and held-for-sale disposal groups](#).

3.3.30 Inventories

Generally, an entity writes down its inventory when the inventory's cost (as reflected in the carrying amount) is greater than the inventory's net realizable value. This could be due, for example, to physical deterioration or obsolescence of the inventory, excess inventory or changes in price levels. Circumstances that may cause an entity to file for bankruptcy could also indicate inventory impairment. [330-10-35-1B]

The following are examples.

- **Sales incentives.** An entity experiencing financial difficulties may attempt to increase its sales volumes by providing sales incentives or discounted pricing to its customers to generate cash. This would affect the assessment of estimated sales prices for inventory on hand, which could result in an impairment of inventory.
- **Cost increases.** An entity may experience financial difficulties because of increasing inventory costs. If the entity cannot raise its prices to adequately recover those costs, it may need to write down its inventory.

An entity may also need to recognize a loss on firm purchase commitments if it does not expect to recover the cost to purchase the inventory upon sale of the finished product. A net loss on a purchase commitment is measured in the same manner as an inventory impairment. [330-10-35-17 – 35-18]

Question 3.3.40 Does an entity increase its per-unit allocation of overhead costs to inventory in times of abnormally low production?

Background: Abnormally low inventory production may occur in entities experiencing financial difficulty. This in itself could be part of the cause of an entity's financial difficulties (e.g. plant shutdowns or worker strikes). In addition, technological obsolescence or shifts in market demand of an entity's products may cause financial difficulty and also result in abnormally low inventory production.

Interpretive response: No. Fixed overhead costs related to production are allocated to inventory based on the normal capacity of the production facilities. When production is abnormally low, an entity expenses the under-absorbed overhead costs as incurred; it does not allocate more overhead to each unit of inventory. [330-10-30-6, 30-7]

3.3.40 Investments

Investments in debt securities

An entity contemplating bankruptcy may need to evaluate its investments in debt securities from two perspectives:

- whether those investments are impaired; and
- whether any held-to-maturity investments need to be reclassified.

Impairment of investments

Often an entity is contemplating bankruptcy due to macroeconomic conditions affecting the general economy or industry in which it operates. If the factors affecting the entity are also negatively affecting entities in which it holds debt securities, the entity needs to consider whether adequate credit losses have been recognized under Topic 326 for its held-to-maturity and available-for-sale debt securities. For a discussion of Topic 326, see KPMG Handbook, [Credit impairment](#).

Reclassification of held-to-maturity investments

Topic 320 requires an entity to reassess the appropriateness of the classification of its debt securities at each reporting date. This reassessment usually focuses on the entity's ability to continue to hold a security to maturity. In a period preceding a bankruptcy filing, an entity may no longer have this ability if it is experiencing cash flow challenges and its need for liquidity requires selling investments. If an entity no longer has the ability to hold an investment to maturity, reclassification to available-for-sale or trading is required. [320-10-35-5 – 35-7]

A sale or transfer of a held-to-maturity security usually contradicts an entity's assertion that it has the intent and ability to hold the securities to maturity. Consequently, the entity reclassifies the remaining held-to-maturity securities to available-for-sale. Exceptions to this would be rare. [320-10-25-6, 25-9, 25-14, 320-10-35-8 – 35-9]

Investments in equity securities

The method used to measure equity securities depends on whether the security has a readily determinable fair value. [321-10-35-1 – 35-2]

Equity security with a readily determinable fair value	Equity security without a readily determinable fair value
Both initially and subsequently, measure at fair value with changes in fair value recognized in net income.	Both initially and subsequently, measure at fair value with changes in fair value recognized in net income.
	Or apply the measurement alternative:
	Measure at cost (adjusted for fair value changes when there are observable prices) less impairment.

If an entity that is contemplating bankruptcy has elected the measurement alternative to measure its equity securities without readily determinable fair values, there may be a heightened risk of impairment of those securities. This is particularly if the entity is contemplating bankruptcy because of macroeconomic conditions affecting the general economy or industry in which the investee operates.

See KPMG Handbook, [Investments](#), for more information about performing an impairment analysis of equity securities.

Equity method investments

Topic 323 requires an entity to account for an investment using the equity method if it can exercise significant influence over the investee. There is a rebuttable presumption that significant influence can be exercised if the investor owns 20% or more of the voting stock of a corporate investee. In addition, an investor considers other indicators, including: [\[323-10-15-6, 15-8\]](#)

- representation on the board of directors;
- participation in policy-making processes;
- material intra-entity transactions;
- interchange of managerial personnel between investor and investee;
- technological dependency; and
- extent of ownership by an investor in relation to the concentration to the other shareholdings.

If an entity in financial distress is making changes to its legal structure, or it restructures its operations due to a shift in strategy, it should carefully consider these indicators to determine whether it can still exercise significant influence over each of its equity method investees.

In addition, Topic 323 requires an entity to evaluate equity method investments for impairments that are other than temporary. [\[323-10-35\]](#)

Question 3.3.50 Does an entity discontinue applying the equity method if it sells enough of its investment to decrease its ownership percentage below 20%?

Interpretive response: Generally, yes. An entity may dispose of a portion of its equity method investment to increase liquidity, resulting in owning less than 20% of the investee's voting stock. In this case, there is a rebuttable presumption that the entity no longer has significant influence over the investee. However, the equity method remains appropriate if the facts and circumstances indicate that the entity has retained significant influence. [323-10-15-8]

See section 2.4 of KPMG Handbook, [Equity method of accounting](#), for more information about the determination of significant influence and equity method investments.

3.3.50 Accounts receivable

Accounts receivable (as well as contract assets and loans receivable) are in the scope of Subtopic 326-20, which requires an entity to estimate credit losses on initial recognition and at each reporting date. See KPMG Handbook, [Credit impairment](#), for guidance on measuring the allowance for credit losses.

Question 3.3.60 What is the effect on an entity's customer accounts receivable when it is experiencing financial difficulty?

Interpretive response: When an entity suffers financial difficulties, it should consider the effect on its allowance for credit losses. For example, as customers become aware of the entity's financial difficulties, it may experience late or nonpayment from customers. This may happen when customers become concerned about the entity's ability to meet its obligations (e.g. future product or service delivery) or as customers in the same industry experience similar financial difficulties.

3.4 Debt

3.4.10 Debt covenants and subjective acceleration clauses

An entity facing financial difficulty may be in violation of debt covenants or in danger of creditors exercising subjective acceleration clauses on its long-term debt. In this case, the entity may have to reclassify the debt to current liabilities.

Violations of debt covenants

Debt agreements generally require debt covenant compliance to be evaluated quarterly or semiannually. Debt covenants are often based on the financial health of an entity, so those contemplating bankruptcy due to financial distress should carefully consider whether they are in violation of any of their debt covenants.

Subjective acceleration clauses

Some debt agreements include subjective acceleration clauses that allow the creditor to accelerate the scheduled maturities of the loan under conditions that are not objectively determinable. Circumstances such as recurring losses or liquidity problems could cause creditors to exercise their acceleration rights. If it is reasonably possible that the creditor will invoke the acceleration clause, an entity should evaluate the relevant facts to determine the proper classification (current or long-term) and appropriate disclosures. If it is probable that the creditor will invoke the acceleration clause, an entity should reclassify debt that otherwise is long-term to current. [470-10-45-2]

For an in-depth discussion of the relevant accounting considerations on debt classification, see section 3.6 of KPMG Handbook, [Debt and equity financing](#).

3.4.20 Troubled debt restructurings, debt extinguishments and modifications

An entity in financial distress may attempt to negotiate the terms of its debt to decrease the interest rate, increase the term, or modify contractual terms in other ways to improve its cash flow. The following table presents the three possible accounting treatments when a debt instrument is modified before a bankruptcy filing.

Characterization	Attributes	Accounting consequences
Troubled debt restructuring	The debtor is experiencing financial difficulty and the creditor grants a concession because of the debtor's financial difficulty.	<p>If the entity transfers assets or issues equity instruments in partial or full settlement of the debt, it first reduces the carrying amount of the debt by the fair value of the assets or equity instruments transferred. [470-60-35-2 – 35-3, 35-8]</p> <p>If the debt is thereby fully settled, the entity recognizes a gain equal to the remaining carrying amount of the debt. [470-60-35-3]</p> <p>If the debt is not fully settled, the entity recognizes a gain only to the extent that the undiscounted cash flows (including contingent payments) of new or modified debt are less than the remaining carrying amount of the old debt. [470-60-35-7]</p>

Characterization	Attributes	Accounting consequences
		If undiscounted cash flows equal or exceed the remaining carrying amount of old debt, no gain is recognized and a new effective interest rate is established prospectively. [470-60-35-5]
Extinguishment of original debt – does not qualify as a troubled debt restructuring	The renegotiated debt is substantially different from the original debt – i.e. the present value of cash flows under the renegotiated debt differs by least 10% from the present value of the remaining cash flows under the original debt. [470-50-40-10 – 40-11]	The old debt is derecognized and new debt is recognized at fair value. [470-50-40-13] The extinguishment gain or loss is measured by comparing the fair value of the new debt to the carrying amount of the old debt. [470-50-40-13] A new effective interest rate is established based on the new debt. [470-50-40-13]
Modification of debt – does not qualify as a troubled debt restructuring	The renegotiated debt is not substantially different from the original debt.	No gain or loss is recognized. [470-50-40-8] A new effective interest rate is established prospectively based on the carrying amount of the debt and revised cash flows. [470-50-40-14]

3.5 Hedge accounting

Subtopic 815-20 describes the criteria that must be met for an instrument to qualify for hedge accounting. These criteria are discussed in KPMG Handbook, [Derivatives and hedging](#).

Financial difficulties experienced by an entity or its counterparty to a hedging instrument can call into question whether it continues to qualify for hedge accounting. For example, hedge accounting is permitted only if the hedging relationship is expected to be (and actually is) highly effective. Among other things, the creditworthiness of the counterparty and the entity’s own nonperformance risk affect whether a hedging relationship is highly effective. An entity’s own nonperformance risk may increase if it is experiencing financial difficulties. Similarly, if an entity is experiencing financial difficulties due to macroeconomic factors and the counterparty to the forecasted transaction is subject to those same factors, the counterparty’s creditworthiness may decline. [815-20-35-14 – 35-18, 25-122]

For a discussion of assessing counterparty creditworthiness or the entity’s own nonperformance risk when evaluating the effectiveness of a hedging relationship, see section 13.2.60 of KPMG Handbook, [Derivatives and hedging](#).

Additionally, in a cash flow hedge, the hedged forecasted transaction must be probable of occurring to be eligible for hedge accounting. If an entity is experiencing financial difficulties, it may no longer be able to assert that a transaction is probable of occurring. The probability of a forecasted transaction

occurring can also be affected by the counterparty's creditworthiness. [815-20-25-15]

For further discussion about assessing the probability of forecasted transactions, see section 9.3.40 of KPMG Handbook, [Derivatives and hedging](#).

3.6 Share-based payments

An entity facing financial difficulties applies the same guidance on share-based payments as it otherwise would. Topic 718 provides guidance on accounting for share-based payment transactions.

An entity may modify or cancel share-based payment awards if it is experiencing financial distress. For example, if an entity is anticipating filing for bankruptcy, it may modify the terms of share-based payments to incentivize key employees to stay with the company through the bankruptcy proceedings. In these cases, careful consideration should be given to the modification or cancellation guidance in Topic 718. Additionally, changes to a share-based payment award may cause its classification to change from equity to liability, or vice versa.

Modifications to share-based payment awards often involve complex valuation models and techniques. Because of this, entities modifying awards should consider involving a valuation specialist.

For further discussion, see KPMG Handbook, [Share-based payment](#).

3.7 Retirement and nonretirement postemployment benefits

An entity in financial distress may freeze its pension plan. Topic 715 contains specific guidance requiring gain or loss recognition when a pension plan curtailment occurs.

Additionally, an entity contemplating bankruptcy may undergo restructuring activities to improve its financial position (see [section 3.11](#)). Those activities may include reducing headcount (e.g. by closing a location or a line of business). Sometimes an entity offers benefits that may be triggered as a result of restructuring activities. Topic 712, Topic 715 and Topic 420 contain guidance on accounting for termination benefits. Termination benefits may take various forms, including lump-sum payments and/or periodic future payments. They may be paid directly from an employer's assets, an existing pension plan, a new employee benefit plan or a combination of those means.

For further discussion about the accounting for retirement and nonretirement postemployment benefits, see KPMG Handbook, [Employee benefits](#).

The following are examples.

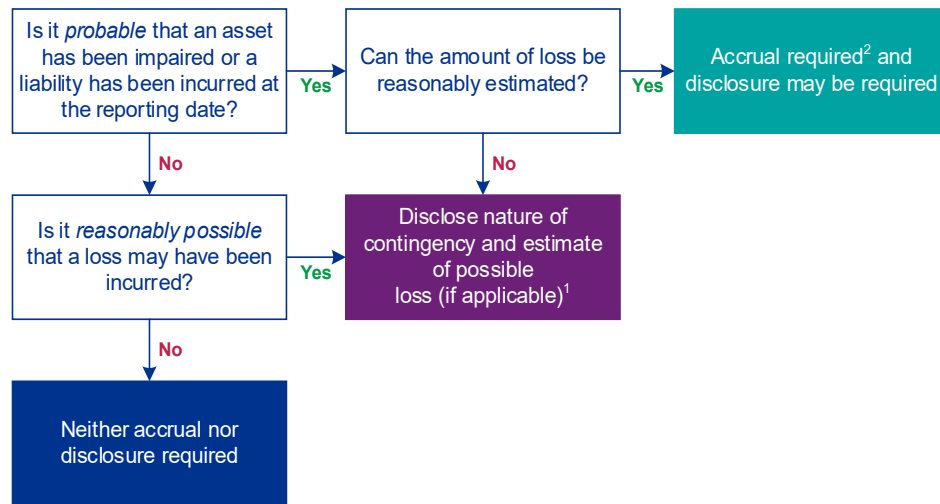
<p>Special termination benefits may be offered in exchange for an employee's voluntary termination of service.</p>	<p>A liability is recognized for a special termination benefit once the employee accepts the offer irrevocably and the amount due to the employee can be reasonably estimated. [712-10-25-1, 715-30-25-10]</p>
<p>Contractual termination benefits may be due to employees upon their termination as a result of a certain event (e.g. a plant closure).</p>	<p>A liability is recognized when it is probable that the employee will be owed the benefit, and the amount due to the employee can be reasonably estimated. [712-10-25-2, 715-30-25-10, 715-60-25-10]</p>
<p>Other involuntary termination benefits may be provided through an ongoing plan, which may be written or achieved through consistent past practices.</p>	<p>If the benefits vest or accumulate, a liability is recognized as the employees provide the services. Otherwise, they are recognized when it is probable the employee will be owed the benefit, and the amount can be reasonably estimated. [712-10-25-4 – 25-5]</p>
<p>One-time termination benefits may be provided on their own or in addition to base contractual benefits or benefits provided through an ongoing plan.</p>	<p>A liability is measured at fair value on the communication date and recognized ratably over the future service period if the employee is required to render services beyond a minimum retention period – which cannot exceed the legal notification period or, in its absence, 60 days. Otherwise, the liability is recognized at fair value on the communication date. [420-10-25-6 – 25-9]</p>

3.8 Loss contingencies

Sometimes an entity may contemplate bankruptcy because an event has occurred that could potentially result in a material financial outlay. This could be due to a catastrophic event, pending litigation or regulatory actions, among other things. Certain events might result in a single or multiple levels of financial loss and exposure.

For example, if an entity experienced an explosion at a manufacturing plant, the negative financial effects may include the costs to repair the plant (payments made beyond any insured limits), economic losses because the plant cannot operate, litigation claims from harmed employees or third-party property damages and regulatory actions for environmental damages or operational misconduct. In this scenario, the costs to write off or impair the carrying amount of the assets are recognized in the period of the event, the costs to repair the plant are expensed or capitalized as incurred depending on the facts and circumstances, economic losses are recognized as incurred, and the possible losses from litigation claims and regulatory actions are accounted for as loss contingencies.

When to recognize and disclose a loss contingency is summarized in the following diagram. [450-20-25-2, 50-3 – 50-5]



Notes:

1. The disclosure requirements apply to both unrecognized losses and possible additional losses in excess of a recognized loss. [450-20-50-3]
2. If a loss contingency relates to a guarantee, the accrual is initially measured at the greater of the fair value of the guarantee (determined under Topic 460 (guarantees)) or the amount to be recognized for the loss contingency (determined under Subtopic 450-20). [460-10-30-3]

As the diagram indicates, if it is reasonably possible (but not probable) that a loss has been incurred or if it is probable that a loss has been incurred but the amount of the loss cannot be reasonably estimated, an entity does not recognize the loss contingency. Instead, the entity discloses both the nature of the contingency and an estimate of the possible loss or range of loss. If the amount of loss cannot be reasonably estimated, the disclosure must state that fact. [450-20-50-3 – 50-4]

In addition, special consideration should be given to unasserted claims that occur before the entity files for bankruptcy; if an entity is contemplating bankruptcy, the likelihood that they will be asserted may increase. An entity is required to disclose the existence of unasserted claims or assessments if: [450-20-50-6]

- it is probable that a claim will be asserted; and
- there is at least a reasonable possibility that the outcome will be unfavorable.

For further discussion about the accounting for loss contingencies, see KPMG Handbook, [Contingencies, commitments and guarantees](#).

3.9 Income taxes

The realizability of deferred tax assets may be affected if an entity is experiencing financial difficulties. Section 4 of KPMG Handbook, [Accounting for income taxes](#), provides guidance on the valuation of deferred tax assets.

In addition, a multinational entity contemplating bankruptcy because of financial difficulties may reevaluate its global cash needs and revise its plans for repatriating or reinvesting foreign earnings. See section 7 of KPMG Handbook, [Accounting for income taxes](#), for information about the tax consequences of changes in an entity's repatriation plans.

3.10 Consolidation

A reporting entity (parent) consolidates another entity (subsidiary) if it has a controlling financial interest in the other entity. This is usually achieved by either: [\[810-10-05-08 – 08A\]](#)

- having the power to direct the activities that most significantly affect the other entity's economic performance, if that entity is a variable interest entity; or
- owning a majority of the other entity's voting interests, if that entity is a voting interest entity.

A parent in financial distress may attempt to increase its liquidity by selling part of its interests in a subsidiary. Alternatively, it may cause a subsidiary to issue shares to third parties, thereby diluting its ownership of the subsidiary's equity. A parent may also make other changes to the subsidiary or its governing structure that could result in changes to its consolidation conclusion.

- For a discussion of factors to consider when reassessing the primary beneficiary of a variable interest entity, see chapter 6 of KPMG Handbook, [Consolidation](#).
- For a discussion of the accounting for the derecognition of, and changes in a parent's ownership interest in, a subsidiary, see chapter 7 of KPMG Handbook, [Consolidation](#).

3.10.10 Decrease in ownership interest while retaining control

A reduction in ownership of a subsidiary's voting interests without losing control can result in either:

- the recognition of a noncontrolling interest, if the parent previously owned 100% of the voting interests; or
- an increase to a previously recognized noncontrolling interest, if the parent previously owned less than 100%.

When a noncontrolling interest in a subsidiary exists, it is generally reported in the balance sheet within equity in the consolidated financial statements but is presented separately from the parent's equity. [\[810-10-45-16\]](#)

Changes in the parent's ownership interest that do not result in loss of control are accounted for by the parent as equity transactions. The parent adjusts the carrying amount of the noncontrolling interest and recognizes the difference between the change in the noncontrolling interest and the fair value of

consideration received in additional paid-in capital attributable to the parent. [810-10-45-23]

For a discussion of the accounting for changes in a parent's ownership that do not result in a loss of control, see chapter 7 of KPMG Handbook, [Consolidation](#).

3.10.20 Loss of control

If a parent sells enough of its interest such that it no longer has a controlling financial interest in a subsidiary that is a business or not-for-profit activity, the parent deconsolidates the subsidiary's assets and liabilities, eliminates the equity components related to that subsidiary (e.g. existing noncontrolling interest, cumulative translation adjustment) and recognizes a gain or loss in net income. [810-10-40-4 – 40-4A]

If the subsidiary is a business or not-for-profit activity, an entity accounts for the loss of control in accordance with Subtopic 810-10. The gain or loss generally is computed as the difference between the fair value of the consideration received and amounts removed from the parent's consolidated balance sheet. If the parent retains a noncontrolling interest in the entity, it records the interest as an investment at fair value and includes the fair value of that interest in the calculation of the gain or loss. [810-10-40-5]

If the subsidiary is not a business or not-for-profit activity, the guidance applied to decreases in ownership depends on the nature of the assets transferred. For example, an entity applies other guidance such as Subtopic 610-20 for nonfinancial assets (including in-substance nonfinancial assets) or Topic 860 for the transfer of financial assets.

For further discussion about accounting for changes in a parent's ownership that result in a loss of control, see chapter 7 of KPMG Handbook, [Consolidation](#).

3.11 Discontinued operations and exit or disposal activities

An entity in financial distress may decide to take actions such as exiting or restructuring a business, reductions in workforce, and restructuring leases and facilities.

3.11.10 Discontinued operations

An entity contemplating bankruptcy may discontinue certain of its operations to increase liquidity, decrease costs or increase efficiencies. A disposal (or planned disposal) of a component (or group of components) of an entity is reported in discontinued operations if the disposal represents a strategic shift that has or will have a major effect on the entity's operations and financial results. [205-20-45-1B]

A component of an entity comprises operations and cash flows that can be clearly distinguished from the rest of the entity (both operationally and for

financial reporting purposes). It may be a reportable segment, an operating segment, a reporting unit, a subsidiary or an asset group. [205-20 Glossary]

A disposal occurs in this context when a component is either disposed of (through sale or other means) or qualifies to be classified as held-for-sale. The criteria that must be met for a component to be classified as held-for-sale are the same as those listed in [section 3.3.20](#). [205-20-45-1A – 45-1B, 45-1G]

The results of discontinued operations are presented as a separate component of income in the statement of operations. Similarly, the cash flows of discontinued operations are presented separately from those of continuing operations in the statement of cash flows. See Question 20.2.10 of KPMG Handbook, [Statement of cash flows](#), for guidance on three acceptable methods of presenting the cash flows from discontinued operations. [205-20-45-3A]

If the discontinued operations meet the held-for-sale criteria (see [section 3.3.20](#)) before being disposed of, the assets and liabilities of the discontinued operations are presented separately from other assets and liabilities in the balance sheet. This presentation is required in the period(s) that a discontinued operation is classified as held-for-sale and all comparative periods presented. However, an entity *accounts* for those assets as held-for-sale (i.e. ceases depreciating them and carries them at the lower of their carrying amounts or fair value less cost to sell) only from the date they qualify as held-for-sale, even if they are retrospectively *presented* as a disposal group in earlier periods.

If the assets and liabilities of the discontinued operations are disposed of before meeting the criteria to be classified as held-for-sale, the assets and liabilities disposed of are still required to be presented separately in the balance sheet for the period(s) presented before the period of disposal. [205-20-45-10]

For further discussion about the accounting for discontinued operations, see KPMG Handbook, [Discontinued operations and held-for-sale disposal groups](#).

3.11.20 Exit or disposal activities

An entity facing financial difficulties often restructures its operations by exiting a line of business or disposing of some of its assets to improve its financial position. Topic 420 includes guidance on accounting for: [420-10-15-3]

- one-time employee termination benefits;
- costs to terminate a contract that is not a lease;
- costs to consolidate facilities or relocate employees;
- costs associated with disposing of discontinued operations; and
- costs associated with an exit activity.

Topic 420 provides details about the above transactions and activities to help an entity determine whether a cost is associated with an exit or disposal activity and therefore is in the scope of the guidance. It generally requires that a liability for a cost associated with an exit or disposal activity be recognized in the period in which the liability is incurred, measured initially at fair value. [420-10-25-1, 420-10-30]

If involuntary termination benefits are provided to an employee under a one-time termination arrangement, those benefits are accounted for under Topic

420. However, other termination benefits (e.g. those provided under an ongoing benefit arrangement) are accounted for under other guidance. See [section 3.7](#) for a discussion of various types of termination benefits and the appropriate accounting treatment. [\[420-10-15-6 – 15-8\]](#)

For further discussion about the accounting for termination benefits, see chapter 4 of KPMG Handbook, [Employee benefits](#).

Lease terminations are accounted for under Topic 842 (see [section 3.11.30](#)).

3.11.30 Leases (as lessee)

If an entity restructures operations as a result of financial difficulties, it may modify or terminate leases.

Lease modifications and terminations

When evaluating a lease modification under Topic 842, the first step is to determine whether the modification represents a separate contract. For an entity in financial distress, this is usually not the case, because a modification is accounted for as a separate contract only when the entity obtains *additional* rights of use and the payments increase commensurate with the standalone price of the additional rights of use. [\[842-10-25-8\]](#)

If the modified agreement is not considered a separate contract, the lease classification is reassessed as of the effective date of the modification. Generally, the lease liability is remeasured on the date the modification is approved and the right-of-use asset is adjusted by the amount of the change in the liability. However, if the lease modification reduces the lessee's right of use, the right-of-use asset is reduced proportionally, and the lessee recognizes a gain or loss for the difference between the reduction of the lease liability and the proportional reduction of the right-of-use asset. [\[842-10-25-9 – 25-13\]](#)

For further discussion about the accounting for lease modifications by lessees, see section 6.7 of KPMG Handbook, [Leases](#).

3.12 Disclosures

3.12.10 Overview

When an entity is contemplating bankruptcy, disclosures may be required that the entity may not have previously considered. The following are examples.

- Topics 350 and 360 require an entity to make certain disclosures in a period in which it recognizes an impairment. [\[350-20-50-2, 350-30-50-3, 360-10-50-2\]](#)
- Topic 330 requires disclosures about losses from the subsequent measurement of inventory, and when an entity incurs losses on firm purchase commitments. [\[330-10-50-2, 50-5\]](#)
- Topic 320 requires incremental disclosures when a debt security has been impaired. [\[320-10-50-6 – 50-8B\]](#)

- Topic 420 requires an entity to include disclosures about exit or disposal activities. [420-10-50-1]
- Topic 470 requires disclosure about subjective acceleration clauses in some circumstances. [470-10-45-2, 50-3]

Management of an entity contemplating bankruptcy should carefully consider disclosure requirements and ensure that disclosures are sufficiently detailed to provide a reader with transparency about the financial health of the entity. In this section, we discuss some disclosure requirements particularly relevant for entities experiencing financial difficulties.

3.12.20 Risks and uncertainties

An entity experiencing financial difficulties needs to carefully consider its disclosures under Topic 275, which provides disclosure guidance about: [275-10-50-1]

- the nature of the entity's operations;
- the use of estimates in preparing the financial statements;
- certain significant estimates; and
- current vulnerability because of certain concentrations.

Question 3.12.10 How might financial difficulties affect an entity's disclosures about the nature of its operations?

Interpretive response: For an entity experiencing financial difficulties and contemplating bankruptcy, it becomes increasingly important to provide comprehensive, transparent disclosures about the risks and uncertainties it is facing.

For example, if an entity is experiencing challenges because demand for its product is decreasing (e.g. due to obsolescence), or it operates in a geographical area that is experiencing a recession, its disclosures about the nature of its operations need to be clear enough that a user can fully understand the associated risks and uncertainties.

Question 3.12.20 How might financial difficulties affect an entity's disclosures about significant estimates?

Interpretive response: An entity experiencing financial difficulties may have a number of significant estimates because of increased sensitivity or volatility of assumptions. Topic 275 requires disclosure if it is at least reasonably possible that an estimate could change in the near term and the effect of that change would be material. [275-10-50-6]

For example, an entity that historically has not disclosed the fair value of its reporting units as a significant estimate may need to reevaluate that practice if

it is experiencing financial difficulties that make goodwill impairments more likely.

Question 3.12.30 How might financial difficulties affect an entity’s disclosures about concentrations?

Interpretive response: Concentrations may become increasingly important in assessing the future financial performance of an entity if the financial challenges it faces are pervasive across the industry or economy in which it operates.

The following are examples of circumstances that could affect an entity’s disclosures concerning concentrations:

- a small number of large customers who are experiencing financial difficulties;
- revenue is concentrated in one product that is rapidly becoming obsolete;
- heavy reliance on a consistent supply of a material that is increasing in cost (e.g. steel); or
- transactions primarily in a geographical location that is experiencing a recession.

3.12.30 Going concern

Unless an entity’s liquidation is imminent (as defined by Subtopic 205-30, liquidation basis of accounting), its financial statements are prepared under the assumption that it will continue as a going concern. While liquidation may not be imminent for an entity experiencing financial difficulties, the assumption that it will continue as a going concern becomes challenged as its financial difficulties persist. [205-40-05-1]

Subtopic 205-40 (going concern) requires an entity’s management to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity’s ability to continue as a going concern. It also provides guidance on how management should consider its plans when it identifies such conditions or events and whether those plans mitigate doubt about an entity’s ability to continue as a going concern. [205-40-50-1, 50-6]

If, as a result of its analysis, management concludes that substantial doubt exists about the entity’s ability to continue as a going concern, the disclosure requirements depend on whether that doubt is alleviated by management’s plans. [205-40-50-12 – 50-13]

Disclosures when substantial doubt is alleviated	Disclosures when substantial doubt is <i>not</i> alleviated
<ul style="list-style-type: none"> • Principal events or conditions that initially raised the substantial doubt. • Management’s evaluation of the significance of those events or 	<ul style="list-style-type: none"> • Principal events or conditions that initially raised the substantial doubt. • Management’s evaluation of the significance of those events or

Disclosures when substantial doubt is alleviated	Disclosures when substantial doubt is <i>not</i> alleviated
<p>conditions in relation to the entity's ability to meet its obligations.</p> <ul style="list-style-type: none"> • Management's plans that alleviated the substantial doubt. 	<p>conditions in relation to the entity's ability to meet its obligations.</p> <ul style="list-style-type: none"> • Management's plans that were intended to alleviate the substantial doubt. • A statement indicating that there is substantial doubt about the entity's ability to continue as a going concern.

For further discussion on the analysis and required disclosures relating to an entity's ability to continue as a going concern, see KPMG Handbook, [Going concern](#).

Question 3.12.40 Does filing a bankruptcy petition automatically raise substantial doubt about an entity's ability to continue as a going concern?

Interpretive response: Generally, yes. While facts and circumstances differ for every entity, we believe an entity contemplating bankruptcy will likely conclude that substantial doubt about its ability to continue as a going concern exists. In that case, the disclosure requirements of Subtopic 205-40 apply.

3.12.40 Additional disclosures for SEC registrants

This section highlights some of the more significant SEC disclosure requirements that a registrant should consider if it is experiencing financial difficulties. In addition, a registrant should consider updating the description of business (e.g. if the registrant has shifted business activities to try to avoid bankruptcy) and risk factors (e.g. because of unprofitable operations in recent periods) sections of its periodic filings.

Asset impairments

In addition to the disclosure requirements of Topics 350 and 360 in the period of an asset impairment, the SEC staff has suggested that SEC registrants consider discussing circumstances that could result in an impairment charge in periods leading up to the impairment, so the charge does not take investors by surprise in the period in which it is recognized. [2002 AICPA Conf]

The SEC staff expects registrants to provide the following information for reporting units that are at risk of failing the quantitative goodwill impairment test: [SEC FRM 9510.3]

- the percentage by which the fair value of the reporting unit exceeds the carrying amount;
- the amount of goodwill allocated to the reporting unit;

- a description of the method(s) used to determine the reporting unit's fair value;
- for each key assumption used in the model:
 - a description of the key assumption;
 - an explanation of how it was determined;
 - the degree of uncertainty associated with the assumption; and
 - a description of the potential events and/or changes in circumstances that could be reasonably expected to negatively affect the assumption.

See [Question 4.15.50](#) for related Form 8-K filing requirements.

Liquidity and capital resources

Regulation S-K requires disclosures in a registrant's MD&A about liquidity and capital resources. A key objective of these disclosures is to provide a clear picture of the registrant's ability to generate cash and to meet known or reasonably likely future cash requirements. [\[Reg S-K Item 303\]](#)

A registrant facing financial difficulties is likely experiencing or anticipating problems maintaining its liquidity. Regulation S-K requires disclosure of any known trends, demands, commitments, events or uncertainties that have or may result in a registrant's liquidity decreasing materially, as well as a discussion of the steps taken to remedy the liquidity deficiency. [\[Reg S-K Item 303\]](#)

Other items that a registrant experiencing financial difficulties should discuss in MD&A include: [\[Reg S-K Item 303\]](#)

- material commitments and how they will be funded – required for all registrants regardless of their financial condition; and
- any risk of breaching a debt covenant.

Exit or disposal costs

In addition to the disclosure requirements of Topic 420, the SEC staff has requested that registrants include a separate description in MD&A of the nature and amounts of the different types of exit costs that have been incurred. If multiple exit plans are being executed, the related costs should be disaggregated by the exit or disposal activities to which they relate. [\[420-10-50, SAB Topic 5.P\]](#)

Because the events or conditions that cause an entity to consider executing an exit plan often occur over a period of time, certain disclosures are sometimes required for MD&A before the related costs or liabilities are recognized under US GAAP. The entity should describe in its MD&A the reason the exit activity has been (or will be) executed and the expected effect it will have on the registrant's financial position, including the anticipated timing of the cash outlays and the sources of their funding. [\[SAB Topic 5.P\]](#)

See [Question 4.15.50](#) for related Form 8-K filing requirements.

3.13 Bankruptcy as a subsequent event

A subsequent event is an event or a transaction that occurs after an entity's reporting date, but before its financial statements are issued (available for issuance). [855-10 Glossary]

If a subsequent event provides additional evidence about conditions that existed at the reporting date, it is considered a *recognized* subsequent event, meaning that the effects of the subsequent event are recognized in the financial statements. A subsequent event is *nonrecognized* if it provides evidence about conditions that did not arise until after the reporting date. However, if the nonrecognized subsequent event is of such a nature that it must be disclosed to keep the financial statements from being misleading, an entity discloses the nature of the event and an estimate of its financial effect. [855-10-25-1, 25-3, 50-2]

For further discussion around subsequent event considerations, see chapter 9 of KPMG Handbook, [Financial statement presentation](#).

Question 3.13.10 Is the filing of a petition for Chapter 11 bankruptcy after the reporting date a recognized subsequent event?

Interpretive response: No. We believe the Chapter 11 bankruptcy petition filing after year-end but before issuance of the entity's financial statements is a nonrecognized subsequent event. This means that an entity does not apply Subtopic 852-10 until the filing occurs. However, the entity should disclose the subsequent event to keep the financial statements from being misleading. The disclosure should include a description of the nature of the event and an estimate of its financial effect, or a statement that an estimate cannot be made. [855-10-50-2]

Additionally, filing a petition after the period-end may provide evidence about conditions that existed at the reporting date that need to be considered. For example, a bankruptcy filing may affect an entity's asset impairment evaluations.

See [Question 4.11.60](#) for a discussion of when a parent loses control of a subsidiary due to the subsidiary filing bankruptcy after the consolidated reporting date.

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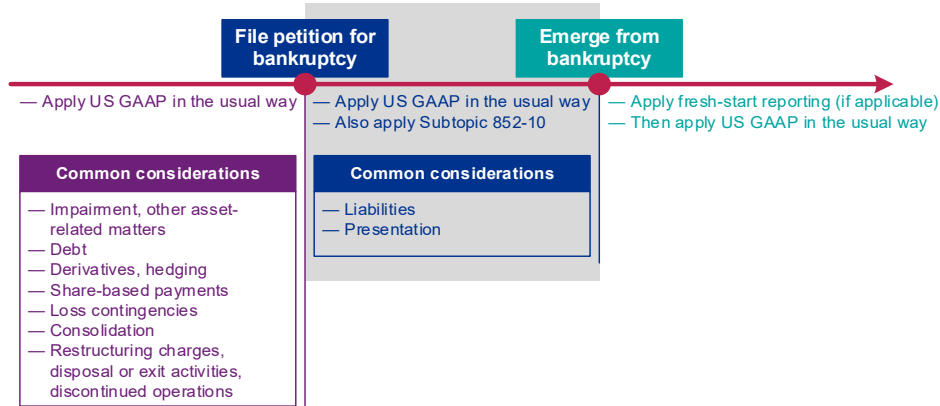
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4.1 How the standard works

As illustrated in the diagram, the financial statements of an entity reporting under Subtopic 852-10 are in many ways similar to those the entity would ordinarily prepare. While an entity is in Chapter 11 bankruptcy, it continues to follow US GAAP applicable to a going concern unless liquidation becomes imminent. However, during bankruptcy, the needs of the financial statement users change.



Subtopic 852-10 attempts to meet those needs by requiring a bankrupt entity to: [205-30-25-1, 852-10-45-2, 45-4]

- distinguish transactions and events that are directly associated with the bankruptcy proceedings from the entity’s ongoing, normal operations; and
- measure certain liabilities based on amounts expected to be approved for payment by the Court.

Additionally, each financial statement includes debtor-in-possession in its title until the entity emerges from bankruptcy.

The requirements in Subtopic 852-10 are incremental, meaning they are applied in addition to (rather than instead of) other US GAAP. Additionally, the bankruptcy process may affect how an entity applies other US GAAP.

This chapter discusses the incremental requirements of Subtopic 852-10 and common instances in which the bankruptcy process can affect how an entity applies other US GAAP.

4.2 Scope of Subtopic 852-10

Excerpt from ASC 852-10

10-1 Presenting an entity's financial evolution in its financial statements during a **Chapter 11 reorganization proceeding** is an objective of the guidance in this Subtopic.

> Financial Reporting during Reorganization Proceedings

45-1 Entering a **reorganization proceeding**, although a significant event, does not ordinarily affect or change the application of generally accepted accounting principles (GAAP) followed by the entity in the preparation of its financial statements. However, the needs of financial statement users change, and thus changes in the reporting practices previously followed by the entity are necessary.

45-2 For the purpose of presenting an entity's financial evolution during a **Chapter 11** reorganization (see paragraph 852-10-10-1), the financial statements for periods including and after filing the Chapter 11 **petition** shall distinguish transactions and events that are directly associated with the reorganization from the ongoing operations of the business.

45-3 Example 1 (see paragraph 852-10-55-2) provides an illustration of financial statements and notes thereto for an entity operating under Chapter 11.

> Entities

15-1 This Subtopic provides guidance on financial reporting by entities that have filed petitions with the **Bankruptcy Court** and expect to reorganize as going concerns under Chapter 11 of title 11 of the United States Code. The guidance in this Subtopic applies to all entities except governmental organizations.

> Transactions

15-2 The guidance in this Subtopic applies to the following transactions and activities:

- a. Reorganizations by entities that expect to reorganize as a going concern under **Chapter 11**
- b. Reorganizations by entities upon emergence from Chapter 11 under confirmed plans.

15-3 The guidance in this Subtopic does not apply to the following transactions and activities:

- a. Debt restructurings outside of Chapter 11
- b. Reorganization activities consisting of liquidation or adoption of plans of liquidation under the **Bankruptcy Code**.

The accounting and financial reporting requirements of Subtopic 852-10 apply once an entity files a petition with the Court for Chapter 11 bankruptcy assuming it expects to reorganize as a going concern. This guidance does not apply to an entity that has filed a petition for Chapter 7 bankruptcy (i.e.

liquidation). The guidance for liquidation basis of accounting is in Subtopic 205-30, which is outside the scope of this publication. [852-10-15-1, 15-2(a), 15-3(b)]

Question 4.2.10 Does Subtopic 852-10 apply to an entity that is reorganizing under foreign bankruptcy laws?

Interpretive response: It depends. We believe an entity should consider the bankruptcy laws in the foreign jurisdiction to determine whether Subtopic 852-10 should be applied.

Specifically, an entity should consider the laws governing the foreign petition filing and how those laws compare to those of the Code, including but not limited to:

- the level of legal/court involvement;
- the existence of any automatic stay provisions; and
- whether the foreign jurisdiction directs segregation of the creditors into different classes.

A foreign entity will have to exercise judgment – and should consider whether to seek legal advice as to how closely the foreign laws compare to those of the Code – to determine whether to apply Subtopic 852-10.

Question 4.2.20 Does Subtopic 852-10 apply to not-for-profit organizations?

Interpretive response: Yes. The guidance in Subtopic 852-10 applies to all entities except governmental organizations. Therefore, we believe Subtopic 852-10 applies to a not-for-profit organization that has filed for bankruptcy and expects to reorganize under Chapter 11 as a going concern. [852-10-15-1]

However, if the entity applies GASB GAAP because it is owned by a government unit, the guidance does not apply. If an entity in bankruptcy is a government or a government-sponsored entity, it applies the guidance in GASB Codification Section Bn5, Bankruptcies. [852-10-15-1]

Question 4.2.30 Does Subtopic 852-10 apply when an entity undergoes a reorganization without filing a bankruptcy petition?

Interpretive response: No. The requirements of Subtopic 852-10 do not apply until a petition is filed. Therefore, if a reorganization is achieved entirely 'out of court', we believe Subtopic 852-10 does not apply. [852-10-15-1]

However, Subtopic 852-20 (quasi-reorganizations) may apply if certain criteria are met. Subtopic 852-20 is outside the scope of this publication.

Question 4.2.40 Does Subtopic 852-10 apply to a prearranged or prepackaged bankruptcy?

Interpretive response: Yes, after the entity has filed for bankruptcy. Subtopic 852-10 applies to an entity that is operating while in bankruptcy, regardless of whether the bankruptcy is prearranged or prepackaged, or is expected to be executed through the standard process with the Court. [852-10-15-1]

For a discussion of prearranged and prepackaged bankruptcies, see [section 2.3.50](#).

4.3 Liabilities under Subtopic 852-10

4.3.10 Overview

Excerpt from ASC 852-10

- > Balance Sheet

45-4 The balance sheet of an entity in Chapter 11 shall distinguish **prepetition liabilities** subject to compromise from those that are not (such as fully secured liabilities that are expected not to be compromised) and **postpetition liabilities**. Liabilities that may be affected by the plan shall be reported at the amounts expected to be allowed, even if they may be settled for lesser amounts. If there is uncertainty about whether a **secured claim** is undersecured, or will be impaired under the **plan of reorganization**, the entire amount of the **claim** shall be included with prepetition claims subject to compromise; such a claim shall not be reclassified unless it is subsequently determined that the claim is not subject to compromise.

45-5 Prepetition liabilities, including claims that become known after a petition is filed, shall be reported on the basis of the expected amount of the **allowed claims** in accordance with Subtopic 450-20, as opposed to the amounts for which those allowed claims may be settled. Once these claims satisfy the accrual provisions of that Subtopic, they shall be recorded in the accounts in accordance with this paragraph. Paragraph 852-10-50-2 notes that claims not subject to reasonable estimation are required to be disclosed in the notes to financial statements.

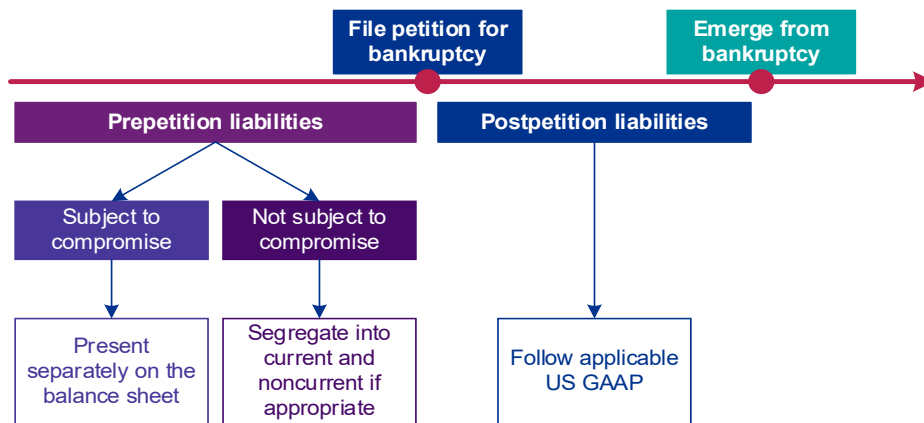
45-7 Paragraph 852-10-45-4 addresses the separation of liabilities subject to compromise from those that are not. Circumstances arising during reorganization proceedings may require a change in the classification of liabilities between those subject to compromise and those not subject to compromise. Liabilities not subject to compromise shall be further segregated into current and noncurrent classifications if the entity presents a classified balance sheet.

45-8 Section 470-10-45 requires current liabilities classification in a classified balance sheet for long-term liabilities that, by their terms, are due on demand or will be due on demand within one year, or the operating cycle, if longer. This

classification requirement also applies to long-term liabilities that are or will be callable by the creditor because of a violation of a provision of the debt agreement. The **automatic stay provisions** of Chapter 11 make it unnecessary to reclassify prepetition long-term liabilities even though prepetition creditors might demand payment or there is a violation of a covenant in the debt agreement.

Subtopic 852-10 significantly affects the classification and presentation of liabilities. Liabilities incurred by the entity before filing for bankruptcy are **prepetition liabilities**, and those incurred after are **postpetition liabilities**. Prepetition liabilities can be either subject to compromise or not subject to compromise. In contrast, postpetition liabilities are not subject to compromise. The bankrupt entity needs to distinguish prepetition liabilities subject to compromise from other liabilities. [852-10-45-4, 45-7]

The following diagram illustrates the distinction between the different liabilities.

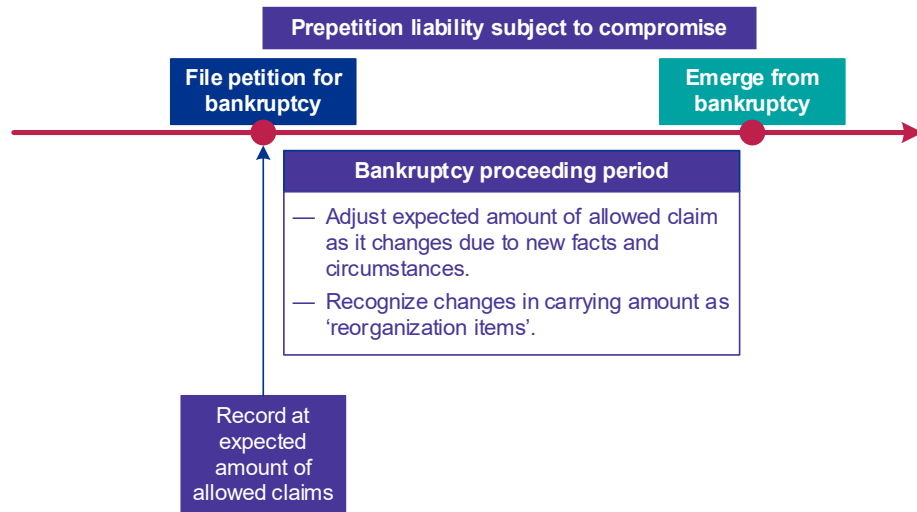


4.3.20 Prepetition liabilities

Classifying and presenting prepetition liabilities subject to compromise

Prepetition liabilities are those that are incurred by the entity before it files for bankruptcy. This includes liabilities considered by the Court to be prepetition claims, such as a rejection of a lease (see [section 4.7](#)). Prepetition liabilities can include claims that become known after the petition is filed, but that were incurred before the petition filing. [852-10 Glossary, 852-10-45-5]

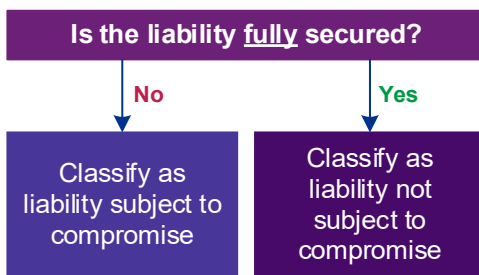
The following diagram illustrates the life cycle of a prepetition liability subject to compromise – from the date of filing for bankruptcy to the date of emerging from bankruptcy (the ‘bankruptcy proceeding period’).



Prepetition liabilities subject to compromise are presented separately on the balance sheet from liabilities not subject to compromise (see [Example 4.13.10](#)). [852-10-45-4]

Question 4.3.10 When are prepetition liabilities subject to compromise?

Interpretive response: A prepetition liability is subject to compromise if it is impaired from the creditor’s perspective under the plan of reorganization. This may be the case if, for example, a claim is unsecured or undersecured – i.e. the value of the security interest is less than the amount of the claim. In contrast, a prepetition liability is not subject to compromise if it is fully secured and therefore not expected to be impaired as a result of bankruptcy proceedings. [852-10-45-4]



Priority claims are generally not impaired because the Code requires that all priority claims be satisfied in full for the entity’s plan of reorganization to be confirmed. Consequently, liabilities recognized for priority claims are presented as not subject to compromise.

Throughout bankruptcy proceedings, a prepetition liability may be reclassified from liabilities subject to compromise to liabilities not subject to compromise or vice versa as new or better information becomes available (see [Question 4.3.20](#)). [852-10-45-4]

Question 4.3.20 How are prepetition liabilities classified when there is uncertainty about whether a secured claim is undersecured?

Interpretive response: If an entity is uncertain about whether a secured claim is undersecured, it initially classifies the claim as a liability subject to compromise in its entirety. [852-10-45-4]

This uncertainty may exist for a number of reasons. For example, the appraised value of collateral may not be known at the time the balance sheet is prepared, or cash flow expectations may be uncertain because the effect of the bankruptcy on those cash flows cannot be reasonably determined. For these reasons and others, many prepetition claims are initially reported as liabilities subject to compromise, even if they are secured.

As the bankruptcy proceedings evolve, a liability classified as subject to compromise is reclassified if:

- the Court approves payment of the claim; or
- new information affects the evaluation of whether the claim is fully secured.

Court approval of payment of claim

It may be appropriate to reclassify a liability initially subject to compromise to liabilities not subject to compromise when the Court approves payment of a claim. For example, the Court often approves certain claims early in the bankruptcy process (e.g. payments to critical vendors or employees) so the entity can continue its operations. Once approved for payment by the Court, a liability is by definition no longer subject to compromise and reclassification is appropriate.

New information about claim's secured status

An entity may identify information that indicates a prepetition liability is fully secured and should be reclassified to liabilities not subject to compromise. For example, revised projections may indicate that the estimated cash flows from the collateral securing a claim are greater than initially anticipated. In this case, the liability is reclassified in its entirety to liabilities not subject to compromise because it is now deemed fully secured. [852-10-45-7]

Similarly, new information may be obtained about a prepetition liability initially classified as not subject to compromise. For example, an entity may determine that all security interests are either unsecured or undersecured and will likely not be repaid in full. It is not unusual to discover that claims that appeared to be fully secured at the onset of bankruptcy proceedings are in fact undersecured. Because of this, an entity continues to assess the classification of its prepetition liabilities at each reporting date during the bankruptcy proceedings.

Question 4.3.30 How is a prepetition liability classified if an entity learns about it after the petition date?

Background: As a result of the schedule of claims filing process, an entity could become aware of additional obligations after it files a petition for bankruptcy that were incurred before filing (e.g. a legal or environmental claim).

Interpretive response: Because prepetition liabilities include claims that become known after a petition is filed, a claim identified after the petition date for which the obligating event occurred before the petition date is classified consistent with other prepetition claims. [852-10-45-5]

Question 4.3.40 Where are liabilities subject to compromise presented on the balance sheet?

Interpretive response: Liabilities subject to compromise are presented as a single financial statement caption on the balance sheet, either before or after noncurrent liabilities. Details about the caption are disclosed in the notes to the financial statements (see [section 4.14](#)).

Prepetition claims are generally prohibited from being paid until after the entity emerges from bankruptcy. The basis for conclusions in Statement of Position 90-7 stated that, because the timing of emergence is usually unknown, and bankruptcy proceedings often take greater than one year from petition filing to emergence, liabilities subject to compromise should be presented separately from current liabilities. [SOP 90-7.43-48]

Further, the automatic stay provisions of the Code prohibit creditors from attempting to collect, assess or recover claims on the entity in bankruptcy. Because of this, it is unnecessary for an entity to recharacterize long-term liabilities subject to compromise as short-term, even though the creditor may demand payment because of a violation of the agreement. [852-10-45-8]

See [Example 4.13.10](#) for an example of the balance sheet presentation of liabilities subject to compromise during bankruptcy proceedings.

Recognizing and measuring prepetition liabilities subject to compromise

Prepetition liabilities subject to compromise are *recognized* when they meet the recognition criteria in Subtopic 450-20 (loss contingencies). That Subtopic requires a loss contingency to be recognized if it is probable and reasonably estimable. [852-10-45-5, 450-20-25-2]

Although liabilities subject to compromise are usually settled for less than the allowed claim amount, they are *measured* at the amount that is expected to be *allowed* by the Court. If that amount cannot be reasonably estimated, the existence of the liability is disclosed in the notes to the financial statements (see [section 4.14](#)). [852-10-45-4, 45-5, 50-2]

Question 4.3.50 When is a prepetition claim probable and reasonably estimable?

Background: A prepetition claim, including a claim that becomes known after a petition is filed, is recognized as a liability when it is probable and reasonably estimable. The liability is measured at the amount of the expected **allowed claim** as opposed to the amounts for which those allowed claims may be settled. [450-20-25-2, 852-10-45-5]

A claim is allowed or expected to be allowed if:

- it is included on the debtor's schedule of assets and liabilities filed with the Court by the debtor – and not marked on the schedule as contingent, unliquidated or disputed by the vendor;
- it is submitted by a creditor and not objected to by the debtor; or
- it has been approved by the Court.

Interpretive response: For some claims (e.g. prepetition debt and accounts payable), determining that the claim is probable and reasonably estimable is relatively easy because the debtor includes them on the schedule filed with the Court and there are contractual amounts owed. For these claims, the liability is reclassified to liabilities subject to compromise when appropriate and measured at the amount of the expected allowed claim.

For other claims, determining whether the Court is expected to allow a claim may be more difficult and may require the assistance of legal counsel. For example, a vendor may file a claim for breach of contract, but there is a dispute about whether the contract has been breached or about the amount of damages. In these cases, the probable and/or reasonably estimable threshold may not be met, and it would be appropriate to wait until the Court approves the claim from the vendor to recognize a liability subject to compromise. See [Questions 4.5.10](#) and [4.5.20](#) for a discussion of measuring prepetition contingent liabilities.

Liabilities subject to compromise are *estimates* of the amount that is expected to be allowed by the Court. As bankruptcy progresses and new or better information about a claim becomes available, an entity's estimate of an allowed claim may change. Any changes to liabilities subject to compromise as a result of changes to the expected allowed claim are recognized as reorganization items in the statement of operations (see [section 4.9.10](#)).

The amount recorded for a claim is not changed to reflect the settlement amount until emergence. These settlement adjustments are generally recognized as reorganization items (see [section 4.9.10](#)).

Example 4.3.10 Lifecycle of a liability subject to compromise

ABC Corp. filed a petition for bankruptcy on July 1, Year 1. At the time of the petition filing, ABC owed Lender \$500 for an unsecured loan.

The claim was allowed by the Court and, at the time of preparing its September 30 financial statements, ABC estimated the allowed claim to be \$500. ABC reclassified the \$500 payable to Lender from loans payable to liabilities subject to compromise on its September 30 balance sheet.

As the bankruptcy proceedings progress, ABC believes that the claim with Lender will ultimately be settled for \$450. However, \$500 is still the best estimate of the *allowed claim*. Therefore, the liability is not adjusted for the amount at which ABC expects it to settle.

On November 1, ABC is notified that the Court has revised the allowed claim to \$475 because a late payment fee has been disallowed. As a result, ABC reduces the carrying amount of liabilities subject to compromise by \$25. The adjustment is recognized as a reorganization item in ABC's statement of operations. ABC records the following journal entry.

	Debit	Credit
Liabilities subject to compromise	25	
Reorganization items		25
<i>To adjust liabilities subject to compromise to amount of allowed claim.</i>		

See [Example 5.3.30](#) for the treatment of the claim payable to Vendor upon ABC's emergence from bankruptcy.

Question 4.3.60 In what period should a claim be recognized if the entity learns about it after the reporting date?

Background: As discussed in [section 3.13](#), if a subsequent event provides additional evidence about conditions that existed at the reporting date, it is recognized in the financial statements. In contrast, if an event provides evidence about conditions that did not arise until after the reporting date, it is a nonrecognized subsequent event that may need to be disclosed.

Interpretive response: The filing of a claim (and the allowance or expected allowance by the Court) after the reporting date, but before the entity's financial statements are issued (or available to be issued), is a recognized subsequent event and the entity recognizes a liability if:

- the condition existed at the reporting date; and
- the claim meets the requirements to be recognized and measured as a prepetition liability subject to compromise (see [Question 4.3.50](#)).

4.3.30 Liabilities not subject to compromise

Liabilities not subject to compromise include prepetition liabilities that are not expected to be impaired under the plan of reorganization (including fully secured liabilities) and postpetition liabilities. In addition to being presented separately

from liabilities subject to compromise, liabilities not subject to compromise should be segregated into current and noncurrent if the entity presents a classified balance sheet. [852-10-45-4, 45-7]

Question 4.3.70 How are liabilities not subject to compromise accounted for?

Interpretive response: During bankruptcy proceedings, liabilities not subject to compromise are accounted for under other applicable US GAAP – i.e. in the same manner as if the entity were not in bankruptcy.

As discussed in [Question 4.3.20](#), the classification of prepetition liabilities can change as the bankruptcy proceedings evolve and the entity obtains new or better information. If the entity determines that a liability that was initially classified as not subject to compromise becomes subject to compromise, the liability is reclassified and the requirements of Subtopic 852-10 apply (see [section 4.3.20](#)).

See [Example 4.13.10](#) for an example balance sheet presentation during bankruptcy proceedings.

4.4 Debt

4.4.10 Prepetition debt

Excerpt from ASC 852-10

- > Balance Sheet

45-6 Debt discounts or premiums as well as debt issue costs shall be viewed as valuations of the related debt. When the debt has become an allowed claim and the allowed claim differs from the net carrying amount of the debt, the recorded amount shall be adjusted to the amount of the allowed claim (thereby adjusting existing discounts or premiums, and deferred issue costs to the extent necessary to report the debt at this allowed amount). The gain or loss resulting from the entries to record the adjustment shall be classified as reorganization items, as discussed in paragraph 852-10-45-9. Premiums and discounts as well as debt issuance cost on debts that are not subject to compromise, such as fully secured claims, shall not be adjusted.

The Court typically allows a claim for unsecured or undersecured debt in an amount totaling the principal balance plus accrued interest as of the petition date. When this occurs, the debt's carrying amount is adjusted to the amount of the allowed claim, regardless of whether the debt had been measured at amortized cost or at fair value under Topic 825's fair value option. Fair value principles no longer apply to prepetition liabilities subject to compromise. Further, if the debt had been measured at amortized cost, this adjustment to its carrying amount includes a write off of unamortized debt issuance costs and

debt premiums or discounts. See [Question 4.4.10](#) for a discussion of when this adjustment is made.

Consistent with the treatment of other prepetition liabilities, this gain or loss is classified as a reorganization item (see [section 4.9.10](#)). [852-10-45-4, 45-6]

If debt is fully secured and therefore not subject to compromise, no adjustment is made to the net carrying amount of the debt (including unamortized debt issuance costs and debt premiums or discounts) and it continues to be accounted for under Topic 470 (debt) and Topic 835 (interest). [852-10-45-6]

Question 4.4.10 When is debt that is subject to compromise adjusted to the amount of the allowed claim?

Background: Generally, prepetition liabilities subject to compromise are measured at the amount that is expected to be allowed by the Court. For unsecured or undersecured debt, which would be considered subject to compromise upon filing, the expected allowed claim is typically the total principal balance plus any accrued interest. [852-10-45-4]

Subtopic 852-10 also indicates that the carrying amount of debt is adjusted to the allowed amount when it has become an allowed claim. When the adjustment is made to the allowed amount, premiums, discounts and debt issuance costs are written off to reorganization items. Subtopic 852-10 is silent on the treatment of debt before it becomes an allowed claim. [852-10-45-4, 45-6]

Because of the nature of bankruptcy proceedings, the debt may not be formally allowed by the Court when the petition is filed. Therefore, it is unclear whether debt should be adjusted when it is expected that it will become an allowed claim (when considered subject to compromise) or when the Court explicitly allows the claim.

Interpretive response: We believe two approaches commonly used in practice are acceptable. An entity should apply a consistent approach to each debt that is subject to compromise.

Approach 1: Expectation

Under this approach, the debt is adjusted to the expected allowed claim when it is *probable* that the Court will allow the claim and the amount of the claim is *reasonably estimable*. Generally, this would be at the petition date for the following reasons.

- **Probable.** Because prepetition debt is a claim the entity is aware of when it files for bankruptcy, it is included on the schedule of claims, and therefore it is expected to be an allowed claim at that time.
- **Reasonably estimable.** Because the Court customarily allows a claim for unsecured or undersecured debt at an amount totaling the principal balance plus accrued interest as of the petition date, the entity can reasonably estimate the amount.

Approach 2: Allowed by the Court

Under this approach, the entity measures the debt and related discount or premium and debt issue costs under other relevant US GAAP until the debt has formally become an allowed claim. At the time the claim is allowed, the adjustment to the amount of the allowed claim is recognized as a reorganization item. However, the debt would be classified as a liability subject to compromise before becoming an allowed claim.

Example 4.4.10 Accounting for debt subject to compromise

ABC Corp. files a petition for bankruptcy on July 1, Year 1. As of that date, ABC has an unsecured loan outstanding with Bank. No principal payments are due on the loan until January 1, Year 4.

The debt was not callable before the filing, and therefore ABC’s balances related to the debt as of July 1, Year 1 are:

Principal balance	1,000
Unamortized discount	100
Unamortized debt issue costs	20
Accrued interest payable	30

Because the debt was included on the schedule filed with the Court when ABC filed for bankruptcy (see [Question 4.4.10](#)), at the petition date ABC expects the Court to allow the claim in the amount of \$1,030 (principal of \$1,000 plus accrued interest of \$30).

ABC follows Approach 1 in [Question 4.4.10](#) and adjusts the balance of the debt to the expected allowed claim on July 1, Year 1 because the expected allowed claim is probable and reasonably estimable. ABC records the following journal entries.

	Debit	Credit
Reorganization items	120	
Debt discount		100
Debt issue costs		20
<i>To write off debt discount and debt issue costs to reorganization items.</i>		
Long-term debt	1,000	
Accrued liabilities	30	
Liabilities subject to compromise		1,030
<i>To present amount of allowed claim as liabilities subject to compromise.</i>		

If ABC followed Approach 2 in [Question 4.4.10](#), it would classify the debt as subject to compromise but otherwise continue to account for the debt under

other applicable GAAP until the debt became an allowed claim. At that time, it would record an entry similar to the one above to write off the debt discount and debt issue costs.

Question 4.4.20 Are premiums, discounts and debt issue costs written off during bankruptcy proceedings if the debt is not subject to compromise?

Interpretive response: No. If debt is fully secured and therefore not subject to compromise, no adjustment is made to the balance of the debt or its related premiums or discounts and debt issue costs. These amounts continue to be accounted for under Topic 470 (debt) and Topic 835 (interest). Therefore, an adjustment to the effective yield or the unamortized amount of premiums, discounts or debt issue costs is made only if required by Topic 470 or Topic 835. [852-10-45-6]

Question 4.4.30 Can debt extinguishment gains or losses resulting from bankruptcy proceedings be presented in discontinued operations?

Interpretive response: Yes. We believe such presentation is acceptable if the debt is clearly associated with the discontinued operation and the gain or loss is disclosed either in the statement of operations or in the notes to the financial statements (see [section 4.14](#)). [852-10-45-9]

Question 4.4.40 Does the troubled debt restructurings guidance apply to an entity in bankruptcy?

Interpretive response: Potentially, yes. The scope of Subtopic 470-60 includes all troubled debt restructurings, including those consummated under reorganization, arrangement, other provisions of the Federal Bankruptcy Act or related federal statutes.

However, Subtopic 470-60 does not apply if, under provisions of those federal statutes or in a quasi-reorganization or corporate readjustment with which a troubled debt restructuring coincides, the debtor restates its liabilities generally. This means that if such restructurings or modifications accomplished under the oversight of the Court encompass most of the amount of the debtor's liabilities, they are not in the scope of Subtopic 470-60. [470-60-15-5, 15-10]

While Subtopic 470-60 will generally not apply in bankruptcy, entities should consider the facts and circumstances of their bankruptcy proceedings when concluding whether they are restructuring the majority of their liabilities. For example, if an entity is executing a prepackaged or prearranged bankruptcy (see [section 2.3.50](#)) with the objective of restructuring only a specific debt agreement, without affecting its other liabilities, it may conclude that the restructuring is a troubled debt restructuring.

For further discussion around accounting for troubled debt restructurings under Subtopic 470-60, see chapter 4 of KPMG Handbook, [Debt and equity financing](#).

Question 4.4.50 Upon filing for bankruptcy, how does an entity account for a deferred gain associated with a liability subject to compromise that resulted from a previous troubled debt restructuring?

Background: Before filing for bankruptcy, an entity may seek financial relief by negotiating a modification to a debt agreement. The modification may have been accounted for as a troubled debt restructuring.

Interpretive response: We believe a deferred gain from a previous troubled debt restructuring associated with a liability subject to compromise should generally be written off to reorganization items at the time of the bankruptcy filing. This is analogous to the accounting treatment for discounts, premiums and debt issue costs. As discussed in [section 4.4.10](#), the Court typically allows a claim for unsecured or undersecured debt in an amount totaling the principal balance plus accrued interest as of the petition date. Therefore, any discounts, premiums and debt issue costs are generally written off to report the debt at the amount of the allowed claim. See [Question 4.4.10](#) for a discussion of when this adjustment is made. [852-10-45-6]

Similar to discounts, premiums and debt issue costs, a deferred gain is not an amount due to the creditor, but a measurement balance resulting from the required accounting treatment. Therefore, we believe the deferred gain should be adjusted similarly to other measurement type accounts recognized and presented within the net carrying amount of the debt.

4.4.20 Debtor-in-possession (DIP) financing

DIP financing is provided to an entity in bankruptcy to finance the ongoing operations of the entity while it reorganizes.

Question 4.4.60 How are fees related to DIP financing accounted for in bankruptcy proceedings?

Background: When entering into a DIP financing arrangement, an entity incurs fees payable to the DIP lender and third parties, including attorneys and rating agencies.

For an entity not in bankruptcy, debt issue costs are typically recognized as a reduction of the carrying amount of the debt and amortized using the effective interest method over the term of the debt as a component of interest expense. However, US GAAP prohibits deferring professional fees and similar expenditures during bankruptcy. It is unclear whether this prohibition is meant to apply to fees for DIP financing. [835-30-35-2, 45-1A, 852-10-45-10]

Interpretive response: We are aware of two approaches to the accounting for these fees, which are explained below. We believe either of these methods is acceptable provided that the fees related to DIP financing are clearly disclosed in the notes to the financial statements (see [section 4.14](#)).

Approach 1: Defer fees

Under this approach, all fees related to the DIP financing are deferred and amortized over the term of the arrangement. This approach is based on the statement in Subtopic 852-10 that interest expense is not a reorganization item. Under this approach, fees related to DIP financing are treated as an additional cost of borrowing while the entity is operating in bankruptcy, similar to the treatment of financing costs for debt obligations incurred outside of bankruptcy. [\[852-10-45-11\]](#)

An entity amortizes these fees into interest expense over the expected term of the DIP financing arrangement. Because the time period over which the entity will operate in bankruptcy is uncertain, the term of the DIP financing arrangement is estimated at the origination of the financing and is updated at each reporting date until emergence.

If the DIP financing is extinguished upon emergence from bankruptcy (which is usually the case as it is replaced with post-emergence debt), any fees related to DIP financing remaining on the balance sheet are expensed. These fees are presented outside of reorganization items. [\[852-10-45-11\]](#)

Approach 2: Expense fees

Under this approach, all fees related to the DIP financing are expensed as incurred and recognized as reorganization items in the statement of operations. This approach is based on AICPA Consulting Services Practice Aid 98-1 (nonauthoritative). The Practice Aid indicates that there is some basis for this provided the charges exceed what would be paid if the entity were not in bankruptcy, and the fees do not represent interest. [\[AICPA CSPA 98-1 9.29\]](#)

Additionally, supporters of this approach believe that all fees related to DIP financing would not otherwise be incurred, and therefore they should be expensed as incurred under Subtopic 852-10 (see [section 4.9.30](#)); this is consistent with other professional fees directly related to the bankruptcy proceeding.

In our experience, many entities that expect to replace the DIP financing when they emerge from bankruptcy follow this approach.

Question 4.4.70 How are cash flows related to DIP financing classified in the statement of cash flows?

Interpretive response: We believe that cash flows related to DIP financing (including fees) should be classified consistent with the treatment of similar financing arrangements required by Topic 230. For guidance on presenting debt financing transactions in the statement of cash flows, see chapter 12 of KPMG Handbook, [Statement of cash flows](#).

See [Example 4.13.30](#) for an example statement of cash flows for an entity in bankruptcy, which includes DIP financing.

Question 4.4.80 How is DIP financing classified on the balance sheet?

Background: DIP financing can be structured in a variety of ways, depending on the facts and circumstances surrounding the debtor’s bankruptcy proceedings. Usually, DIP financing is structured as a term loan, but some debtors may obtain a revolving credit facility. DIP financing must be approved by the Court.

Interpretive response: DIP financing is entered into postpetition and therefore it is not subject to compromise (see [section 4.3.30](#)). Consistent with other liabilities not subject to compromise, if an entity prepares a classified balance sheet, DIP financing is classified as a current and/or noncurrent liability based on its terms and the related analysis under Subtopic 470-10.

4.5 Other considerations for liabilities

There are many considerations when accounting for liabilities while in bankruptcy. This section discusses some of the more common considerations. However, an entity should consider facts and circumstances specific to its liabilities to determine the appropriate accounting treatment while in bankruptcy.

4.5.10 Contingent liabilities

A contingency is an existing condition, situation or set of circumstances involving uncertainty as to possible gain or loss to an entity that will ultimately be resolved when one or more future events occur or fail to occur. [[450-10 Glossary](#)]

As discussed in [section 4.3.20](#), Subtopic 450-20 provides overall guidance on accounting for loss contingencies. However, additional guidance exists for certain types of loss contingencies, as illustrated in the following table (not exhaustive). [[450-20-60](#)]

Guidance	Type of loss contingency	Description
Subtopic 410-20	Asset retirement obligations	Contingencies associated with the retirement of a long-lived asset that result from the acquisition, construction, development or normal operation of a long-lived asset. [450-20-60-7]

Guidance	Type of loss contingency	Description
Subtopic 410-30	Environmental remediation liabilities	Contingencies related to environmental remediation liabilities that arise from the improper operation of a long-lived asset. [450-20-60-8]
Subtopic 460-10	Product warranties and product defects	Contingencies related to the performance of nonfinancial assets that are owned by the guaranteed party. [460-10 Glossary]
Topic 460	Guarantees	Contingent obligations that do not meet the definition of a derivative that can require the guarantor to make payments to the guaranteed party for a number of reasons: [460-10-15-4] <ul style="list-style-type: none"> • based on changes in an underlying; • based on another entity's failure to perform under an obligating agreement; or • based on indirect guarantees of the indebtedness of others.
Subtopic 954-450	Malpractice claims	Contingent obligations against a medical professional for malpractice. [450-20-60-21]

Regardless of the type of contingency, once an entity files for bankruptcy, it must consider whether each obligation is expected to be an allowed claim. If the obligation is an allowed claim, it is accounted for under Subtopic 852-10 when it meets the requirements to be recognized and measured as a prepetition liability subject to compromise (see [Question 4.3.50](#)).

Question 4.5.10 Does an entity reclassify an accrual related to ongoing litigation to liabilities subject to compromise at the time it files for bankruptcy?

Background: Before bankruptcy, an entity may or may not have accrued liabilities related to ongoing litigation. For some types of litigation, an entity may conclude that a loss is both probable and reasonably estimable, and therefore recognize an accrual. However, for other litigation matters, an entity may not recognize an accrual, concluding either that a loss is not probable or that the amount is not reasonably estimable. [450-20-25-2]

For an entity not in bankruptcy, the amount accrued for a contingency such as a loss from litigation is based on an estimate of the amount at which the entity expects the related lawsuit to settle; or the minimum amount within a range of loss when no amount within the range is a better estimate than any other. This amount may differ from a settlement in bankruptcy.

Interpretive response: Generally, yes. Claims related to ongoing lawsuits underlying a prepetition contingent liability initially fall under the automatic stay

provisions when the entity files a petition for bankruptcy; legal cases outstanding at that time become part of the bankruptcy proceedings. Therefore, contingencies for litigation accrued before bankruptcy are usually classified as liabilities subject to compromise.

The entity adjusts the contingent liability subject to compromise to the amount of the allowed claim (see [Question 4.3.50](#)). Absent any other changes or information from the bankruptcy proceedings about the amount of the allowed claim, we believe the contingent liability should continue to be recorded at the same amount as it was prior to the filing. When additional information is known about the amount of the allowed claim, the liability should be adjusted.

However, there may be situations in which the entity has enough certainty as of the filing date to conclude that the claim will not be subject to compromise. For example, when the plaintiff petitions the Court to exclude the litigation from the bankruptcy case and the entity expects the claim to be excluded based on available information. This is often the case with environmental remediation liabilities, particularly if the US government is a party to the matter (see [Question 4.5.20](#)).

During bankruptcy proceedings, the Court assesses each case and decides whether to dispose of it (through outright dismissal or determining a judgment), or to permit the continuance of the litigation post-emergence. The entity should monitor the Court's progress to determine whether the liability should be reclassified into or out of liabilities subject to compromise based on these proceedings.

Disposal through judgment (including settlement)

If a case is disposed of through a judgment by the Court or settlement by the parties before emergence, the judgment or settlement amount becomes an allowed claim that is part of the unsecured class of claims; the liability is classified as subject to compromise if not already and is adjusted to the amount of the allowed claim.

As discussed in [Question 4.3.50](#), liabilities subject to compromise are measured at the amount that is allowed or expected to be allowed by the Court. Therefore, the liability for the case is not reduced below the amount of the allowed claim even if it becomes apparent that the claim will be settled, as part of the plan of reorganization, for an amount less than the allowed claim. Instead, upon emergence from bankruptcy when the entity settles the obligation, the difference between the liability recognized and the settlement amount is presented as a reorganization item in the predecessor financial statements.

Disposal through outright dismissal

If the Court dismisses a case without judgment being awarded to the plaintiff, the entity derecognizes the liability through reorganization items in the statement of operations only when all corresponding appeals to the Court have been exhausted. This generally occurs when the plan of reorganization is confirmed by the Court and the entity emerges from bankruptcy.

Example 4.5.10 Accounting for a litigation-related accrual during bankruptcy

ABC Corp. is a construction company that had recognized a \$1 billion contingent liability for asbestos-related litigation. In an effort to manage its asbestos liability, ABC files a petition for bankruptcy on March 1, Year 1, to use the Court-supervised reorganization process to resolve all of its present and future asbestos claims.

As a consequence of ABC filing for bankruptcy, holders of asbestos claims are stayed from continuing to prosecute pending litigation and from filing new lawsuits against ABC. In addition, ABC is prohibited from paying any prepetition claims unless they are authorized by the Court.

Significant differences exist in the way ABC's asbestos-related claims may be addressed in the bankruptcy process as opposed to if it were not in bankruptcy. At the filing date, ABC does not have information about the amount the Court expects to allow. Therefore, ABC continues to measure its asbestos liability at the prepetition amount until the Court acts on the claims. ABC classifies the liability as subject to compromise.

Question 4.5.20 How are environmental remediation liabilities accounted for while an entity is in bankruptcy?

Background: Subtopic 410-30 requires a liability for an environmental remediation obligation to be recognized if the criteria in Subtopic 450-20 are met – i.e. it is probable that a liability has been incurred and the loss can be reasonably estimated. [410-30-25-4]

To conclude that it is probable that an environmental remediation liability has been incurred, both of the following criteria must be met: [410-30-25-4]

- litigation has commenced or a claim or assessment has been asserted or is probable; and
- it is probable that the outcome of this litigation, claim or assessment will be unfavorable.

Interpretive response: Environmental remediation liabilities are accounted for during bankruptcy consistent with other contingent liabilities; however, they are not generally classified as liabilities subject to compromise (see [Question 4.5.10](#)). This is because environmental obligations existing at the date the entity files a petition for bankruptcy typically are not dismissed in the bankruptcy proceedings and instead remain an obligation of the entity after emerging from bankruptcy, particularly if the US government is a party to the matter.

Question 4.5.30 How are asset retirement obligations (AROs) accounted for in bankruptcy?

Background: Unlike an environmental remediation liability that arises from improper operations (see [Question 4.5.20](#)), AROs are obligations associated

with the retirement of a long-lived asset that result from the acquisition, construction or development and/or the *normal* operation of a long-lived asset; this includes environmental remediation liabilities that arise from the normal operation of a long-lived asset that are associated with the retirement of that asset. [410-20 Glossary]

Interpretive response: Usually an ARO continues to be accounted for under Subtopic 410-20 during bankruptcy. Although an ARO represents a legal obligation, it generally does not represent an amount owed to another party, and therefore there is no counterparty to file a claim against the entity.

In limited circumstances, an ARO may be reclassified to liabilities subject to compromise. For example, an entity may rent space and have a contractual obligation to remove leasehold improvements. If the entity rejects the lease and fails to remove the leasehold improvements before returning the property to the lessor, the lessor may file a claim to recover the cost of removing the leasehold improvements. In this case, the ARO is reclassified to liabilities subject to compromise when the criteria for doing so are met (see [Question 4.3.20](#)).

4.6 Executory contracts

An executory contract is generally understood to be a contract under which performance remains due from any party to the contract. Executory contracts in place at the time the petition is filed can be assumed with or without modification or rejected during bankruptcy proceedings (see [section 2.3.30](#)) subject to Court approval.

If an entity rejects a contract, it is protected from the counterparty seeking remedies by the automatic stay provisions (see [section 2.3.30](#)) and the counterparty will generally file a proof of claim for damages or losses incurred as a result of the action.

The following summarizes the accounting treatment for executory contracts depending on whether they are assumed or rejected.

If the contract is:	Treat the contract:
Rejected	As an unsecured claim, which generally means the following. <ul style="list-style-type: none"> • Record a liability at the estimated allowed amount, (including amounts due under the terms of the contract as well as penalties and other clauses). • Classify as a liability subject to compromise, unless it will be satisfied in full.
Assumed	As it would be treated in the normal course of business. <ul style="list-style-type: none"> • Remit all past amounts owed to the counterparty. • Account for the contract through bankruptcy and upon emergence in its current state. • Do not classify as a liability subject to compromise.

There are many types of executory contracts, including but not limited to:

- operating lease agreements (discussed in [section 4.7](#));
- revenue contracts; and
- supply contracts.

Generally, an executory contract has no financial reporting consequence until at least one party (partially) performs – e.g. a contractor meets a building milestone, a purchase is made or a service is rendered – or the contract is terminated or modified.

Question 4.6.10 How are executory contracts with vendors accounted for in bankruptcy?

Interpretive response: The accounting for executory contracts with vendors (e.g. supply or service contracts) depends on whether the contract is assumed or rejected by the entity.

- **Contract assumed.** If an executory contract is assumed without modification during bankruptcy proceedings, it continues to be accounted for under the US GAAP applicable to the contract with no changes.
- **Contract rejected.** If an executory contract is rejected, the counterparty can file a proof of claim as a result of the rejection. The claim could relate to amounts due at the filing date (e.g. accounts payable) and/or damages resulting from the rejection. The claims are generally considered unsecured claims subject to compromise and recognized if it is probable the Court will allow the claim and the amount can be reasonably estimated (see [Question 4.3.50](#)). However, all facts and circumstances about a claim and whether it is expected to be impaired under the plan should be considered in determining whether it is subject to compromise.

We believe that amounts recognized because of the termination of an executory contract should be presented as a reorganization item (see [section 4.9.10](#)).

Question 4.6.20 How is deferred revenue (or a contract liability) related to an existing sales contract accounted for in bankruptcy?

Interpretive response: It depends on whether the sales contract is assumed without modification, rejected or modified.

Contracts with customers to provide goods or services are generally executory contracts; therefore, the accounting for the related deferred revenue (or contract liability) generally follows the model discussed in [Question 4.6.10](#).

- If an executory contract is assumed without modification during bankruptcy proceedings, it continues to be accounted for under applicable US GAAP (e.g. Topic 606).

- If the sales contract is modified or amended by mutual agreement, the modification is accounted for under applicable US GAAP (e.g. Topic 606). For guidance on accounting for contract modifications under Topic 606 see chapter 11 of KPMG Handbook, [Revenue recognition](#).
- If an executory contract is rejected, the counterparty can file a proof of claim as a result of the rejection. A customer's claim could relate to advanced deposits and/or damages for a breach of contract.

The claims are generally considered unsecured claims subject to compromise and recognized at the amount expected to be allowed by the Court if it is probable the Court will allow the claim and the amount can be reasonably estimated (see [Question 4.3.50](#)). However, all facts and circumstances about a claim and whether it is expected to be impaired under the plan should be considered in determining whether it is subject to compromise.

Any remaining recorded liabilities associated with the contract (i.e. deferred revenue or contract liabilities), beyond the estimated claim amount, are written off as a reorganization item.

If the sales contract is not an executory contract, it continues to be accounted for as it ordinarily would under US GAAP.

4.7 Lessee's accounting for leases

4.7.10 Overview

During bankruptcy proceedings, an unexpired lease agreement can be affirmed (assumed without modification), amended (renegotiated or assumed as modified) or rejected, subject to approval by the Court. When a lease is rejected, the underlying asset is generally returned to the lessor; the lessee is protected from the lessor seeking further remedies by the automatic stay provisions (see [section 2.3.20](#)) and the lessor will generally file a proof of claim for damages or losses incurred as a result of the action.

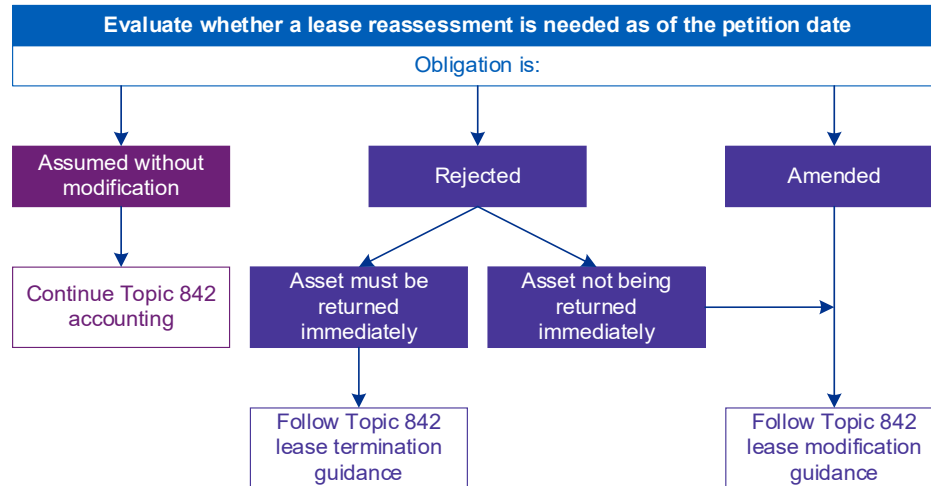
While leases are generally treated in bankruptcy consistent with the preceding paragraph, it is important to understand the legal treatment because accounting leases (those that meet the definition of a lease in Topic 842) may be treated differently by the Court. For example, in some cases an accounting lease may be treated like a secured borrowing by the Court, in which case the lessor would be considered a creditor and the lease obligation a claim.

This section describes the accounting for leases that are assumed, modified or rejected during bankruptcy. The entity accounts for arrangements considered secured borrowings consistent with other debt (see [section 4.4](#)).

4.7.20 Topic 842

An entity records a lease liability and a right-of-use (ROU) asset on its balance sheet, regardless of how the lease is classified, for all leases that are not short-term leases (as defined).

For guidance on how to account for leases as a lessee, see chapter 6 of KPMG Handbook, [Leases](#).



Question 4.7.10 Does filing for bankruptcy by a lessee trigger a reassessment of the lease term or a lessee purchase option?

Background: Topic 842 requires a lessee to reassess the lease term or a lessee option to purchase the underlying asset when one of the following occurs; see section 6.6.1 of KPMG Handbook, [Leases](#).

- An event written into the contract obliges the lessee to exercise (or not exercise) an option.
- The lessee elects to exercise an option that it had previously determined it was not reasonably certain to exercise.
- The lessee elects not to exercise an option that it had previously determined it was reasonably certain to exercise.
- A 'triggering event' occurs – i.e. a significant event or significant change in circumstances that (1) is within the lessee's control, and (2) directly affects the assessment of whether the lessee is reasonably certain to exercise the extension or purchase option.

Interpretive response: It depends. We believe filing for bankruptcy is a significant event within the lessee's control – either it initiated the filing or undertook actions that triggered its debtors' to impose bankruptcy on the entity – and therefore the filing meets the first criterion for a triggering event.

However, determining when a lessee's bankruptcy directly affects whether it is reasonably certain to exercise a lease extension (including by not exercising an available termination option) or exercise a purchase option – i.e. meets the second criterion for a triggering event – will depend on the facts and circumstances. A lessee may conclude that filing for bankruptcy, and the events leading to the bankruptcy, are triggering events for all of its leases or for only certain of its leases.

For example, if the lessee expects to emerge from bankruptcy with significant changes to some parts of its operations and only insignificant (or no) changes to other parts, it may conclude that:

- the bankruptcy does not meet the second triggering event criterion for those leases used in the relatively unaffected parts of its operations; but
- meets the second triggering event criterion for those leases used in the significantly affected parts of its operations.

If the effect of the bankruptcy is expected to be pervasive to the lessee's operations, or if the lessee may not emerge from bankruptcy, the entity may conclude that the bankruptcy filing is a triggering event for most (or even all) of its leases.

Even if the bankruptcy is not expected to significantly affect the lessee's operations, the filing may trigger a reassessment of ancillary or non-essential leases (e.g. of a non-essential corporate aircraft or facility).

If the lessee determines that a reassessment is required as a result of the filing, the reassessment is performed at the filing date. This is regardless of whether the lessee intends to assume, amend or reject the lease in bankruptcy.

If the reassessment leads to a change in either the lease term or the assessment of whether the lessee is reasonably certain to exercise a purchase option, the lessee remeasures its lease liability and the ROU asset. In addition, the measurement date of these items may be significantly affected by a change in the discount rate for the lease, which is updated in the remeasurement. If the lessee uses its incremental borrowing rate as the discount rate for the lease, that rate may be significantly higher than it was before the bankruptcy filing; this is because the lessee's creditworthiness may have significantly deteriorated since lease commencement.

For guidance about when and how a lessee reassesses its leases, see section 6.6 of KPMG Handbook, [Leases](#).

Question 4.7.20 How does an entity account for a lease that is assumed without modification?

Interpretive response: An entity continues to account for the lease under Topic 842 in the usual way because, in assuming the lease, the parties to the contract have reached an agreement to continue the contract without modification. Therefore, liabilities associated with an assumed lease are not subject to compromise.

A lease agreement is only considered to be assumed without modification if no amendments are made to the agreement – e.g. no changes in total rent due,

timing of payments, term. Any amendments that change the scope or consideration for the lease would result in the application of lease modification accounting.

Appropriate disclosure about assumed leases and other executory contracts should be made in the notes to the financial statements (see [section 4.14](#)).

Question 4.7.30 How does an entity account for a lease that is amended in bankruptcy?

Interpretive response: When a lease agreement is amended as to the scope of or consideration for the lease as part of bankruptcy proceedings, it is accounted for under the lease modification guidance of Topic 842. This guidance is applied on the date that the modification is approved by all relevant parties. For an entity in bankruptcy, this includes approval by the Court.

For guidance on accounting for lease modifications as a lessee, see section 6.7 of KPMG Handbook, [Leases](#).

Question 4.7.40 How does an entity account for a lease that is rejected in bankruptcy?

Background: When a lease is rejected as part of a bankruptcy, the underlying asset is generally returned to the lessor. However, the lessee may have a period of time (e.g. six months) before it must return the underlying asset to the lessor, including vacating leased premises.

Interpretive response: The entity's accounting for the rejection depends on the timing of returning the underlying asset.

- **Underlying asset returned immediately.** If the asset is returned as of the effective date or is required to be returned immediately thereafter, the rejection is accounted for as a lease termination; see section 6.8 of KPMG Handbook, [Leases](#).
- **Underlying asset *not* returned immediately.** If the lessee retains the right to use the asset for a period of time after the rejection is approved, the rejection is accounted for as a modification that reduces the lease term; see section 6.7 of KPMG Handbook, [Leases](#). In applying that guidance, the lessee remeasures and reallocates the remaining consideration in the contract and remeasures the lease liability using a discount rate determined at the effective date of the modification.

As discussed in [Question 4.7.30](#), the effective date of the modification is the time at which it is approved by all relevant parties (including the Court). Before the rejection is approved by the Court, the lessee does not adjust the amounts recognized under Topic 842. [Question 4.7.50](#) discusses evaluating a lessor's claims upon rejection.

When the lease is modified to reduce the lease term as described above, the lessee also decreases the carrying amount of the ROU asset. If that amount

exceeds the pre-modification carrying amount of the ROU asset, the excess is recognized as a gain.

We believe any gain recognized as a result of terminating or modifying the lease should be presented as a reorganization item; this is because it results directly from the bankruptcy proceedings (see [section 4.9.10](#)). However, if in conjunction with the rejection the entity and lessor enter into a new lease for the same (or a similar) asset, we believe the transaction (i.e. the rejection of the original lease and entering into the new lease) is, in substance, a lease modification and should be accounted for as such under the lease modification guidance of Topic 842.

Question 4.7.50 How does an entity account for a lessor's claim when a lease is rejected?

Background: As discussed in [Question 4.7.40](#), until a lease is rejected the lessee does not adjust the amounts recognized under Topic 842. When the rejection is approved, it is accounted for as a termination or modification. Upon a rejection, the lessor generally files a claim for late payments due from the lessee and damages resulting from rejecting the lease.

Interpretive response: Upon rejection, the accounting for the claim for damages and/or payments due at the petition date depends on whether it is subject to compromise.

A liability for past-due rent on a rejected lease is a claim that generally meets the requirements to be classified as subject to compromise; this is because it is unsecured and expected to be impaired. When the liability is considered subject to compromise, it is adjusted to the amount expected to be allowed.

Any claim for damages resulting from the rejection is recognized as a liability subject to compromise when it is probable and reasonably estimable (see [Question 4.3.50](#)). However, all facts and circumstances about the claim and whether it is expected to be impaired under the plan should be considered in determining whether it is subject to compromise.

Example 4.7.10 Rejection of an operating lease

Lessee filed a petition for bankruptcy on October 15, Year 2. At the date of the filing, Lessee was renting an aircraft from Lessor. The lease was classified as an operating lease and is accounted for under Topic 842.

On October 15, Year 2, Lessee owed Lessor \$1,500 for the last three months' rent; this amount is included in Lessee's lease liability. In addition, Lessee owed Lessor \$75 in late payment fees, which is recognized as a separate accrued liability on Lessee's balance sheet. Because the lease had not yet been rejected or modified, Lessee does not adjust the amounts recognized under Topic 842 at the petition date.

Lessee's carrying amounts related to the lease on October 15, Year 2 are as follows, which include any effect of Lessee's remeasurement of the lease on filing for bankruptcy (see [Question 4.7.10](#)).

Late payment fee liability	75
Lease liability (including \$1,500 past-due rent payments)	11,293
Right-of-use asset	7,593

On October 18, Year 2, Lessee filed a motion with the Court to reject the aircraft lease with Lessor; the motion was approved by the Court on October 21, Year 2. As a result of the lease rejection, Lessee must return the aircraft to Lessor within six months. The lease is treated as an executory contract under bankruptcy law.

On October 25, Year 2 Lessor filed a claim with the Court in the amount of \$2,575. This represented \$1,500 of missed payments by Lessee, damages for breach of contract of \$1,000 and late payment fees of \$75. At the time the claim was filed, Lessee expected the Court to allow the entire claim. The claim is allowed by the Court on October 30, Year 2 and is expected to be impaired by the plan.

Because Lessee will continue to use the aircraft for six months, the rejection of the lease is accounted for as a lease term modification. As a result, Lessee remeasures the lease liability at the effective date of the modification (October 21, Year 2) based on a remaining lease term of six months, with monthly payments of \$500 and Lessee's incremental borrowing rate at the effective date of the modification of 15%. As a result, the post-modification carrying amount of the lease liability is reduced to \$2,909. Rejection of the lease after the reporting date represents a nonrecognized subsequent event because it is a condition that arose after the reporting date.

Because \$1,500 of the pre-modification lease liability is part of the claim filed by Lessor, it is reclassified to liabilities subject to compromise. The remaining \$6,884 reduction to the lease liability is a corresponding adjustment to the ROU asset. The \$1,000 claim for damages is recognized as a liability subject to compromise and the related expense as a reorganization item.

Lessee records the following journal entries for the month of October Year 2.

	Debit	Credit
Lease liability	1,500	
Accrued expenses	75	
Liabilities subject to compromise		1,575
<i>To reclassify portion of lease liability that represents past-due rent, and accrued late payment fees, to liabilities subject to compromise.</i>		
Lease liability ¹	6,884	
ROU asset		6,884
<i>To reduce carrying amount of lease liability before modification to modified carrying amount.</i>		

	Debit	Credit
Reorganization items	1,000	
Liabilities subject to compromise		1,000
<i>To recognize damages as liabilities subject to compromise.</i>		
Note:		
1. \$11,293 - \$1,500 reclassified to liabilities subject to compromise - \$2,909 ending lease liability = \$6,884.		

4.8 Preferential payments

As discussed in [section 2.3.20](#), if an entity in bankruptcy exercises its avoidance powers to cancel certain prepetition transactions, the counterparty may be required to return payments received from the entity (referred to as preferential payments). The counterparty is then permitted to submit a claim to the Court for the obligation.

Question 4.8.10 How are preferential payments accounted for in bankruptcy?

Interpretive response: When an entity in bankruptcy demands the return of payments from a counterparty, we believe it should recognize a receivable for the amount once the Court approves the request. The entity should also record a liability subject to compromise for the claim expected to be filed by the counterparty.

4.9 Statement of operations under Subtopic 852-10

4.9.10 Reorganization items

Excerpt from ASC 852-10

- > Statement of Operations

45-9 The statement of operations shall portray the results of operations of the reporting entity while it is in Chapter 11. Revenues, expenses (including professional fees), realized gains and losses, and provisions for losses resulting from the reorganization and restructuring of the business shall be reported separately as **reorganization items**, except for those required to be reported as discontinued operations in conformity with Subtopic 205-20.

An entity in bankruptcy distinguishes transactions and events that are directly associated with the bankruptcy proceedings from its ongoing, normal

operations. To accomplish this, expenses, gains and losses resulting from bankruptcy proceedings are reported as **reorganization items** separately in the statement of operations. [852-10-45-9]

Question 4.9.10 What types of transactions are presented as reorganization items in the statement of operations?

Interpretive response: The reorganization items caption in the statement of operations consists only of amounts that are incremental and directly related to bankruptcy proceedings. Segregation of these items from normal business operations provides meaningful disclosure during a bankruptcy.

The following are items that typically are considered reorganization items versus those that are not.

Present as reorganization items?	
Yes	No
<ul style="list-style-type: none"> Changes to liabilities and related accounts resulting from the application of Subtopic 852-10 (Question 4.3.50) Gains/losses from adjusting the carrying amount of debt to the amount of the allowed claim (Question 4.4.10) Losses from rejecting or modifying executory contracts (Question 4.6.10) Interest income related to invested capital in excess of normal (section 4.9.20) Other expenses directly related to bankruptcy proceedings (section 4.9.30) 	<ul style="list-style-type: none"> Revenue Impairment charges Gains/losses from the sale of assets (see below) Restructuring costs resulting from normal operations Interest expense (section 4.9.20) Interest income related to normal invested capital (section 4.9.20) Reorganization activities associated with a discontinued operation (Question 4.11.160) Tax effects of reorganization items

When determining if a loss is a reorganization item, an important distinction to make is whether it is incremental and directly related to the bankruptcy proceedings. It is incremental if it would not have been incurred but for the proceedings – e.g. losses incurred on an executory contract that is terminated as part of the bankruptcy proceedings.

Although Subtopic 852-10 suggests that revenue can be a reorganization item, we expect the treatment of revenue as such to be rare. Additionally, impairment charges (even those incurred during bankruptcy proceedings) are not reorganization items because the charge likely would have been incurred even if the entity were not in bankruptcy. [852-10-45-9]

We believe that gains or losses associated with the sale of assets (and the related selling costs) should typically not be reorganization items; this is because they are incurred as part of the ongoing operations of the entity.

However, these amounts might be included in reorganization items if the entity can show that the asset is being sold because of a requirement in a Court-approved plan of reorganization, and would not have otherwise been disposed of.

See [Example 4.13.20](#) for an example statement of operations presentation during bankruptcy proceedings.

4.9.20 Interest

Interest expense

Excerpt from ASC 852-10

- > Statement of Operations

45-11 Interest expense shall be reported only to the extent that it will be paid during the proceeding or that it is probable that it will be an allowed priority, secured, or unsecured claim. Interest expense is not a reorganization item.

An entity in bankruptcy recognizes interest expense only to the extent that:

- the interest will be paid during the bankruptcy proceedings; or
- it is probable that the interest will be an allowed claim.

Interest expense is not presented as a reorganization item, because the entity would continue to accrue interest on its outstanding debt even if it were not in bankruptcy. [\[852-10-45-11\]](#)

Question 4.9.20 Is interest expense on debt obligations recognized during bankruptcy?

Interpretive response: Subtopic 852-10 limits the amount of interest expense to the amount that (1) will be paid during the proceeding, or (2) is probable of being an allowed claim. The guidance also states that interest expense is not a reorganization item. [\[852-10-45-11\]](#)

Postpetition interest expense on prepetition debt subject to compromise usually does not accrue during proceedings, and therefore it does not meet the criteria to be recognized. As discussed in [Question 4.4.10](#), the Court typically allows a claim for unsecured or undersecured debt in an amount totaling the principal balance plus accrued interest as of the *petition date* – i.e. postpetition interest is usually not included in the claim allowed by the Court.

However, interest on fully secured claims (i.e. not subject to compromise) may accrue to the extent that the value of the underlying collateral exceeds the principal amount of the claim, or the Court approves the payment of related postpetition interest expense. [\[SOP 90-7.51\]](#)

Interest on DIP financing (see [section 4.4.20](#)) generally is recognized during bankruptcy.

The extent to which reported interest expense differs from stated contractual interest is disclosed in the notes to the financial statements (see [section 4.14](#)). [852-10-45-11, 50-3]

While the above treatment of interest expense is typical during bankruptcy proceedings, an entity evaluates the specific facts and circumstances of its debt arrangements and the proceedings when determining the appropriate accounting treatment.

Interest income

Excerpt from ASC 852-10

- > Statement of Operations

45-12 Interest income earned by an entity in Chapter 11 that it would not have earned but for the proceeding, normally all interest income, shall be reported as a reorganization item.

An entity may continue to earn interest income on its invested capital (e.g. cash and/or investments) while it is in bankruptcy. However, because of the automatic stay provisions of the Code (see [section 2.3.20](#)), the entity's invested capital may increase above normal levels because funds generally are not used to pay prepetition liabilities while the entity is in bankruptcy. This results in an increase in interest income earned by the entity, which likely will be used to pay creditors upon bankruptcy emergence under the plan of reorganization. [SOP 90-7.52]

Interest income earned by the entity on the excess invested capital accumulated as a result of the proceeding is presented as a reorganization item. Interest income applicable to normal invested capital should be reported as an operating item (not a reorganization item) to the extent management is able to reasonably estimate it. [852-10-45-12, SOP 90-7.52]

Example 4.9.10 Accounting for interest income while in bankruptcy

ABC Corp. filed a petition for bankruptcy on July 1, Year 1. Before filing for bankruptcy, ABC earned approximately \$300 a month of interest income – based on its average invested capital balance of \$100,000.

As a result of filing for bankruptcy and the application of the automatic stay provisions of the Code, ABC's average invested capital balance increases to \$150,000. As a result, from July 1 to September 30 ABC earns \$1,350 of interest income, rather than the \$900 it would have earned had it not been in bankruptcy.

In its quarter-to-date September 30, Year 1 statement of operations, ABC presents the \$450 of interest income earned on the incremental \$50,000 average invested capital as a reorganization item. ABC recognizes the remaining \$900 earned on its normal average invested capital as interest income.

4.9.30 Other fees

Excerpt from ASC 852-10

- > Statement of Operations

45-10 It is not appropriate to defer professional fees and similar types of expenditures until the plan is confirmed and then reduce gain from debt discharge to the extent of the previously deferred expenses. It is also not appropriate to accrue professional fees and similar types of expenditures upon the filing of the Chapter 11 petition. Rather, because professional fees and similar types of expenditures directly relating to the Chapter 11 proceeding do not result in assets or liabilities, they shall be expensed as incurred and reported as reorganization items.

An entity in bankruptcy incurs various types of professional fees during the bankruptcy proceedings. Because professional fees directly related to the bankruptcy proceedings do not result in assets and liabilities, they are expensed as incurred and reported as reorganization items. [852-10-45-10]

Question 4.9.30 How is a contingent fee incurred when an entity emerges from bankruptcy accounted for?

Background: A contingent or success fee is payable to certain service providers (such as investment bankers) only if the entity emerges from bankruptcy. Subtopic 852-10 requires professional fees directly related to bankruptcy proceedings to be expensed as incurred and presented as reorganization items. [852-10-45-10]

Interpretive response: We believe contingent fees should be accounted for in accordance with Subtopic 450-20 and recognized when probable and reasonably estimable. However, the fee generally is not recognized as a reorganization item until the entity emerges from bankruptcy because the fee is not considered probable until that time. In this situation, if the entity applies fresh-start reporting (see [chapter 5](#)), it recognizes the expense in the predecessor period.

4.10 Other accounting considerations

4.10.10 Overview

Although there are incremental accounting and reporting requirements once an entity files a petition for bankruptcy (as discussed in [sections 4.3 to 4.9](#)), filing a petition does not generally affect the application of other relevant US GAAP. Many of the requirements discussed in [chapter 3](#) continue to apply while the entity undergoes bankruptcy proceedings. This section discusses how an entity should consider those issues while in bankruptcy and how they interact with the requirements of Subtopic 852-10.

4.10.20 Goodwill and indefinite-lived intangible assets

The requirements of Topic 350 apply to an entity in bankruptcy. Therefore, an entity continues to evaluate whether there are triggering events that require goodwill and indefinite-lived intangible assets to be tested for impairment more frequently than the annual testing (see [section 3.3.10](#)).

Question 4.10.10 How does filing for bankruptcy affect the Topic 350 impairment tests?

Interpretive response: As discussed in [section 3.3.10](#), an entity often has a triggering event before filing for bankruptcy. In addition, at the time of filing, an entity evaluates whether a triggering event has occurred. In making this determination, an entity should document the factors it considered, and whether or not it has concluded that a trigger has occurred.

If an impairment charge is recognized, an entity should document why the timing of the charge is appropriate. If an impairment charge is not recognized, an entity should consider the need for expanded disclosures in the notes to the financial statements (see [section 4.14](#)).

For additional guidance on goodwill impairment testing, see KPMG Handbook, [Impairment of nonfinancial assets](#).

4.10.30 Long-lived assets

Topic 360 applies to an entity operating in bankruptcy. Two aspects in particular under that Topic may apply to a bankrupt entity.

- The bankrupt entity continues to monitor for triggering events indicating possible impairment of its long-lived assets (i.e. property, plant and equipment and finite-lived intangible assets).
- If a bankrupt entity reorganizes its operations to dispose of certain assets or operating segments during bankruptcy, those assets or operating segments may qualify as held-for-sale.

See [section 3.3.20](#) for a discussion of long-lived asset accounting considerations before entering bankruptcy.

Question 4.10.20 How does filing for bankruptcy affect the Topic 360 recoverability test?

Interpretive response: The following two impairment indicators discussed in Topic 360 are often prevalent when an entity files for bankruptcy: [\[360-10-35-21\(c\), 35-21\(f\)\]](#)

- a current expectation that, more likely than not, a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of

its useful life – due to plans to dispose of some operations to raise funds;
and

- there has been a significant adverse change in the business climate that could affect the value of a long-lived asset.

If a triggering event is identified, the entity proceeds to the recoverability test. The estimated, undiscounted future cash flows expected to result from the use and eventual disposition of the asset (asset group) are compared to the carrying amount of the asset (asset group). [360-10-35-17]

Estimates of future cash flows should be based on supportable assumptions, and should be reasonable in relation to other information used by the entity. Examples include budgets, forecasts, projections, accruals related to executive compensation and information communicated to others. The estimated future cash flows should take into account the possible scenarios that might arise following the filing. While an entity could use either a single best estimate or probability-weighted cash flows, the relevance of using probability-weighted cash flows will be heightened when the entity is considering alternative courses of action for an asset group.

The general requirements of the recoverability test are discussed in chapter 7 of KPMG Handbook, [Impairment of nonfinancial assets](#), and Question 7.2.30 discusses estimating cash flows based on using either a single best estimate or probability-weighted approach.

The following discussion highlights two specific ways in which bankruptcy proceedings can affect estimates of future cash flows.

Potential disposal of long-lived assets

Undiscounted future cash flows are estimated based on entity-specific assumptions about the use and eventual disposal of the asset. Therefore, if the entity's plan of reorganization contemplates the disposal of certain long-lived assets, the estimated future cash flows associated with those assets needs to consider that. In developing its estimates, the entity should also consider that assets may be sold by public auction, and the Court may approve the auction price if the amount is believed to be comparable to or better than the amount that would be received in liquidation.

Potential extinguishment of liabilities in the asset group

An asset group is the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities. An asset group often includes operating liabilities associated with the assets, so the undiscounted future cash flows used in the impairment analysis include changes in working capital balances attributed to the asset group. [360-10 Glossary]

An entity should consider how an asset group's expected cash flows are affected if a liability included in the asset group is expected to be extinguished for an amount different from its carrying amount as a prepetition liability if that course of action is under consideration.

Question 4.10.30 Can assets that were held-and-used before bankruptcy meet the held-for-sale criteria after the filing but before the Court approves their sale?

Interpretive response: Generally, no. A long-lived asset (disposal group) to be sold is classified as held-for-sale in the period in which all of the criteria in Topic 360 are met (see [section 3.3.20](#)).

In our experience, presentation of a disposal group as held-for-sale by an entity in bankruptcy is usually delayed until Court approval has been obtained. For a more in-depth discussion, see Question 4.2.60 in KPMG Handbook, [Discontinued operations and held-for-sale disposal groups](#).

4.10.40 Derivatives and hedge accounting

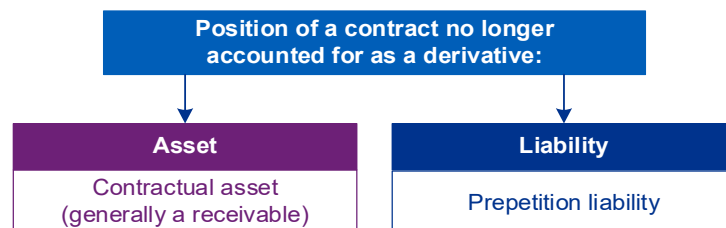
The accounting for a derivative instrument in bankruptcy largely depends on its contractual terms. The effect on a discontinued hedging relationship depends on whether that relationship was designated as a cash flow hedge or a fair value hedge. For a discussion of derivatives and hedge accounting considerations while an entity is experiencing financial difficulties, see [section 3.5](#).

Question 4.10.40 How does filing for bankruptcy affect the accounting for a derivative?

Interpretive response: The effect of filing for bankruptcy on the accounting for a derivative instrument depends primarily on whether the instrument continues to meet the criteria to be accounted for as a derivative.

In the event of bankruptcy, the terms of many derivative contracts either (1) give the counterparty the right to terminate the agreement or (2) automatically cause the agreement to terminate. An entity with derivative contracts should review their terms to understand whether each contract continues to meet the definition of a derivative after the bankruptcy filing.

- If it does, the entity continues to apply Topic 815 to the contract.
- If it does not, the accounting treatment depends on whether the contract is in an asset or a liability position, as shown in the diagram.



Certain derivative instruments are not subject to the automatic stay provisions of the Code, in which case they are not subject to compromise. An entity filing

for bankruptcy may need to consult with legal counsel to determine the effect of a bankruptcy filing on its derivative instruments.

If a derivative that was designated as a hedging instrument no longer meets the definition of a derivative, hedge accounting is discontinued. If a derivative that was designated as a hedging instrument continues to meet the definition of a derivative, an entity should ascertain that the hedging relationship continues to be highly effective before continuing to apply hedge accounting.

For additional guidance on hedge accounting, see KPMG Handbook, [Derivatives and hedging](#).

Question 4.10.50 How are amounts in AOCI from cash flow hedges accounted for upon hedge termination?

Interpretive response: Net gains or losses related to discontinued cash flow hedges are reported in AOCI and reclassified to earnings when the forecasted transaction is reported in earnings, unless it is probable that the forecasted transaction will not occur by the end of the originally specified time period (or within an additional two-month period). For additional guidance on accounting for terminated cash flow hedges, see section 10.5 of KPMG Handbook, [Derivatives and hedging](#). [815-30-40-4]

An entity should specifically consider the facts and circumstances related to its bankruptcy proceedings when determining if it is probable that the forecasted transaction will not occur by the end of the originally specified time period.

For example, we believe that in many cases an entity will conclude that amounts remaining in AOCI related to interest rate swaps on debt subject to compromise should be reclassified because the forecasted interest payments are not probable of occurring as originally specified or within the additional two-month period. This is because during the bankruptcy proceeding, the entity's plan of reorganization will often result in a significant modification to existing debt arrangements, the issuance of common stock to satisfy the existing debt arrangements and/or payments (including interest payments) will be suspended until the entity emerges from bankruptcy. As a result, the entity may not be able to ascertain whether any future interest payments on the debt will be made or if such future payments will be in cash or equity.

Entities need to evaluate the specific facts and circumstances for other types of cash flow hedges.

Question 4.10.60 How are adjustments to the carrying amount of a hedged item in a fair value hedge accounted for when the hedging relationship is terminated?

Interpretive response: As shown in the following table, the answer depends on the nature of the hedged item.

Nature of hedged item	Accounting treatment
Firm commitment	Derecognize the asset or liability recognized in fair value hedge accounting with a corresponding gain or loss if the hedged item no longer meets the definition of a firm commitment. [815-25-40-5]
Asset or liability not subject to compromise	Account for the adjustment to the carrying amount from fair value hedge accounting in the same manner as the underlying asset. [815-20-35-8]
Interest-bearing financial asset or liability not subject to compromise	Amortize the adjustment to earnings beginning no later than when fair value hedge accounting is discontinued, over a period consistent with the amortization of other related discounts or premiums. [815-20-35-9 – 35-9A]
Liability subject to compromise	Derecognize the adjustment when the carrying amount of the liability is adjusted to the expected amount of the allowable claim. [852-10-45-6]

For additional guidance on accounting for terminated fair value hedges, see section 8.5 of KPMG Handbook, [Derivatives and hedging](#).

4.10.50 Share-based payments

The guidance in Topic 718 applies to an entity in bankruptcy. While in bankruptcy an entity may need to evaluate the guidance on modifying or canceling share-based payment awards and on classifying awards as equity or liabilities, as changes to the awards or circumstances that arise from filing a petition for bankruptcy may result in the need to apply that guidance.

Question 4.10.70 Does the probable cancellation of stock under a plan of reorganization affect an assumed forfeiture rate used to determine compensation cost?

Background: Under Topic 718, an entity may elect to estimate the number of forfeitures expected to occur or recognize the effect of forfeitures in compensation cost when they occur. [718-10-35-3]

Interpretive response: No. If an entity elects to estimate its forfeiture rate, we believe the entity should not adjust its forfeiture assumptions as a result of management's belief that some or all of the stock to be issued upon exercise of options or vesting of restricted stock will be canceled under a plan of reorganization.

Management should not reflect anticipated cancellations in the current measurement of compensation expense because the outcome of the bankruptcy proceedings (and therefore the implementation of the plan of reorganization) is unknown. Therefore, the entity should continue to follow Topic 718 to recognize share-based compensation expense while operating in bankruptcy. When estimating forfeitures, the entity should consider all relevant facts and circumstances including, but not limited to, historical forfeiture rates

and the effect of restructuring activities (e.g. a reduction in the workforce) as a result of the bankruptcy process.

If a share-based compensation award is canceled or modified, the entity follows the applicable guidance in Topic 718.

For guidance on accounting for share-based compensation arrangements, see KPMG Handbook, [Share-based payment](#).

4.10.60 Retirement and nonretirement postemployment benefits

An entity in bankruptcy continues to apply the applicable GAAP (e.g. Topic 712, Topic 715 or Topic 420) when accounting for retirement and nonretirement postemployment benefits. If a plan of reorganization includes modifying or terminating retirement benefits, the curtailment, negative plan amendment and settlement provisions of Subtopic 715-30 or Subtopic 715-60 will likely be triggered. For guidance on accounting for pensions and other postemployment benefits, see KPMG Handbook, [Employee benefits](#).

See discussion about possible accounting consequences related to retirement and nonretirement postemployment benefits while an entity is experiencing financial difficulties in [section 3.7](#).

Question 4.10.75 How are pre-petition employee termination benefits accounted for in bankruptcy?

Interpretive response: Employee termination benefits generally continue to be accounted for at the amount required by the applicable GAAP (e.g. Topic 712, Topic 715 or Topic 420) until settled or acted on by the Court. If the Court approves these benefits as an allowed claim at an amount that is less than the previously recognized liability, the adjustment to the liability is classified as a reorganization item (see [section 4.9.10](#)).

For further discussion about the accounting for termination benefits, see chapter 4 of KPMG Handbook, [Employee benefits](#).

Classifying these liabilities as subject to compromise before the Court acts on them depends on the facts and circumstances, which should be evaluated consistent with the discussion in [Question 4.3.10](#). The classification evaluation could change as the bankruptcy proceedings evolve and the entity obtains new or better information.

Question 4.10.80 When is a modification to, or a termination of, pension and postretirement benefits recognized?

Interpretive response: If the plan of reorganization contemplates a modification to existing pension or postretirement benefits, the timing of the financial statement effect of the modification depends on whether the modification is effective during bankruptcy, or not until after emergence.

Freezing a pension plan could result in a negative plan amendment or a curtailment. If the Court approves the action during bankruptcy, the entity should evaluate the guidance in Topic 715 to determine the appropriate accounting at that time – i.e. while the entity is still in bankruptcy. [715-30-35-74 – 35-96, 55-54 – 55-55]

Alternatively, an entity's plan of reorganization may include modification or termination of a pension or postretirement benefit plan only upon emergence from bankruptcy. If this is the case, we believe the modification or termination should not be recognized until the modification or termination is effective; this will usually be when the entity emerges from bankruptcy. For further discussion about the accounting for modification or termination of a pension or postretirement benefit plan, see KPMG Handbook, [Employee benefits](#).

The net gain or loss resulting from the modification or termination is reported as a reorganization item in the predecessor's statement of operations (see [Question 4.9.10](#)). This treatment is consistent with treatment of curtailment losses that are triggered by the consummation of a business combination. [805-20-55-51]

Question 4.10.90 Is the interest cost component of net periodic benefit cost recognized while in bankruptcy?

Interpretive response: Yes. We believe an entity should continue to recognize the interest cost component of net periodic benefit cost for defined benefit pension and postretirement plans while in bankruptcy.

As discussed in [Question 4.9.20](#), Subtopic 852-10 requires an entity to recognize interest expense only up to the amount that will be paid during the proceedings or the amount that is probable of being allowed as a priority, secured or unsecured claim. We do not believe this guidance was intended to apply to the interest cost component of net periodic benefit cost, which represents the increase in the projected or accumulated postretirement benefit obligation due to the passage of time. In addition, Topic 715 explicitly states that the interest cost component of net periodic benefit cost should not be considered interest for purposes of applying Topic 835. [715-30-35-9, 715-60-35-9]

This position is further supported by discussion in the basis for conclusions to ASU 2017-07, Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost. Though not authoritative, the basis for conclusions indicates that the FASB considered requiring the interest cost component of net benefit cost to be capitalized in assets, but ultimately

rejected the idea because it does not represent a borrowing cost related to expenditures for an asset. [ASU 2017-07.BC25]

For further discussion about the accounting for the interest cost component of net periodic benefit cost, see chapter 7 of KPMG Handbook, [Employee benefits](#).

4.10.70 Equity and convertible debt

If an entity has issued a convertible debt instrument, any element of the instrument that is classified as a liability (e.g. host instrument, bifurcated embedded derivative) is subject to the guidance on liabilities subject to compromise (see [section 4.3](#)). This means that the liability will likely be classified as subject to compromise, and should be remeasured under Subtopic 852-10 (see [Question 4.3.50](#)).

Similarly, an entity may have an equity instrument, or portions of an instrument, classified as a liability (e.g. mandatorily redeemable preferred stock). Any prepetition liabilities of this nature are subject to the guidance on liabilities subject to compromise (see [section 4.3](#)).

The terms of these instruments can be complex and should be carefully evaluated to determine to what extent they are affected by the bankruptcy proceedings.

Question 4.10.100 Does an entity in bankruptcy continue to recognize cumulative dividends on preferred stock?

Interpretive response: Yes. We believe that an entity in bankruptcy should continue to recognize dividends on cumulative preferred stock under applicable US GAAP or SEC requirements, unless:

- the terms and conditions of the instrument explicitly provide for discontinuing the payment of preferred stock dividends upon entering bankruptcy; or
- the entity expects the Court to deny the claim for future dividends.

Section 502 of the Code explicitly states that it will not allow a claim for 'unmatured interest' if the claim is objected to by the entity in bankruptcy (or another party). However, we do not believe it is appropriate to analogize this provision in the Code to preferred stock dividends. Such an analogy to an accounting treatment that is based on specific law would not be appropriate when that specific law does not explicitly address the instrument being accounted for.

4.10.80 Foreign currency denominated liabilities

Question 4.10.110 At what amount is a foreign currency denominated prepetition liability recognized during bankruptcy?

Interpretive response: If the liability effectively converts to a US dollar denominated claim during bankruptcy proceedings, we believe an entity should fix the carrying amount of the liability in US dollars using the applicable foreign currency translation rate as of the petition date. Any difference between the final settlement amount of the liability and its carrying amount is a reorganization item upon settlement.

If the liability does not effectively convert to a US dollar denominated obligation, the entity continues to remeasure the liability at the current exchange rate each reporting date in the usual way. [830-20-35-2]

Whether a liability denominated in a foreign currency effectively converts to a US dollar denominated claim is a matter of law. Consultation with legal counsel may be necessary.

4.10.90 Cash and cash equivalents

Question 4.10.120 How are cash and cash equivalents classified during bankruptcy?

Background: Topic 210 provides guidance on classifying assets as current or noncurrent. Among other things, it requires that current assets exclude cash and claims to cash that are restricted as to withdrawal or use for other than current operations. [210-10-45-4(a)]

Interpretive response: In our experience, an entity operating while in bankruptcy generally does not show cash and cash equivalents related to normal business operations as restricted, even though the Court is required to approve expenditures. However, the authority of the Court on the operations of the business and the implications to liquidity and uses of cash should be disclosed (see [section 4.14](#)).

If restrictions on cash are triggered as a result of the bankruptcy petition, or actions are taken that are not considered to be 'in the normal course of operations', we believe an entity should classify cash as restricted; this is because of the restrictions placed on such assets through the bankruptcy proceedings. The entity should also disclose information about the nature of the restriction. [230-10-50-7]

An example of this is an external financing obligation that is fully secured by a fixed asset maintained by the entity. If the entity sells the related fixed asset and the proceeds are not immediately applied to the outstanding debt that was

collateralized by the fixed asset, the entity should classify the cash proceeds as restricted on the balance sheet with appropriate note disclosure.

4.10.100 Income taxes

When an entity is in bankruptcy, Topic 740 continues to apply. In particular, an entity in bankruptcy should carefully evaluate the realizability of its deferred tax assets. For guidance on accounting for income taxes, see KPMG Handbook, [Accounting for income taxes](#).

Question 4.10.130 How are liabilities for uncertain tax positions accounted for during bankruptcy?

Background: The Code provides for certain tax claims to have a priority status within the unsecured claims classification that is higher than that of several other categories (see [section 2.3.20](#)).

Creditors can assert a priority and state the amount and basis therefor, which is then considered by the Court during the reorganization process. Each claim in each priority category must be paid in full before any claim in the next category receives any distribution. For a plan of reorganization to be confirmed, all priority claims must be satisfied in full. The Code establishes the order of priorities of the categories of claims (see [section 2.3.20](#)).

Interpretive response: The accounting for uncertain tax positions while an entity is in bankruptcy depends on whether the underlying obligation meets the definition of a claim. Because uncertain tax positions may not result in cash payments to the taxing authority even if detected (e.g. if the entity had a net operating loss carryforward that would be used to satisfy the obligation), they may not meet the definition of a claim at the petition filing date. However, an obligation related to a tax position taken before the filing date could meet the definition of a claim under the Code, if it represents a right to payment by the taxing authorities as of the filing date.

If an uncertain tax position meets the definition of a claim, it should be evaluated to determine if it is a liability subject to compromise (see [Question 4.3.10](#)). Uncertain tax positions that have a priority status generally are not subject to compromise. Regardless of the classification of the liability, the entity is still required to show all of the required disclosures of Topic 740 in its financial statements. [\[852-10-50-1\]](#)

Accrued interest and penalties for actual pecuniary losses at the petition date related to existing income tax uncertainties meeting the definition of a claim are treated the same as the underlying tax claim, which may be a secured claim, a priority claim or an unsecured claim.

Entities should consult their tax advisors and legal counsel to consider the treatment of income tax uncertainties during the bankruptcy reorganization process.

Question 4.10.140 How are deferred tax liabilities classified during bankruptcy?

Interpretive response: We believe deferred tax liabilities do not meet the definition of a claim under the Code. Instead, they are liabilities recognized for the future tax consequences of temporary differences. Therefore, they are not classified as liabilities subject to compromise.

4.11 Financial statement presentation

4.11.10 Segment reporting

Question 4.11.10 Does filing for bankruptcy cause an entity to immediately reassess its operating and reporting segments?

Background: A key concept in Topic 280 is the 'management approach', which is how management assesses performance and allocates resources in its business. In applying Topic 280, one of the criteria used to determine whether a component is an operating segment is the requirement that operating results of the component are regularly reviewed by the entity's chief operating decision maker (CODM). [280-10-50-1(b)]

During bankruptcy proceedings, an entity may change the manner in which it assesses performance and makes resource allocation decisions. Quite often the CODM will review financial information at levels different from those reviewed before filing the bankruptcy petition. Specifically, an entity may compile data and analyze operations at a lower level of detail as decisions about employee terminations, lease assumption or rejection and other actions are considered.

Interpretive response: We believe the filing of a bankruptcy petition by itself does not result in an immediate reassessment of the entity's operating and reportable segments.

The threshold issue in these circumstances is whether actions during bankruptcy proceedings are temporary, or whether they will result in a fundamental change to the entity's operations or management's approach to managing the business.

We believe a temporary review of the financial information of a component for purposes of developing a plan of reorganization generally does not constitute a 'regular' review of that financial information. [280-10-50-1 – 50-4]

However, such changes are not always temporary. Instead, an entity in bankruptcy could make changes to its internal reporting structure such that the segment measures used by the CODM to assess performance and make resource allocation decisions are different from those previously used. For example, such changes may result from decisions to:

- revise the basis or types of amounts allocated from non-operating segment activities (e.g. corporate activities) to operating segments; or
- revise the internal reporting (segment) accounting policies.

In addition, an entity in bankruptcy may restructure its operations such that the identity of the CODM needs to be reassessed. A change in CODM can also be an indicator of a change in operating and reporting segments.

If, after considering these changes, the entity determines that there has been a change in the way in which the CODM assesses performance and allocates resources, the entity should report its segment information using the new segment measure retrospectively for all periods presented, beginning in the period the change occurred.

An entity should also reexamine the aggregation criteria in Topic 280 to assess whether aggregation continues to be appropriate for currently aggregated operating segments. Topic 280 allows aggregation of operating segments if the segments have similar economic characteristics, and if the segments are similar in the following areas: [280-10-50-11]

- the nature of the products and services;
- the nature of the production processes;
- the type or class of customer for the products and services;
- the methods used to distribute the products or provide the services; and
- if applicable, the nature of the regulatory environment.

For additional guidance, see KPMG Handbook, [Segment reporting](#).

4.11.20 Consolidation

Because the provisions of Subtopic 852-10 apply only to a legal entity that has filed a petition for bankruptcy, it is important to understand which legal entities in a consolidated group are included in a bankruptcy petition filing. [852-10-15-2]

The following chart summarizes consolidation scenarios when either the parent or the subsidiary (or both) files a petition for bankruptcy. The guidance that follows in this section elaborates on some of these common scenarios.

Who is a party to the bankruptcy petition?	Which entity reflects Subtopic 852-10 in its stand-alone financial statements?		Should parent continue to consolidate subsidiary?
	Parent	Subsidiary	
Parent only	✓	✗	Yes
Consolidated subsidiary only	✗	✓	No
Parent and consolidated subsidiary	✓	✓	It depends

Only parent files for bankruptcy

Question 4.11.20 Does a parent that files for bankruptcy continue to consolidate a subsidiary that has not?

Interpretive response: Generally, yes. The parent generally retains control over the subsidiary even if it has filed a petition for bankruptcy protection and is itself controlled by the Court. This is because the subsidiary has not filed for bankruptcy and therefore is not controlled by the Court.

Question 4.11.30 Does Subtopic 852-10 apply to a subsidiary's stand-alone financial statements if the subsidiary is not included in the parent's bankruptcy petition?

Interpretive response: No. If the subsidiary is not part of the parent's bankruptcy petition, it is not part of the bankruptcy proceedings and therefore is not in the scope of Subtopic 852-10. Therefore, stand-alone financial statements of the subsidiary do not reflect the provisions of that Subtopic.

However, we believe the subsidiary's financial statements should disclose that the parent is in bankruptcy (see [section 4.14](#)). The recovery of amounts receivable from the parent, if any, should be carefully evaluated under these circumstances.

Only consolidated subsidiary files for bankruptcy

Question 4.11.40 Does a parent continue to consolidate a majority-owned subsidiary that is a voting interest entity after the subsidiary files for bankruptcy?

Background: There are two primary models for determining whether a reporting entity (parent) should consolidate another legal entity (subsidiary). Both accounting models require the reporting entity to identify whether it has a controlling financial interest in a legal entity. The first, addressed in this question, is a voting interest entity model. The second is a variable interest entity (VIE) model (see [Question 4.11.50](#)).

Under the voting interest entity model, a parent generally meets the consolidation criteria if it owns a majority of the voting shares of a subsidiary. [\[810-10-25-1\]](#)

Interpretive response: Generally, no. Topic 810 specifically prohibits consolidation of a majority-owned subsidiary if control does not rest with the majority owner due to, among other things, legal reorganization or bankruptcy of the subsidiary. Topic 810 also indicates that a subsidiary should be deconsolidated if, among other things, the subsidiary becomes subject to the control of a government, Court, administrator or regulator. [\[810-10-15-10, 55-4A\]](#)

Operating while in bankruptcy usually indicates that control does not rest with the majority owner because the Court must approve all significant actions. As a result, deconsolidation of the subsidiary is appropriate in most cases.

Concluding that continued consolidation of a subsidiary in bankruptcy is appropriate requires a fairly unique set of facts and is appropriate only in infrequent and uncommon circumstances. A 2003 SEC staff speech highlighted that while the staff believes that bankruptcy indicates that control does not rest with the majority owner, there are circumstances in which the continued consolidation of a subsidiary in bankruptcy is more meaningful. The staff member described a specific example in which the staff did not object to the parent's conclusion to continue to consolidate its subsidiary during bankruptcy. [\[2003 AICPA Conf\]](#)

In that fact pattern, the parent was the majority common shareholder, a priority debt holder and the subsidiary's single largest creditor. Because of its creditor position, the parent was able to negotiate a prepackaged bankruptcy with the subsidiary's other creditors (see [section 2.3.50](#)). Under the terms of the prepackaged bankruptcy, the parent expected to maintain majority voting control after the bankruptcy and for the bankruptcy to be completed in less than one year. [\[2003 AICPA Conf\]](#)

A conclusion to continue to consolidate and its basis should be adequately disclosed, and the entity should reassess its facts and circumstances to confirm the appropriateness of that conclusion at each reporting date (see [section 4.14](#)).

Question 4.11.50 Is filing for bankruptcy a reconsideration event when assessing whether an entity is a VIE?

Background: There are two primary models for determining whether a reporting entity (parent) should consolidate another legal entity (subsidiary). Both accounting models require the reporting entity to identify whether it has a controlling financial interest in a legal entity. The first is a voting interest entity model (see [Question 4.11.40](#)).

The second, addressed in this question, is a variable interest entity (VIE) model. Under this model, a parent generally meets the consolidation criteria if it has the power to direct the activities that most significantly affect the other entity's economic performance, and the obligation to absorb losses of, or the right to receive benefits from, the VIE that could potentially be significant to the VIE. [\[810-10-05-8 – 05-8A\]](#)

Interpretive response: We believe an entity (parent) should reassess an investee entity's VIE status under Topic 810 if the investee files for bankruptcy; this is because investors typically lose the power to direct the activities that most significantly affect the entity's economic performance. Topic 810 requires reassessment of whether a legal entity is a VIE if, among other things, changes in facts and circumstances cause the holders of the equity investment at risk to lose the power to direct the activities of the entity that most significantly affect its economic performance. [\[810-10-35-4\]](#)

An entity that has filed for bankruptcy may be a VIE because the equity investment at risk is not sufficient or the equity investors may no longer have power to direct the activities that most significantly affect the entity's economic performance (because the Court may control the entity). It is likely that a previously consolidated entity will be required to be deconsolidated after the bankruptcy filing because the parent lacks the power to direct the activities that most significantly affect the entity's economic performance.

For additional guidance on the consolidation, see KPMG Handbook, [Consolidation](#).

Question 4.11.60 Is a parent's loss of control due to a subsidiary's bankruptcy filing after year-end a recognized subsequent event?

Interpretive response: No. As discussed in [Question 3.13.10](#), we believe that a bankruptcy petition filing after year-end is a nonrecognized subsequent event. A parent company deconsolidates a subsidiary as of the date it ceases to have a controlling financial interest. As a result, the parent continues to consolidate the subsidiary as of year-end. [\[810-10-40-4\]](#)

The parent should include appropriate disclosure of the subsequent event in the year-end financial statements (see [section 4.14](#)).

Question 4.11.70 How does a parent calculate the gain or loss resulting from deconsolidating a subsidiary?

Background: As discussed in [Question 4.11.40](#), Topic 810 indicates that a subsidiary should be deconsolidated if, among other things, the subsidiary becomes subject to the control of a government, Court, administrator or regulator. [[810-10-15-10](#), [55-4A](#)]

Interpretive response: To calculate a gain or loss on deconsolidation, the parent: [[810-10-40-4A](#), [40-5](#)]

- derecognizes the assets, liabilities and equity components related to the subsidiary; this includes any noncontrolling interest and amounts previously recognized in AOCI (including any cumulative translation adjustments);
- recognizes any liabilities assumed or receivables due from the subsidiary; and
- recognizes a gain or loss in net income (assuming the deconsolidated subsidiary is a business as defined in Topic 805).

Applying this guidance when a subsidiary with negative equity petitions for bankruptcy often results in an overall gain. However, the parent should also consider whether there are any additional accounting consequences resulting from deconsolidation of the subsidiary that may affect the gain or loss recognized on deconsolidation.

The following are examples.

- **Guarantee liabilities.** Topic 460 does not apply to guarantees issued between a parent and its subsidiary. However, if the parent previously issued a guarantee on behalf of the subsidiary, it recognizes the guarantee liability when the subsidiary is deconsolidated (see [Question 4.11.90](#)). [[460-10-25-1\(g\)](#)]
- **Joint and several liabilities.** If the parent is jointly liable for obligations of the now-deconsolidated subsidiary, it recognizes a liability if the total amount of the obligation is fixed. The liability is measured as the sum of: [[405-40-15-1](#), [30-1](#)]
 - the amount the parent is directly responsible for under the joint and several liability arrangement; and
 - the amount the parent expects to pay on behalf of the deconsolidated subsidiary.
- **Other liabilities.** If the parent is contractually responsible for certain of the deconsolidated subsidiary's liabilities (e.g. because the Court may hold it liable) without having issued a guarantee in the scope of Topic 460, it determines whether a liability should be recognized (see [Question 4.11.100](#)).
- **Intercompany receivables and payables.** If the parent entity previously recognized intercompany receivables from or payables to the subsidiary that were eliminated in consolidation, the receivables or payables are recognized in the parent's financial statements on deconsolidation, and the receivables are assessed for recoverability (see [Question 4.11.140](#)).

For additional guidance on deconsolidation, see chapter 7 of the KPMG Handbook, [Consolidation](#). For guidance on deconsolidating foreign entities and recognizing the cumulative translation adjustment, see section 4 of KPMG Handbook, [Foreign currency](#).

Question 4.11.80 Is an investment in a deconsolidated subsidiary accounted for under the equity method?

Background: As discussed in [Question 4.11.40](#), when a subsidiary files a petition for bankruptcy, control of the subsidiary is usually with the Court. If the parent no longer has a controlling financial interest, deconsolidation is appropriate.

Interpretive response: We believe that an entity generally should not account for a deconsolidated subsidiary using the equity method. Topic 323 provides guidance on when and how to apply the equity method of accounting. The same limitations under which a majority-owned subsidiary should not be consolidated apply as limitations on the use of the equity method, including when the investee is in legal reorganization or bankruptcy. [\[323-10-35-2\]](#)

When an entity deconsolidates a subsidiary and its remaining investment is not accounted for under the equity method, its investment in the entity is generally accounted for in one of two ways: [\[323-10-05-4, 321-10-35-1 – 35-2\]](#)

- at fair value, with unrealized holding gains and losses included in earnings; or
- at cost minus impairment, adjusted to fair value if the entity identifies observable price changes in orderly transactions for the same or a similar investment in the same subsidiary.

See KPMG Handbook, [Investments](#), for more information about accounting for equity investments under Topic 321.

Question 4.11.90 How does a parent account for a guarantee issued on behalf a deconsolidated subsidiary?

Background: As discussed in [Question 4.11.40](#), if a subsidiary files for bankruptcy but its parent does not, the parent is generally required to deconsolidate the subsidiary because it has lost control of the subsidiary to the Court. Before losing control of the subsidiary, the parent issued a guarantee (that is in the scope of Subtopic 460-10) on behalf of the subsidiary that requires the guarantor to make payments to the guaranteed party should the subsidiary fail to perform under an obligating agreement.

A liability for a guarantee is not recognized if the guarantee is issued by a parent to its consolidated subsidiary. However, once a parent deconsolidates a subsidiary, the guarantee becomes subject to the recognition provisions of Subtopic 460-10. [\[460-10-25-1\(g\)\]](#)

Interpretive response: Assuming the guarantee does not qualify for another scope exception in Subtopic 460-10, we believe the parent should recognize the

guarantee when it deconsolidates the subsidiary; in that case, the parent measures the guarantee as if it were newly issued on the date of deconsolidation. Our view is based on an SEC staff speech that addressed recognizing a pre-existing guarantee of a subsidiary's performance when the parent spins off the subsidiary. [\[2007 AICPA Conf\]](#)

A guarantee is initially measured at the higher of: [\[450-20-25-2, 460-10-30-3\]](#)

- its fair value; and
- the amount that would be recognized under the measurement guidance of Subtopic 450-20 (loss contingencies), if a loss is both probable and reasonable estimable.

A liability recognized for the guarantee reduces the gain (or increases the loss) on deconsolidation (see [Question 4.11.70](#)).

Question 4.11.100 How does a parent account for obligations of a deconsolidated subsidiary for which it is liable?

Background: A parent deconsolidates a subsidiary when the subsidiary files for bankruptcy because it has lost control of the subsidiary. However, this question addresses the situation where the parent is still contractually responsible for certain of the subsidiary's liabilities.

Interpretive response: If the parent is contractually responsible for the subsidiary's liabilities (e.g. because the Court may hold it liable), but it has not issued a guarantee in the scope of Topic 460, it determines whether a loss should be recognized for claims against it by the former subsidiary's creditors under Subtopic 450-20 (loss contingencies). Any loss reduces the gain (or increases the loss) on deconsolidation (see [Question 4.11.70](#)).

If a loss is not both probable and reasonably estimable, or if an exposure exists beyond the amount accrued, the contingency is disclosed if a loss (or an additional loss) is at least reasonably possible (see [section 4.14](#)). [\[450-20-50-3\]](#)

Question 4.11.110 When does a parent begin to consolidate a bankrupt entity it acquires?

Interpretive response: The parent consolidates the newly acquired bankrupt subsidiary once it has control of the subsidiary. As discussed in [Question 4.11.40](#), the parent generally does not obtain control earlier than the date the acquired subsidiary emerges from bankruptcy if it is under control of the Court while it is bankruptcy. The parent should evaluate consolidation under the voting interest entity or variable interest entity model, as appropriate. [\[810-10-15\]](#)

For additional guidance on consolidation, see KPMG Handbook, [Consolidation](#).

Parent and/or consolidated subsidiary file for bankruptcy

Excerpt from ASC 852-10

- > Condensed Combined Financial Statements

45-14 Consolidated financial statements that include one or more entities in reorganization proceedings and one or more entities not in reorganization proceedings shall include condensed combined financial statements of the entities in reorganization proceedings. The combined financial statements shall be prepared on the same basis as the consolidated financial statements.

45-15 In addition to making the required paragraph 852-10-50-4 disclosures, the propriety of the carrying amounts of intra-entity receivables from entities in Chapter 11 shall be evaluated.

Question 4.11.120 Does a parent continue to consolidate a subsidiary after both have filed for bankruptcy?

Interpretive response: It depends. As discussed in [Questions 4.11.40](#) and [4.11.50](#), the parent should only continue to consolidate if it maintains control over the subsidiary. When an entity files for bankruptcy, control usually rests with the Court and not with the parent. When this is the case, deconsolidation is appropriate.

In some cases, a consolidated entity files a single petition with the Court that includes both the parent and the subsidiary. When there is a single petition in a single jurisdiction, the Court generally views the consolidated entity as a single group and the parent is generally able to demonstrate that it continues to maintain control of a majority-owned subsidiary that is operating under the same petition filing. In these situations, continued consolidation is appropriate.

However, if the parent and subsidiary execute separate petition filings or they file petitions in separate jurisdictions (e.g. parent company files in the United States and the subsidiary files in a foreign jurisdiction), then the parent likely has lost control over the subsidiary (see [Question 4.11.40](#)). If control is lost, the parent deconsolidates the subsidiary at the date that control is lost, which is typically the date the subsidiary filed its bankruptcy petition. Due to the specific legal considerations that may be involved in these situations, consultation with legal counsel is likely necessary.

Question 4.11.130 Is incremental reporting required if consolidated financial statements include both entities that are in bankruptcy and entities that are not?

Interpretive response: Yes. When consolidated financial statements include both entities that are in bankruptcy and entities that are not, the parent is

required to present condensed combined financial statements of the entities in bankruptcy. The condensed combined financial statements should also disclose details of the intercompany receivables and payables of entities in bankruptcy (see [section 4.14](#)). [852-10-45-14, 50-4]

[Question 4.11.140](#) discusses measuring intercompany receivables and payables when an entity in the group is in bankruptcy.

Question 4.11.140 How are intercompany balances accounted for when a party to the balances is in bankruptcy?

Background: Related entities often have intercompany amounts payable to and receivable from each other. The measurement of those balances can be affected if one or more of the related entities is in bankruptcy.

Interpretive response: We believe the treatment of intercompany payables and receivables when a party to the balance is in bankruptcy depends on whether the subsidiary is deconsolidated or continues to be consolidated.

Subsidiary is deconsolidated

As discussed in [Question 4.11.40](#), if a subsidiary files for bankruptcy, we generally expect the parent to deconsolidate the subsidiary due to loss of control. In this situation, the subsidiary accounts for its intercompany payables to its former parent or sister entities in the same manner as all prepetition liabilities. The obligation is presented as a prepetition liability, and it is measured at the amount of the claim expected to be allowed by the Court.

For the financial statements of the parent (that now exclude the subsidiary in bankruptcy) or the stand-alone financial statements of the subsidiary, each entity should assess the recoverability of receivables from the other entity under Topic 310 (or Topic 326 if adopted). This includes the effect on that recoverability as a result of the entity's bankruptcy proceedings. Each entity should adjust the carrying amount of the receivables as appropriate.

For guidance on assessing the recoverability of trade receivables under Topic 326, see chapter 18 of KPMG Handbook, [Credit impairment](#).

Subsidiary remains consolidated

If the parent does not lose control of the subsidiary and continues to consolidate, it continues to eliminate intercompany receivables and payables. Further, as discussed in [Question 4.11.130](#), the parent is required to present condensed combined financial statements of the entities in bankruptcy, including its subsidiaries. The condensed combined financial statements should disclose details of the intercompany receivables and payables of entities in bankruptcy. Additionally, the propriety of the carrying amounts of the intercompany balances should be evaluated. [852-10-45-14 – 45-15, 50-4]

4.11.30 Discontinued operations

Subtopic 205-20 requires a component of an entity to be reported in discontinued operations if the disposal represents a 'strategic shift' that has or will have a major effect on the entity's operations and financial results. A disposal occurs in this context when a component is either disposed of or qualifies to be classified as held-for-sale. [205-20-45-1A – 45-1B]

For additional guidance on accounting for discontinued operations while an entity is experiencing financial difficulties, see [section 3.11.10](#).

Question 4.11.150 How are liabilities subject to compromise presented when they are part of a discontinued operation?

Interpretive response: If the buyer agrees to assume the liabilities, we believe they should be classified as liabilities held-for-sale, assuming all other criteria for held-for-sale classification are met.

Otherwise, when an entity is in bankruptcy, we believe liabilities subject to compromise should be classified as such, rather than presented in discontinued operations. If a liability subject to compromise that would otherwise be presented with discontinued operations becomes not subject to compromise (see [Question 4.3.20](#)), we believe it is appropriate to reclassify the liability to discontinued operations.

Question 4.11.160 Where does an entity in bankruptcy present a loss from remeasuring an asset held-for-sale that is part of a discontinued operation?

Background: Before the petition filing date, an entity reports a component in discontinued operations and recognizes and measures the long-lived assets of the disposal group as held-for-sale. In accordance with Topic 360, the entity measures the long-lived assets at the lower of their carrying amount or fair value less cost to sell, and presents the resulting loss within discontinued operations in its statement of operations. [205-20-45-3C, 360-10-35-43]

After the petition filing date, the entity revises its estimate of the held-for-sale assets' fair value less costs to sell. If the revision results in an additional loss, that loss is recognized in the entity's statement of operations.

Interpretive response: We believe an entity in bankruptcy should report discontinued operations based on the criteria in Subtopic 205-20, just the same as if it were not in bankruptcy. Therefore, if disposal costs and other amounts related to the discontinued component (including adjustments to the fair value less cost to sell the asset group) would normally be presented in discontinued operations absent the bankruptcy filing, we believe those amounts should continue to be classified as such – even if the entity is operating while in bankruptcy. This is because Subtopic 852-10 explicitly prohibits amounts

required to be presented as discontinued operations from being presented as reorganization items (see [section 4.9.10](#)). [852-10-45-9]

See [Example 4.13.20](#) for an example statement of operations for an entity in bankruptcy, which includes disposal costs and other amounts related to discontinued operations.

4.12 Section 363 sales

As discussed in [section 2.3.60](#), Section 363 of the Code allows an entity to sell substantially all of its assets free and clear of liens and encumbrances. The proceeds of the sale are then paid in priority order to the creditors with a security interest in those assets.

Question 4.12.10 How does an entity in bankruptcy account for a Section 363 sale?

Interpretive response: The answer depends on whether the group of assets meets the definition of a business in Topic 805; see section 2 of KPMG Handbook, [Business combinations](#), for guidance on the definition of a business.

- If it does, the sale is in the scope of Topic 810 (consolidation).
- If it does not, the sale is usually in the scope of Subtopic 610-20 (gains and losses from the derecognition of nonfinancial assets). [610-20-15-4]

In a typical Section 363 sale, the entity sells all (or substantially all) of its assets such that what is being sold meets the definition of a business under Topic 805. When a group of assets that is a business is sold, the entity recognizes a gain or loss for the difference between the carrying amount of the group of assets and the fair value of the consideration received in the sale. [810-10-40-5]

If the sale is in the scope of Subtopic 610-20, the accounting is similar to the accounting for a sale of nonfinancial assets to a customer under Topic 606.

Question 4.12.20 How is a 'break-up fee' accounted for in bankruptcy?

Background: As discussed in [section 2.3.60](#), a Section 363 sale is often initiated by the entity entering into an agreement with a 'stalking horse' entity that agrees to purchase the entity's assets and in turn initiates the competitive bidding process. The agreement with the stalking horse entity usually includes a provision for a break-up fee, which is paid by the bankrupt entity to the stalking horse entity if it is ultimately not the highest bidder in the auction and another entity acquires the assets.

Interpretive response: If an entity in bankruptcy executes a Section 363 sale and incurs a break-up fee, the liability is accounted for like any other postpetition liability (see [section 4.3.10](#)) and presented as a reorganization item in the entity's statement of operations (see [section 4.9.10](#)).

4.13 Example financial statements while in bankruptcy

4.13.10 Overview

Excerpt from ASC 852-10

> Illustrations

• > Example 1: Illustrative Financial Statements and Notes to Financial Statements for an Entity Operating Under Chapter 11

55-2 The following Example illustrates the guidance in paragraphs 852-10-45-1 through 45-13 and 852-10-50-2 through 50-3 relating to financial statement reporting practices during the period that an entity is in reorganization. Illustrative financial statements and accompanying notes follow.

55-3 XYZ Company is a manufacturing concern headquartered in Tennessee, with a fiscal year ending on December 31. On January 10, 19X1, XYZ filed a **petition** for relief under Chapter 11 of the federal bankruptcy laws. The following financial statements (balance sheet and statements of operations and cash flows) are presented as of and for the year ended December 31.

Illustrative Financial Statements and Notes to Financial Statements for an Entity Operating Under Chapter 11

**XYZ Company
 (Debtor in Possession)
 Balance Sheet
 December 31, 19X1**

Assets	(000s)
Current assets	
Cash	\$ 110
Accounts receivable, net	300
Inventory	250
Other current assets	30
Total current assets	690
Property, plant and equipment, net	430
Goodwill	210
Total Assets	\$ 1,330
Liabilities and Shareholders' Deficit	
	(000s)
Liabilities Not Subject to Compromise	
Current Liabilities:	
Short-term borrowings	\$ 25
Accounts payable—trade	200
Other liabilities	50
Total current liabilities	275
Liabilities Subject to Compromise	1,100 ^(a)
Total liabilities	1,375
Shareholders' (deficit)	
Preferred stock	325
Common stock	75
Retained earnings (deficit)	(445)
Total liabilities & Shareholders' (Deficit)	\$ 1,330

(a) Liabilities subject to compromise consist of the following:
 Secured debt, 14%, secured by first mortgage on building \$ 300,000 ^(b)

Priority tax claims	50,000
Senior subordinated secured notes, 15%	275,000
Trade and other miscellaneous claims	225,000
Subordinated debentures, 17%	250,000
	\$ 1,100,000

(b) The secured debt in this case should be considered, due to various factors, subject to compromise.

The accompanying notes are an integral part of the financial statements.

XYZ Company
(Debtor-in-Possession)
Statement of Operations
For the Year Ended December 31, 19X1
 (000s)

	19X1
Revenues:	
Sales	\$ 2,400
Cost and expenses:	
Cost of goods sold	1,800
Selling, operating and administrative	550
Interest (contractual interest \$5)	3
	2,353
Earnings before reorganization items and income tax benefit	47
Reorganization items:	
Loss on disposal of facility	(60)
Professional fees	(50)
Provision for rejected executory contracts	(10)
Interest earned on accumulated cash resulting from Chapter 11 proceeding	1
	(119)
Loss before income tax benefit and discontinued operations	(72)
Income tax benefit	10
Loss before discontinued operations	(62)
Discontinued operations:	
Loss from operations of discontinued procedures segment	(56)
Net loss	\$ (118)
Loss per common share:	
Loss before discontinued operations	\$ (0.62)
Discontinued operations	(0.56)
Net loss	\$ (1.18)

The accompanying notes are an integral part of the financial statements.

XYZ Company
(Debtor-in-Possession)
Statement of Cash Flows
For the Year Ended December 31, 19X1
Increase in Cash and Cash Equivalents
 (000s)

	19X1
Cash flows from operating activities:	
Cash received from customers	\$ 2,200
Cash paid to suppliers and employees	(2,070)
Interest paid	(3)
Net cash provided by operating activities before reorganization items	147
Operating cash flows from reorganization items:	
Interest received on cash accumulated because of the Chapter 11 proceeding	1

Professional fees paid for services rendered in connection with the Chapter 11 proceeding	(50)
Net cash used in reorganization items	(49)
Net cash provided by operating activities	<u>98</u>
Cash flows from investing activities:	
Capital expenditures	(5)
Proceeds from sale of facility due to Chapter 11 proceeding	40
Net cash provided by investing activities	<u>35</u>
Cash flows from financing activities:	
Net borrowings under short-term credit facility (post petition)	25
Repayment of cash overdraft	(45)
Principal payments on prepetition debt authorized by court	(3)
Net cash used in financing activities	<u>(23)</u>
Net increase in cash and cash equivalents	110
Cash and cash equivalents at beginning of year	-
Cash and cash equivalents at end of year	<u><u>\$ 110</u></u>
Reconciliation of net loss to net cash provided by operating activities	
Net loss	\$ (118)
Adjustments to reconcile net loss to net cash provided by operating activities	
Depreciation	20
Loss on disposal of facility	60
Provision for rejected executory contracts	10
Loss on discontinued operations	56
Increase in postpetition payables and other liabilities	250
Increase in accounts receivable	(180)
Net cash provided by operating activities	<u><u>\$ 98</u></u>

The accompanying notes are an integral part of the financial statements.

XYZ Company Notes to Financial Statements December 31, 19X1

Note X—Petition for Relief Under Chapter 11

On January 10, 19X1, XYZ Company (the Debtor) filed petitions for relief under Chapter 11 of the federal bankruptcy laws in the United States Bankruptcy Court for the Western District of Tennessee. Under Chapter 11, certain claims against the Debtor in existence before the filing of the petitions for relief under the federal bankruptcy laws are stayed while the Debtor continues business operations as Debtor-in-possession. These claims are reflected in the December 31, 19X1, balance sheet as liabilities subject to compromise. Additional claims (liabilities subject to compromise) may arise after the filing date resulting from rejection of executory contracts, including leases, and from the determination by the court (or agreed to by parties in interest) of allowed claims for contingencies and other disputed amounts. Claims secured against the Debtor's assets (secured claims) also are stayed, although the holders of such claims have the right to move the court for relief from the stay. Secured claims are secured primarily by liens on the Debtor's property, plant, and equipment.

The Debtor received approval from the Bankruptcy Court to pay or otherwise honor certain of its prepetition obligations, including employee wages and product warranties. The Debtor has determined that there is insufficient collateral to cover the interest portion of scheduled payments on its prepetition debt obligations. Contractual interest on those obligations amounts to \$5,000, which is \$2,000 in excess of reported interest expense; therefore, the debtor has discontinued accruing interest on these obligations. See Note X in Example

2 (paragraph 852-10-55-11) for a discussion of the credit arrangements entered into after the Chapter 11 filings.

The financial statement presentation requirements for an entity in bankruptcy are largely the same as the requirements for those that are not. The most notable difference is that the financial statements of an entity in bankruptcy must clearly distinguish transactions and events that are directly associated with the bankruptcy proceedings from the ongoing, normal operations of the entity. This is the primary objective of Subtopic 852-10.[852-10-45-10]

This section provides a comprehensive example of basic financial statements prepared while an entity is in bankruptcy. This example illustrates the guidance discussed throughout this chapter and highlights additional requirements of an entity's financial statement presentation while in bankruptcy.

4.13.20 Balance sheet presentation

To accomplish the objective of Subtopic 852-10 when presenting a balance sheet, an entity presents liabilities as either subject to compromise or not, as discussed in section 4.3.

Example 4.13.10 Balance sheet under Subtopic 852-10

ABC Corp. is a calendar year-end company that filed a petition for bankruptcy on July 1, Year 1. ABC's December 31, Year 1 balance sheet is as follows.

ABC Corporation	
(Debtor-in-Possession)¹	
Balance Sheet	
December 31, 20X1	
Assets	(000s)
Current assets	
Cash	\$ 4,000
Short-term investments	500
Accounts receivable, net	1,000
Inventory	500
Other current assets	700
Total current assets	6,700
Property, plant and equipment, net	5,000
Intangible assets	1,000
Other assets	2,000
Total Assets	\$ 14,700
Liabilities and Shareholders' Deficit	
Current Liabilities:	
Debtor-in-possession financing ²	\$ 1,000
Accounts payable	1,000

Other accrued liabilities	2,000
Total current liabilities	4,000
Long-term debt	4,000
Other liabilities	1,000
Total liabilities not subject to compromise	9,000
Liabilities subject to compromise ³	9,000
Total liabilities	18,000
Shareholders' (deficit):	
Common stock	500
Additional paid-in capital	3,500
Accumulated deficit	(7,300)
Total shareholders' (deficit)	(3,300)
Total liabilities and shareholders' (deficit)	\$ 14,700

Because it is operating while in bankruptcy, ABC makes the following adjustments to its balance sheet presentation.

1	Identifies itself as 'Debtor-in-Possession' in the title.
2	Classifies DIP financing as a current liability not subject to compromise, based on the terms of the debt agreement.
3	Separately presents liabilities subject to compromise, either before noncurrent liabilities or after (see Question 4.3.40).

4.13.30 Statement of operations presentation

To distinguish transactions and events that are directly associated with the bankruptcy proceedings from the entity's ongoing, normal operations, an entity presents reorganization items as a separate caption in the statement of operations. [852-10-45-9]

Example 4.13.20 Statement of operations under Subtopic 852-10

ABC Corp. is a calendar year-end company that filed a petition for bankruptcy on July 1, Year 1. ABC's December 31, Year 1 statement of operations is as follows.

ABC Corporation	
(Debtor-in-Possession)¹	
Statement of Operations	
For the Year Ended December 31, 20X1	
(000's)	
	20X1
Net sales	\$ 20,000
Cost of goods sold	16,000
Gross margin	4,000
Operating expenses:	
Selling, general and administrative expenses	5,500
Restructuring and impairment charges	1,000
Other expenses	500
Total operating expenses	7,000
Loss before interest, reorganization items, and income taxes	(3,000)
Interest expense (contractual interest, \$500) ²	275
Reorganization items, net ³	500
Loss before income tax benefit and discontinued operations	(3,775)
Income tax benefit	600
Loss before discontinued operations	(3,175)
Discontinued operations:	
Loss from operations of a discontinued component	(500)
Net loss	\$ (3,675)

Because it is operating while in bankruptcy, ABC makes the following adjustments to its statement of operations presentation.

1	Identifies itself as 'Debtor-in-Possession' in the title.
2	As discussed in section 4.9.20 , an entity in bankruptcy recognizes interest expense only up to the amount that will be paid during the proceeding or the amount that is probable of being an allowed claim. The extent to which reported interest expense differs from stated contractual interest is required to be disclosed. This requirement can be met by disclosing the amount parenthetically on the face of the statement of operations. [852-10-50-3]
3	Separately presents reorganization items (see section 4.9.10). Details of reorganization items are presented in the notes to the financial statements (see section 4.14).

4.13.40 Statement of cash flows presentation

Excerpt from ASC 852-10

• > Statement of Cash Flows

45-13 Reorganization items shall be presented separately within the operating, investing, and financing categories of the statement of cash flows. This presentation can be better accomplished by the use of the direct method of presenting the statement. Paragraph 230-10-45-25 lists the operating items that shall be reported separately when the direct method is used. That paragraph encourages further breakdown of those operating items if the entity considers such a breakdown meaningful and feasible. Further identification of cash flows from reorganization items should be provided to the extent feasible. For example, interest received might be segregated between estimated normal recurring interest received and interest received on cash accumulated because of the reorganization. If the indirect method is used, details of operating cash receipts and payments resulting from the reorganization shall be disclosed in a supplementary schedule or in the notes to financial statements. (See paragraph 852-10-50-6A.)

Similar to the statement of operations, reorganization items are presented separately within the operating, investing and financing categories of the statement of cash flows. It is easier to meet this requirement if the statement of cash flows is presented under the direct method. If the indirect method is used, the entity should disclose details of cash receipts and payments directly resulting from bankruptcy proceedings, either in a supplementary schedule or in the notes to the financial statements (see [section 4.14](#)). [852-10-45-13]

For guidance on changing the presentation method for the statement of cash flows, see section 3.3.40 of KPMG Handbook, [Statement of cash flows](#).

Example 4.13.30 Statement of cash flows (prepared under the direct method) under Subtopic 852-10

ABC Corp. is a calendar year-end company that filed a petition for bankruptcy on July 1, Year 1. ABC's December 31, Year 1 statement of cash flows is as follows.

ABC Corporation	
(Debtor-in-Possession)¹	
Statement of Cash Flows	
For the Year Ended December 31, 20X1	
(000's)	
	20X1
Cash flows from operating activities:	
Cash received from customers	\$ 19,000
Cash payments to vendors and employees	(21,500)

Interest paid	(275)
Net cash used by operating activities before reorganization items	(2,775)
Operating cash flows from reorganization items:	
Interest received	50
Professional fees paid for services related to bankruptcy proceedings ²	(150)
Net cash used for reorganization items	(100)
Net cash used by operating activities	(2,875)
Cash flows from investing activities:	
Purchases of property, plant and equipment	(50)
Proceeds from sale of equipment due to bankruptcy proceedings ²	200
Net cash provided by investing activities	150
Cash flows from financing activities:	
Receipt of DIP financing ²	1,000
DIP financing costs ²	(50)
Repayment of prepetition of debt	(500)
Net cash provided by financing activities	450
Net decrease in cash and cash equivalents	(2,275)
Cash and cash equivalents at beginning of year	4,275
Cash and cash equivalents at end of year	2,000
Reconciliation of net loss to net cash used by operating activities	
Net loss	(3,175)
Adjustments to reconcile net loss to net cash used by operating activities	
Depreciation	275
Amortization of intangible assets	75
Loss on sale of equipment due to bankruptcy proceedings	50
Decrease in accounts receivable	225
Increase in accounts payable	(150)
Increase in other accrued liabilities	(175)
Net cash used by operating activities	\$ (2,875)

Because it is operating while in bankruptcy, ABC makes the following adjustments to its statement of cash flows presentation.

1	Identifies itself as 'Debtor-in-Possession' in the title.
2	Clearly differentiates reorganization items within operating, investing and financing activities.

Because ABC uses the direct method to prepare its statement of cash flows, no additional disclosure about cash receipts and payments directly resulting from bankruptcy proceedings is necessary.

4.14 Disclosures

Excerpt from ASC 852-10

- > EPS

45-16 Earnings per share (EPS) shall be reported, if required, in conformity with Topic 260. If it is probable that the plan will require the issuance of common stock or common stock equivalents, thereby diluting current equity interests, that fact shall be disclosed.

General

50-1 This Section provides incremental disclosure guidance for entities with transactions within the scope of this Subtopic. It is incremental to disclosure guidance otherwise applicable to an entity under other generally accepted accounting principles (GAAP).

> Financial Reporting during Reorganization Proceedings

50-2 The notes to financial statements of an entity in Chapter 11 shall disclose both of the following:

- Claims** not subject to reasonable estimation based on the provisions of Subtopic 450-20
- The principal categories of the claims subject to compromise.

50-3 The extent to which reported interest expense differs from stated contractual interest shall be disclosed. It may be appropriate to disclose this parenthetically on the face of the statement of operations.

50-4 Intra-entity receivables and payables of entities in reorganization proceedings shall be disclosed in the condensed combined financial statements referred to in paragraph 852-10-45-14.

50-5 Paragraph 852-10-45-16 identifies a situation in which disclosure of a probable issuance of common stock or common stock equivalents is required.

50-6 Example 1 (see paragraph 852-10-55-2) provides an illustration of financial statements and notes thereto for an entity operating under **Chapter 11**.

50-6A If the indirect method is used to prepare the statement of cash flows, details of operating cash receipts and payments resulting from the reorganization shall be disclosed in a supplementary schedule or in the notes to the financial statements. (See paragraph 852-10-45-13.)

An entity in bankruptcy is still required to follow the disclosure requirements of other relevant US GAAP. The incremental disclosure requirements of Subtopic 852-10 are minimal. Perhaps more importantly, the disclosures required by other relevant US GAAP may need to be elaborated on while an entity is in bankruptcy to provide the users of those financial statements with adequate transparency as to the entity's financial health. [852-10-50-1]

Subtopic 852-10 requires the following disclosures when an entity is in bankruptcy: [852-10-50-2 – 50-5, 45-13, 45-16]

- details of any claims that are probable but cannot be reasonably estimated;
- details about the principal categories of the liabilities subject to compromise caption on the balance sheet;
- extent to which reported interest expense differs from stated contractual interest;
- intra-entity receivables and payables of entities in bankruptcy proceedings (if the entity is required to present condensed combined financial statements);
- details of the operating cash receipts and payments directly resulting from the bankruptcy proceedings (if the entity uses the indirect method to prepare its statement of cash flows); and
- whether it is probable that the plan of reorganization will require the issuance of common stock or equivalents that would dilute current equity interests.

Question 4.14.10 What are additional items that an entity in bankruptcy should consider disclosing?

Interpretive response: Each entity in bankruptcy has its own facts and circumstances requiring different types or amounts of information to be disclosed. While not an exhaustive list, we believe an entity in bankruptcy should consider the following disclosures in the notes to its financial statements – aimed at providing transparency about the bankruptcy proceedings.

- Administrative details:
 - the date of the petition filing;
 - the jurisdiction in which the petition was filed;
 - the entities in the consolidated group that are included in the petition (if applicable).
- Other details:
 - a description of the circumstances and events leading to bankruptcy;
 - a summary of the expected timeline of the proceedings;
 - an update on key bankruptcy related events that have occurred;
 - implications of the Court’s authority over operations of the entity to liquidity and uses of cash.
- Details about significant leases or other executory contracts that were accepted or rejected as part of the proceedings.
- Details about any significant bankruptcy related subsequent events.

An entity in bankruptcy should disclose any other events or circumstances resulting from the bankruptcy proceedings that significantly affect its financial statements, in addition to the disclosure requirements in Topic 275 (risks and uncertainties). Disclosure should also be made for situations when lack of disclosure would render the financial statements misleading.

The following items identify common situations discussed in this chapter that require disclosure.

- If the entity is presenting discontinued operations, it should disclose details of the amounts included in discontinued operations – unless the details are presented on the face of the statement of operations. [205-20-50-1]
- If the entity obtained DIP financing, it should disclose details about the financing, including principal amount and related fees and terms of the financing. [210-10-S99-1]
- If the bankruptcy affected other areas of the financial statements, disclosure may be required under other applicable US GAAP, such as debt covenant violations, impairment of intangible assets and long-lived assets, income taxes, share-based compensation, foreign currency and others. [852-10-50-1]

4.15 SEC registrants

4.15.10 SEC reporting requirements

SEC registrants in bankruptcy are not relieved of their current and periodic SEC reporting obligations. Neither the Code nor the federal securities laws provide an exemption from the Securities Exchange Act of 1934 (the Exchange Act) periodic reporting requirements for registrants that have filed for bankruptcy.

Question 4.15.10 Are SEC registrants operating in bankruptcy relieved from their SEC reporting requirements?

Interpretive response: No. However, the SEC will generally accept reports that differ in form or content from reports required to be filed under the Exchange Act when they are not deemed to be inconsistent with the protection of investors. [SEC SLB No. 2]

A registrant operating in bankruptcy may request a ‘no-action’ position from the Division of Corporation Finance that provides for acceptance of modified Exchange Act reports from registrants subject to the jurisdiction of the Bankruptcy Court. In providing a no-action position, the Division of Corporation Finance determines whether modified reporting is consistent with the protection of investors. [SEC SLB No. 2]

Staff Legal Bulletin No. 2 (SLB) makes clear reference to the need to file a request for a ‘no-action’ position. In a meeting with the SEC Regulations Committee in March 2023, the SEC staff commented that there is no requirement to request a ‘no-action’ position from the staff prior to using the SLB 2 if the registrant can refer to relevant prior no-action positions that have been published to help determine whether modified Exchange Act reporting would be appropriate in the registrant’s individual facts and circumstances. Nevertheless, to reduce the risk that facts and circumstances may be different

from prior no-action positions, registrants may choose to obtain the staff's views.

Question 4.15.20 What information does an SEC registrant in bankruptcy include in its request for a no-action position?

Interpretive response: The request for a no-action position includes the following information regarding disclosure of financial condition and market for the registrant's securities. [SEC SLB No. 2]

- **Whether the registrant complied with its Exchange Act reporting obligations before it filed for bankruptcy.** Because the registrant's efforts to inform the market of its financial condition are important, a registrant submitting a request for a no-action position should have been current in its Exchange Act reports for the 12 months before it filed for bankruptcy.
- **When the registrant filed its Form 8-K announcing its bankruptcy filing, and whether it made any other efforts to advise the market of its financial condition.** There is no specific, objective test concerning the timing of the Form 8-K filing; however, the registrant should state the date the Form 8-K was due and filed. If the registrant filed the Form 8-K after the due date, the reason should be explained. The registrant should also discuss any other efforts it made to inform its security holders and the market of its financial condition.
- **Why the registrant is unable to continue Exchange Act reporting.** The registrant should discuss the following in its request:
 - whether it has ceased its operations or the extent to which it has curtailed operations;
 - why filing periodic reports would present an undue hardship;
 - why it cannot comply with the disclosure requirements; and
 - why it believes granting the request is consistent with the protection of investors.

Management of the registrant should also represent, if true, that:

- the filing of periodic reports would present an undue hardship; and
 - the information contained in the monthly operating reports filed with the Court pursuant to the Code is sufficient for the protection of investors while the registrant is subject to the jurisdiction of the Court.
- **Nature and extent of trading in the registrant's securities.** The registrant should discuss in detail the market for its securities.

The Division of Corporation Finance will not approve a request for a no-action position if the registrant's securities trade on a national securities exchange or the Nasdaq, because it indicates that there is an active market for the registrant's stock. Registrants that do not have securities traded on a national securities exchange or the Nasdaq should quantify the effect of

the bankruptcy filing on the trading in their securities. This information should demonstrate that there is minimal trading in the securities.

The registrant should state the number of market makers for its securities. It also should provide detailed information regarding the number of shares traded and the number of trades per month for each of the three months before it filed for bankruptcy and each month after that filing. General statements in the request that trading has been 'minimal' or 'insignificant' are not sufficient to enable the Division of Corporation Finance to reach a conclusion on the request. An unequivocal statement that there is 'no trading' in the registrant's securities is sufficient.

A registrant should submit its request for no-action position promptly after it has entered bankruptcy. A request is considered to be submitted 'promptly' if it is filed before the date the registrant's first periodic report is due following the registrant's filing for bankruptcy.

Question 4.15.30 What modified reports will the SEC accept if an SEC registrant in bankruptcy has been approved for a no-action position?

Interpretive response: If the registrant has successfully obtained a no-action position from the Division of Corporation Finance, generally the SEC staff will accept the monthly operating reports a registrant must file with the Bankruptcy Court; this is instead of Form 10-K and Form 10-Q filings. The registrant must file each monthly report with the SEC on a Form 8-K within 15 calendar days after the monthly report is due to the Court. [SEC SLB No. 2]

The relief given applies only to filing Form 10-K and Form 10-Q. The registrant must still satisfy all other provisions of the Exchange Act, including filing the current reports required by Form 8-K and satisfying the proxy, issuer tender offer and going-private provisions. [SEC SLB No. 2]

Question 4.15.40 Do SEC registrants operating in bankruptcy need to assess the effectiveness of internal control over financial reporting?

Interpretive response: Generally, yes. A registrant must provide a report of management's assessment of internal control over financial reporting with a statement that the registered public accounting firm that audited the financial statements included in the annual report has issued an attestation report on the registrant's internal control over financial reporting, or that the annual report does not include an attestation report pursuant to the rules of the SEC, [Reg S-K 308]

As discussed in [Question 4.15.10](#), registrants operating in bankruptcy are not relieved of their periodic reporting obligations, unless a no-action position is obtained from the Division of Corporation Finance that provides for acceptance

of modified Exchange Act reports from registrants subject to the jurisdiction of the Bankruptcy Court.

We believe this same concept carries over to the registrant’s requirement to assess the effectiveness of internal control over financial reporting. Neither the Code nor the federal securities laws provide an exemption from Exchange Act periodic reporting for registrants that have filed for bankruptcy. Therefore, the requirement to assess the effectiveness of internal control over financial reporting continues to apply during bankruptcy.

Question 4.15.50 When is an SEC registrant in bankruptcy required to file a Form 8-K?

Background: An SEC registrant is required to file a Form 8-K after the occurrence of any of the following events.

Registrant’s business and operations	Securities trading and markets	Corporate governance and management
Entry into or termination of a material definitive agreement	Notice of delisting or failure to satisfy continued listing rule or standard	Change in control of registrant
Entry into bankruptcy or receivership	Transfer of listing	Departure of directors or certain officers
Mine safety – reporting of shutdowns and patterns of violations	Unregistered sales of equity securities	Election of directors or appointment of certain officers
	Material modifications to rights of security holders	Compensatory arrangements of certain officers
Financial information	Matters related to accountants and financial statements	Amendments to articles of incorporation or bylaws
Completion of acquisition or disposition of assets	Changes in registrant’s certifying accountant	Change in fiscal year
Results of operations and financial condition	Non-reliance on previously issued financial statements or related audit report or completed interim review	Temporary suspension of trading under registrant’s employee benefit plans
Creation of, or triggering events that accelerate or increase, direct financial obligation or obligation under off-balance sheet arrangement		Amendments to registrant’s code of ethics
Costs associated with exit or disposal activities		Waiver of provision of registrant’s code of ethics
Material impairments		Change in shell company status
		Submission of matters to a vote of security holders
		Shareholder director nominations

Interpretive response: As discussed in [Question 4.15.30](#), the relief provided to registrants in bankruptcy for modified reporting applies only to filing Form 10-K and Form 10-Q. Therefore, the registrant must continue to file Form 8-K in accordance with the Exchange Act rules.

While not an exhaustive list, below is an explanation of some of the more common events a registrant in bankruptcy may experience that require reporting on Form 8-K. [\[Form 8-K General\]](#)

- **Entry into bankruptcy or receivership.** Registrants are required to file a Form 8-K with the SEC when they enter into bankruptcy and when an order confirming a plan of reorganization, arrangement or liquidation has been entered by a court or governmental authority that has supervision over substantially all of the assets or business of the registrant (or its parent).
- **Disposition of assets.** Registrants that dispose of a significant amount of assets are required to file a Form 8-K disclosing the date of the transaction; a description of the assets disposed of; the party to whom the assets were sold; and the nature and amount of consideration received.
- **Costs associated with exit or disposal activities.** Registrants are required to file a Form 8-K when they are committed to an exit or disposal plan, or have incurred material charges as a result of disposing of a long-lived asset or terminating employees under a plan of termination described in Topic 420.
- **Material impairments.** Registrants are required to file a Form 8-K when they recognize a material charge for impairment to one or more of their assets.

Management of registrants in bankruptcy should be familiar with the rules governing Form 8-K filings, as many developments throughout the bankruptcy process may qualify as reportable events to be disclosed on Form 8-K.

4.15.20 Disclosures

SEC registrants that have not been approved to provide modified Exchange Act reports (see [Question 4.15.10](#)) are required to continue filing periodic reports on Form 10-K and Form 10-Q. The following table provides some example Form 10-K disclosure requirements that may be of elevated importance when the registrant is in bankruptcy.

Item 1: Business
Background information regarding bankruptcy.
Strategy/program developed to stabilize, improve and strengthen the business and help ensure the entity emerges from reorganization.
Any DIP facility and its planned use.
Recent developments related to bankruptcy and resulting actions.
Impairment charges due to constraints resulting from bankruptcy.
Suspension of trading of registrant's stock.

Item 1A: Risk factors
Risks relating to bankruptcy, such as: <ul style="list-style-type: none"> • Uncertainty resulting from the bankruptcy – e.g. actions and decisions of creditors, obtaining Court approval of the plan, ability to avoid burdensome contracts, ability to continue normal operations. • Adverse effects of bankruptcy on ongoing operations.

Item 1A: Risk factors
<ul style="list-style-type: none"> • Adverse effects of claims made after bankruptcy or claims not discharged in bankruptcy. • Limitations on registrant's ability to use net operating loss carryforwards in the future. • Adverse effects of bankruptcy on the price of registrant's outstanding debt and equity securities. • Limitations on secured creditors' ability to realize value from their collateral. • Potential inability to emerge from bankruptcy.
<p>Capital resources and liquidity considerations in relation to bankruptcy, such as:</p> <ul style="list-style-type: none"> • Liquidity needs and challenges faced to maintain adequate liquidity. • Restrictions imposed by DIP facility that may adversely affect liquidity. • Potential inability to meet debt service requirements. • Potential inability to secure additional financing. • Potential restrictions on operations due to bankruptcy or credit rating downgrades.

Item 5: Market for registrant's common equity, related stockholder matters and issuer purchases of equity securities
Delisting of common stock.
Anticipated inability to pay cash dividends in the foreseeable future due to bankruptcy and cash constraints.

Item 7: MD&A
Brief description of how business is operating while in bankruptcy.
Plans for bankruptcy reorganization, including actions to be taken and challenges to be faced.
Details of reorganization items, such as professional fees, adjustments to prepetition liabilities, and losses that are probable and reasonably estimable.
Deconsolidation of certain entities due to loss of control resulting from bankruptcy.
Details about liabilities subject to compromise, including nature and amount, whether they have been extinguished and contract rejections.
Assets written off or impaired.
Liquidity and capital resources affected by bankruptcy.
Critical accounting policies – financial reporting under bankruptcy.
<p>If registrant emerges from bankruptcy subsequent to reporting period-end but before issuance of its financial statements, include a discussion of:</p> <ul style="list-style-type: none"> • Financial reporting matters and comparability of financial information. • Applicability of fresh-start reporting. • Fresh-start adjustments and their effect on operating results. • Details of exit credit facility upon emergence

4.15.30 Other considerations

Question 4.15.60 Is preferred stock in temporary equity reclassified to stockholders' equity if it likely will be converted to common stock upon bankruptcy emergence?

Interpretive response: No. A bankrupt registrant may recommend to the Court that preferred stock be converted to common stock when the registrant emerges from bankruptcy. However, this expectation is not sufficient to reclassify preferred stock from temporary equity to stockholders' equity. Any actions that are to occur as a result of confirmation of a plan of reorganization are not accounted for until the Court approves the plan.

If the effect of the plan is or will be significant to the financial statements, the registrant should disclose the terms of the plan in the notes to its financial statements and appropriate sections of Form 10-K, if applicable (see [section 4.14](#)).

5. Emerging from Chapter 11 bankruptcy

Detailed contents

Item significantly updated in this edition: #

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Questions

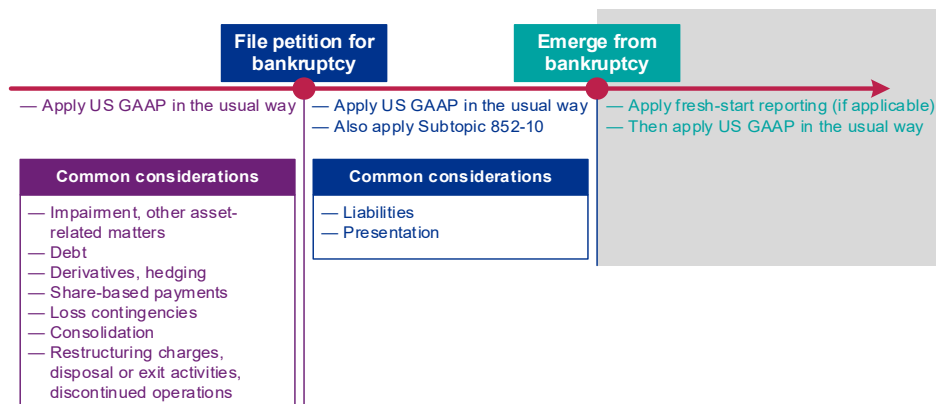
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5.1 How the standard works

An entity emerges from Chapter 11 bankruptcy when the Court has confirmed the plan of reorganization and conditions precedent (if any) are met. Once confirmed by the Court, the plan is binding on the debtor and creditors. Depending on the conditions set forth in the plan documents, an entity may emerge at confirmation or at some milestone thereafter – at which point the entity records the effects of the plan in its financial statements.

If the reporting entity qualifies for fresh-start reporting, the entity’s reorganization value is assigned to its assets, its liabilities and equity. Assigning value to its assets and liabilities is performed using the business combination acquisition method principles in Subtopic 805-20. The post-emergence entity is typically referred to as the emerging or successor entity. From an accounting and financial reporting perspective, the **emerging entity** is considered a new reporting entity separate from the pre-emergence (or predecessor entity).



An entity that does not qualify for fresh-start reporting continues to apply other US GAAP. Liabilities compromised by the confirmed bankruptcy plan are stated at the present value of the amounts to be paid (see [section 5.4](#)).

5.2 Applicability of fresh-start reporting

Excerpt from ASC 852-10

> Financial Reporting When Entities Emerge from Chapter 11 Reorganization

45-17 Entities whose plans have been confirmed by the court and have thereby emerged from Chapter 11 shall apply the reporting principles in paragraphs 852-10-45-19 through 45-29 as of the confirmation date or as of a later date, as discussed in the following paragraph, when all material conditions precedent to the plan's becoming binding are resolved.

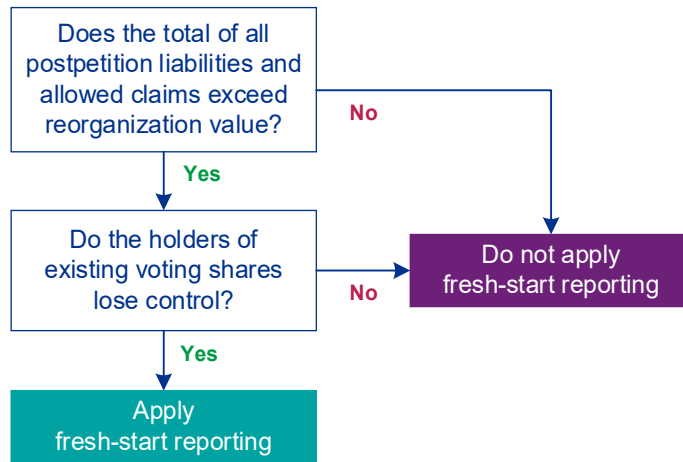
45-18 The effects of a plan should be included in the entity's financial statements as of the date the plan is confirmed. However, inclusion shall be delayed to a date not later than the effective date if there is a material unsatisfied condition precedent to the plan's becoming binding on all the parties in interest or if there is a stay pending appeal. That might occur, for example, if obtaining financing for the plan or for the transfer of material assets to the debtor by a third party is a condition to the plan's becoming effective. Financial statements prepared as of the date after the parties in interest have approved a plan through the voting process, and issued after the plan has been confirmed by the court, shall report the effects of the plan if there are no material unsatisfied conditions.

• > Fresh-Start Reporting

45-19 If the reorganization value of the assets of the emerging entity immediately before the date of confirmation is less than the total of all postpetition liabilities and allowed claims, and if holders of existing voting shares immediately before confirmation receive less than 50 percent of the voting shares of the emerging entity, the entity shall adopt fresh-start reporting upon its emergence from Chapter 11. The loss of control contemplated by the plan must be substantive and not temporary. That is, the new controlling interest must not revert to the shareholders existing immediately before the plan was filed or confirmed.

An entity applies fresh-start reporting under Subtopic 852-10 when it emerges from Chapter 11 if: [\[852-10-45-19\]](#)

- the entity's reorganization value immediately before the date of confirmation is less than the total of all its postpetition liabilities and allowed claims; and
- the holders of existing voting shares immediately before confirmation lose control of the entity and the loss of control is not temporary; for this purpose, losing control means those shareholders receive less than 50% of the emerging entity's voting shares.



If either of these criteria is not met, the emerging entity does not qualify for fresh-start reporting and continues to apply US GAAP (see [section 5.4](#)).

5.2.10 Reorganization value

Excerpt from ASC 852-10

20 Glossary

Reorganization Value

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

The first criterion required to apply fresh-start reporting is that the **reorganization value** of the emerging entity immediately before the date of confirmation is less than the sum of all postpetition liabilities and allowed claims. Reorganization value, which is a US GAAP term and not a term defined in the Code, is the aggregate value of the emerging entity's assets before considering liabilities. [\[852-10 Glossary\]](#)

Question 5.2.10 Is reorganization value the same as fair value?

Interpretive response: No. Fair value is 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. Reorganization value is intended to estimate the amount a willing buyer would pay for an entity's assets immediately after emerging from bankruptcy. [\[820-10 Glossary\]](#)

Reorganization value is usually based on a Court-determined value using assumptions negotiated among the interested parties (see [Question 5.2.20](#)). Differences between fair value and reorganization value include the following.

Category	Fair value	Reorganization value
Underlying assumptions	Market participant assumptions (estimated by the reporting entity) [820-10 Glossary]	Entity-specific assumptions (negotiated among the interested parties) [852-10-05-10]
Price	Exit price: The price received to sell an asset [820-10 Glossary, 820-10-30-2]	Entry price: The amount a willing buyer would pay for the assets [852-10 Glossary]
Unit of valuation	Generally each individual asset (or liability) [820-10 Glossary, 820-10-35-2E]	Emerging entity's assets as a group; excludes liabilities [852-10 Glossary]

Question 5.2.20 Is reorganization value equal to the value in an entity's plan of reorganization?

Interpretive response: Generally, no. The plan of reorganization approved by the Court usually includes a measure of the entity's value on emerging from bankruptcy using a going concern premise. In our experience, the most common measure of an emerging entity's Court-approved value is enterprise value. This value is generally different from, and therefore needs to be reconciled to, reorganization value (see [Question 5.2.30](#)).

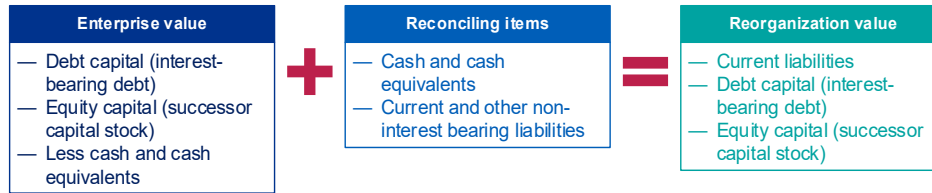
Reorganization value is an asset value concept and is the value of the reconstituted entity before considering liabilities. Enterprise value is generally prepared by finance professionals engaged by the bankrupt entity using assumptions negotiated among the interested parties, to provide an indication of the value of the emerging entity regardless of how it is capitalized (e.g. debt versus equity capitalization). Enterprise value therefore usually differs from reorganization value.

Question 5.2.30 How does an entity reconcile enterprise value to reorganization value?

Background: Under the most commonly used approach, enterprise value is equal to the sum of the values of the entity's post-emergence equity and interest-bearing debt, less cash remaining in the entity after settling prepetition liabilities. Reorganization value is an asset value concept and includes all assets of the emerging entity immediately after the restructuring (see [Question 5.2.20](#)). The Court-approved enterprise value must first be reconciled to reorganization value to determine whether fresh-start reporting applies.

Interpretive response: When enterprise value is calculated as described in the background, an entity generally must add back cash and current and other non-interest-bearing liabilities to arrive at reorganization value. Under this approach,

the total for the right side of the balance sheet (total liabilities and total equity) is used as a proxy to determine the total for the left side of the balance sheet (total assets or reorganization value).



Performing this reconciliation requires identifying and understanding all components of the calculation of an entity’s enterprise value (or other measure of value approved by the Court); this is because enterprise value is not calculated the same way in all instances.

Some items to consider include the following.

- In the calculation of enterprise value, cash is typically deducted and therefore needs to be added back to arrive at reorganization value. However, in some instances, some or all cash may be included in enterprise value. Only the cash that has been excluded from enterprise value is added back, and only to the extent the cash will remain in the emerging entity. Cash that is paid out on emergence to settle prepetition liabilities is not added back.
- Enterprise value typically excludes working capital liabilities, but in some instances they may be included. Working capital liabilities included in enterprise value are not added back (to avoid double-counting).
- Other liabilities excluded from enterprise value (e.g. pension liabilities, asset retirement obligations) are added back to ensure that all liabilities are included.
- A plan of reorganization may require the entity to sell specific assets that will not be part of its continuing operations. If those assets are sold *after* the entity emerges from bankruptcy, usually they will need to be added back to enterprise value to arrive at reorganization value; this is because enterprise value is usually based on the emerging entity’s post-emergence continuing operations (i.e. excluding assets to be disposed of).

Question 5.2.40 How does an entity determine reorganization value if the Court approves a valuation range rather than a point estimate?

Background: In certain proceedings, the Court may approve a range for enterprise value instead of a point estimate. Ranges may be more common in industries that have a higher degree of variability due to market characteristics, such as oil and gas. This may help give the stakeholders perspective on the fluidity in value based on a range of acceptable assumptions at the time the Court approved the range.

Interpretive response: If the Court approves a valuation range in the plan of reorganization, management uses all available information to identify a point estimate to serve as the starting point to determine reorganization value. The SEC staff has requested that registrants disclose how they determined reorganization value, including the methodology and assumptions used (see [section 5.3.30](#)).

Question 5.2.45 Can an entity use a value outside the Court-approved valuation range to determine reorganization value?

Background: An entity’s reorganization value is usually based on a Court-approved value using assumptions negotiated among the interested parties, such as an enterprise value (see [Questions 5.2.10](#) and [5.2.20](#)). This value, whether a point estimate or a range of estimates, is part of the entity’s plan of reorganization and is approved by the Court on the confirmation date. As discussed in [Question 5.2.40](#), an entity uses a point estimate to serve as the starting point to determine reorganization value.

Interpretive response: Generally, no. The terms precedent for an entity to emerge from bankruptcy are specified in the plan of reorganization, which includes the entity’s Court-approved value. Therefore, the fresh-start reporting criteria should be based on a reorganization value derived from the value (or range of values) in the plan of reorganization.

If the criteria are met and fresh-start reporting is applied, that same reorganization value should be used to assign value to the emerging entity’s assets and liabilities (as further discussed in [section 5.3.20](#)).

This interpretive response also applies if time has elapsed between the confirmation date and the date the entity emerges from bankruptcy, and a change in market conditions indicates that the current value is different from the value approved by the Court.

Example 5.2.10 Using enterprise value to determine reorganization value

ABC Corp. is in the oil and gas industry. The Court-approved enterprise value was a range from \$1,290 to \$1,490.

Because of downward fluctuations in oil prices from the date the range of enterprise value was finalized to the date of emerging from bankruptcy, ABC concluded that it should use the low end of the range, \$1,290, as the starting point for determining reorganization value.

The components of ABC’s enterprise value calculation are as follows.

Post-emergence equity	1,000
Post-emergence debt	890

Less: Cash remaining after settling prepetition liabilities	(600)
Enterprise value	1,290

ABC has current liabilities of \$310, and reconciles enterprise value to reorganization value as follows.

Enterprise value	1,290
Add back: Cash remaining after settling prepetition liabilities	600
Add: Current liabilities	310
Reorganization value	2,200

5.2.20 The reorganization value test

This first criterion for fresh-start reporting is that the sum of postpetition liabilities and allowed claims must exceed reorganization value – the reorganization value or solvency test.

Postpetition liabilities include all liabilities incurred after filing for Chapter 11 bankruptcy that remain outstanding immediately before the plan is confirmed by the Court. Allowed claims are all claims allowed by the Court that are not settled before the date of emergence; they are measured at the amounts allowed by the Court (see [section 4.3.20](#)). [852-10-45-5, 45-19]

Example 5.2.20 Performing the reorganization value test

Continuing [Example 5.2.10](#), ABC has the following postpetition liabilities and allowed claims outstanding immediately before the date of confirmation.

Allowed claims	4,800
Postpetition liabilities (current)	310
Postpetition debt (noncurrent)	340
Total postpetition liabilities and allowed claims	5,450

Because the total of ABC's postpetition liabilities and allowed claims immediately before emergence (\$5,450) exceeds ABC's reorganization value (\$2,200), the first criterion for fresh-start reporting is met.

ABC still needs to consider the second criterion before concluding that fresh-start reporting applies (see [section 5.2.30](#)).

Question 5.2.50 Does a parent include its subsidiaries that did not file for bankruptcy protection in its calculation of reorganization value?

Background: Parent is in the process of emerging from Chapter 11 bankruptcy protection. When Parent filed for bankruptcy, its subsidiaries continued normal operations and did not file for bankruptcy.

Interpretive response: Yes. We believe that a parent's non-debtor subsidiaries should be included in the calculation of reorganization value. This is because they are part of the consolidated entity and all of the entity's assets and liabilities should be considered in the reorganization value test. Those assets represent resources that may be available to satisfy the parent's postpetition liabilities and allowed claims (e.g. through the sale of a subsidiary).

We believe that the parent may perform the reorganization value test on either a consolidated or unconsolidated basis. Under either approach, it is important that the test be performed on a like-for-like basis.

Approach 1: Consolidated basis

If the reorganization value test is performed on a consolidated basis, the parent includes its non-debtor subsidiaries' assets in calculating reorganization value. The parent then compares its consolidated reorganization value to its consolidated postpetition liabilities and allowed claims, which includes the liabilities of consolidated subsidiaries.

Approach 2: Unconsolidated basis

Alternatively, if the reorganization value test is performed on an unconsolidated basis, the parent's investments in non-debtor subsidiaries are considered assets available to satisfy the parent's postpetition liabilities and allowed claims.

Under the unconsolidated approach, the sum of (1) the fair value of the parent's investment in each of those subsidiaries and (2) the reorganization value of the parent's other assets is compared to the parent's postpetition liabilities and allowed claims. The parent's allowed claims and postpetition liabilities exclude the non-debtor subsidiaries' liabilities, because they are already considered in valuing the parent's investments in the subsidiaries. In this situation, the fair value of each investment in (1) might include a liquidity adjustment; this is discussed in section G of KPMG Handbook, [Fair value measurement](#).

Example 5.2.30 Treatment of non-debtor subsidiary in the reorganization value test

Parent is emerging from Chapter 11 bankruptcy. One of its wholly owned subsidiaries continued normal operations and did not file for bankruptcy protection.

Scenario 1: Reorganization value test performed on consolidated basis

The following information is relevant for purposes of performing the test immediately before the date of confirmation:

- Enterprise value of Parent is \$2,500, which excludes Subsidiary, non-interest bearing working capital liabilities of \$300 and cash of \$50.
- Enterprise value of Subsidiary is \$200, which excludes non-interest bearing working capital liabilities of \$30 and cash of \$10.
- Total postpetition liabilities and allowed claims of Parent on a stand-alone basis are \$3,400. Subsidiary has total liabilities of \$100.

On a consolidated basis, the reorganization value test is performed as follows.

	Parent (excl. Sub)	Subsidiary	Parent (consolidated)
Enterprise value	2,500	200	2,700
Add: Non-interest bearing working capital liabilities	300	30	330
Add: Cash	50	10	60
Reorganization value	2,850	240	3,090
Less: Total of all postpetition liabilities and allowed claims of the consolidated Parent	3,400	100	3,500
Solvent/(insolvent)			(410)

The reorganization value is less than the total of all postpetition liabilities and allowed claims of the consolidated parent by \$410. Therefore, Parent meets the first criterion for fresh-start reporting. Parent still needs to perform the loss of control test (see [section 5.2.30](#)) before concluding that fresh-start reporting applies.

Scenario 2: Reorganization value test performed on unconsolidated basis

In addition to the information about Parent in Scenario 1, the fair value of Parent's investment in Subsidiary is assumed to be \$140 (reorganization value of \$240 less liabilities of \$100).

On an unconsolidated basis, the reorganization value test is performed as follows, showing that the first criterion for fresh-start reporting is met.

Enterprise value of Parent	2,500
Add: Working capital and other liabilities	300
Add: Cash	50
Add: Investment in Subsidiary	140
Reorganization value	2,990
Postpetition liabilities and allowed claims of Parent	3,400
Solvent/(insolvent)	(410)

5.2.30 Loss of control test

The second criterion necessary to apply fresh-start reporting is that there is a loss of control. This criterion is met if the holders of voting shares immediately before emergence from bankruptcy receive less than 50% of the voting shares of the emerging entity. It is not necessary that a single entity has obtained control, but rather that the entity's voting shareholders before the confirmation lost control of the emerging entity. The loss of control by the pre-emergence shareholders must be substantive and not temporary. [852-10-45-19]

Question 5.2.60 Are potentially dilutive instruments considered in the loss of control test?

Interpretive response: Generally, no. The potential dilutive effects resulting from warrants and options, for example, are disregarded in assessing whether a loss of control occurred upon emergence.

Question 5.2.70 Is the loss of control criterion met if creditors have > 50% of voting shares on emergence and previously controlled the entity through a debt arrangement?

Background: Before emerging from Chapter 11, a group of debt holders had control of an entity through their lending arrangement, which gave them rights to elect a majority of the entity's board of directors. However, those debt holders had no voting shares.

Interpretive response: No. Although the legal form of subordinated debt is not an equity position, the debt holders did have voting control of the entity through their ability to elect a majority of the entity's board of directors. Therefore, we believe the loss of control criterion has not been met. In substance, the debt holders had control before emergence and they continue to have control after emergence. [852-10-45-19]

Question 5.2.80 Is the loss of control criterion met if the majority shareholder maintains majority ownership post-emergence because of its debt position in the predecessor?

Background: Before emerging from Chapter 11, the majority shareholder of an entity was also its largest creditor. When the entity emerged from Chapter 11, that same shareholder obtained a majority of the voting shares in exchange for its debt position in the predecessor entity.

Interpretive response: No. The majority shareholder before emergence did not lose control of the entity; therefore, the loss of control criterion is not met.

Question 5.2.90 Is the loss of control criterion met if the majority shareholder of the predecessor obtains a majority ownership upon emergence through an additional investment?

Interpretive response: No. The fact that the majority shareholder retains its ownership interest in the emerging entity due to its additional investment does result in the loss of control criterion being met. Accordingly, if the majority shareholder retains 50% or more of the emerging entity through an additional investment, the entity would not meet the loss of control criterion.

Question 5.2.100 Is mandatorily redeemable preferred stock considered 'voting shares' if holders are eligible to vote on all matters submitted to the holders of common stock?

Background: Immediately before confirmation, an entity had mandatorily redeemable preferred stock (MRPS) outstanding and each share provided the holder the ability to vote on matters such as the election of the directors equal to a common equivalent number of shares immediately before plan confirmation.

Interpretive response: Yes. We believe the MRPS should be considered voting shares because the MRPS holders have the right to vote on substantive matters, such as the election of directors.

Question 5.2.110 In assessing the loss of control criterion, does an entity assume conversion of non-voting convertible preferred stock issued upon emergence?

Background: As part of an entity's emergence from Chapter 11, the plan of reorganization provides for the issuance of non-voting convertible preferred stock on the date of confirmation. If converted, the preferred shareholders would have a controlling voting interest.

Interpretive response: It depends. If conversion of the preferred shares after the confirmation date results in the same group of owners regaining control of the entity, the entity may not qualify for fresh-start reporting because the initial loss of control was temporary and therefore was not substantive.

If the likelihood of conversion is not readily determinable at the date of confirmation, we do not believe that conversion of the non-voting preferred stock should be assumed. However, the entity must be able to demonstrate that the original stockholders have lost control of the entity and that the loss of control is substantive, not temporary. All relevant facts and circumstances should be considered. [852-10-45-19]

5.3 Applying fresh-start reporting

Excerpt from ASC 852-10

• > Fresh-Start Reporting

45-20 Entities that adopt fresh-start reporting in conformity with the preceding paragraph shall apply the following principles:

- a. The reorganization value of the entity shall be assigned to the entity's assets and liabilities in conformity with the procedures specified by Subtopic 805-20. If any portion of the reorganization value cannot be attributed to specific tangible or identified intangible assets of the emerging entity, such amounts shall be reported as goodwill in accordance with paragraph 350-20-25-2.
- b. ...
- c. Deferred taxes shall be determined under the requirements of paragraph 852-740-45-1.

45-21 The financial statements of the entity as of and for the period immediately preceding the date determined in conformity with the guidance in paragraph 852-10-45-17 shall reflect all activity through that date in conformity with the guidance in paragraphs 852-10-45-1 through 45-16. Additionally, the effects of the adjustments on the reported amounts of individual assets and liabilities resulting from the adoption of fresh-start reporting and the effects of the forgiveness of debt shall be reflected in the predecessor entity's final statement of operations. Forgiveness of debt, if any, shall be reported as an extinguishment of debt and classified in accordance with Subtopic 220-20. Adopting fresh-start reporting results in a new reporting entity with no beginning retained earnings or deficit. When fresh-start reporting is adopted, the notes to the initial fresh-start financial statements shall disclose the additional information identified in paragraph 852-10-50-7.

• • > Comparative Financial Statements

45-26 Fresh-start financial statements prepared by entities emerging from Chapter 11 will not be comparable with those prepared before their plans were confirmed because they are, in effect, those of a new entity. Thus, comparative financial statements that straddle a confirmation date shall not be presented.

45-27 Regulatory agencies may require the presentation of predecessor financial statements. However, such presentations shall not be viewed as a continuum because the financial statements are those of a different reporting entity and are prepared using a different basis of accounting, and, therefore,

are not comparable. Attempts to disclose and explain exceptions that affect comparability would likely result in reporting that is so unwieldy it would not be useful.

45-28 Example 2 (see paragraph 852-10-55-4) provides an illustration of fresh-start reporting and the related illustrative notes to financial statements.

5.3.10 When to apply fresh-start reporting

Question 5.3.10 At what date is fresh-start reporting applied?

Interpretive response: Fresh-start reporting is applied as of the emergence date, which is the later of: [852-10-45-17 – 45-18]

- **Confirmation date**, the date that the Court confirms the plan of reorganization; and
- **Effective date**, the date that all material, unresolved conditions precedent to the plan becoming binding have been resolved.

If the Court approves the entity's plan of reorganization, but a material condition precedent remains unresolved (e.g. obtaining exit financing), the entity does not adopt fresh-start reporting until the financing is obtained. In the meantime, it continues to follow the same accounting principles as before emerging from bankruptcy (see [chapter 4](#)). Usually the Court issues a notice of effectiveness when the conditions precedent are satisfied.

Question 5.3.20 Can an entity use a convenience date for the accounting cutoff in applying fresh-start reporting?

Interpretive response: Yes, if the difference is not material to the predecessor or successor financial statements. Although FASB Statement No. 141 permitted using a convenience date when both parties to the transaction designate the end of an accounting period between the dates that a business combination is initiated and consummated, this specific provision was not carried forward into Topic 805 (Statement 141(R)). [FAS 141.48]

However, the basis for conclusions to FASB Statement No. 141(R) (nonauthoritative) highlights that although this concept was excluded from Topic 805, the financial statement effects of this change were rarely likely to be material. Therefore, unless events between the convenience date and the actual acquisition date result in material changes in the amounts recognized, the entity's practice would comply with Topic 805. [FAS 141R.B110]

If the emerging entity selects a reporting date that is different from the confirmation date (or effective date), it needs to demonstrate that the difference is not material to its financial reporting both:

- qualitatively, considering debt covenant implications and overall presentation in the context of the entity's normal reporting period-end dates; and
- quantitatively, considering:
 - the measurement differences between the emergence date and the convenience date; and
 - the impact of the results of operations on a prospective basis.

Although using a convenience date is permitted in certain circumstances, it would not be appropriate when it crosses over an annual (or quarterly, for a public company) reporting period-end. The effects of fresh-start adjustments cannot be recognized in a reporting period before the entity actually emerges from bankruptcy.

Example 5.3.10 Using a convenience date for fresh-start reporting

ABC Corp. is a calendar year-end public company that reports quarterly.

Scenario 1: Date of emergence is before period-end

ABC's plan of reorganization was confirmed on September 27 with no material, unresolved conditions precedent. ABC concludes that its operating results from September 27 through September 30 are not material to either the predecessor or successor periods.

In this scenario, ABC dates its financial statements as of and for the period ended September 27, but decides to include the immaterial results of operations for the three-day period between September 27 and 30 in its pre-emergence reporting period.

Scenario 2: Date of emergence is after period-end

ABC's plan of reorganization was confirmed on October 3 with no material, unresolved conditions precedent. ABC concludes that its operating results from September 30 through October 3 are not material to either the predecessor or successor periods.

ABC cannot apply fresh-start reporting and recognize the related adjustments in its September 30 interim financial statements. Although immaterial, the effects of fresh-start adjustments must be recognized in the predecessor financial statements in the period that includes the date of emergence from bankruptcy. In this scenario, that will be the period ended December 31.

Question 5.3.30 Can an entity apply fresh-start reporting before the confirmation date?

Background: If the entity emerging from Chapter 11 bankruptcy meets the criteria to apply fresh-start reporting, fresh-start reporting is presented in the financial statements as of the confirmation date or as of a later date when all

material conditions precedent to the plan becoming binding on all parties are resolved (see [Question 5.3.10](#)). [852-10-45-17 – 45-18]

Interpretive response: No. We believe an entity may not apply fresh-start reporting as of a date earlier than the date the Court approves the plan of reorganization (confirmation date). This is the case even if the plan has been approved by all of the entity’s creditors.

In our experience, Court confirmation of a plan of reorganization is not perfunctory and therefore should not be assumed by the emerging entity.

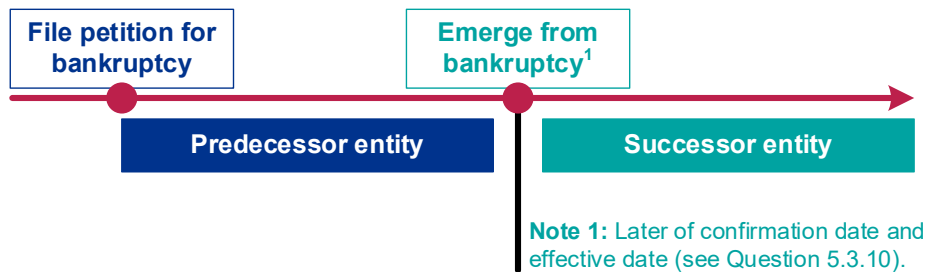
Question 5.3.40 Is confirmation of a plan of reorganization by the Court a recognized subsequent event?

Interpretive response: No. Subtopic 852-10 explicitly states that the effects of an entity’s plan of reorganization are recognized as of the date the plan is confirmed or as of a later date if there are material unsatisfied conditions precedent to the plan becoming binding on all parties (see [Question 5.3.10](#)). [852-10-45-17 – 45-18, 855-10-25-3]

Accordingly, Court confirmation of a plan of reorganization is a nonrecognized subsequent event, because it does not confirm conditions that existed as of the period-end date.

5.3.20 How to apply fresh-start reporting

If fresh-start reporting applies, the emerging entity is treated as a new entity for financial reporting. When pre-emergence period financial statements are presented (e.g. as required by the SEC), the pre- and post-emergence periods are usually separated by a ‘black line’ in the financial statements because they are not comparable. Reorganization costs, the effects of fresh-start adjustments of assets and liabilities to fair value and gains from the extinguishment of liabilities are recognized in the statement of operations of the predecessor entity. Retained earnings (or deficit) of the emerging entity are reset to zero. The period before emergence is generally referred to as the ‘predecessor’ and the period after emergence as the ‘successor’. [852-10-45-21, 45-26]



The reorganization value of the emerging entity is assigned to the entity’s assets, and to its liabilities and equity. Assigning value to its assets and

liabilities is performed using the business acquisition method principles in Subtopic 805-20. Further, this generally involves recording the assets and liabilities at fair value under the measurement principles of Topic 820. For guidance on recognizing and measuring assets and liabilities under Subtopic 805-20, see sections 7 and 17, respectively, of KPMG Handbook, [Business combinations](#). [852-10-45-20]

Applying Subtopic 805-20 in fresh-start reporting may result in recognizing identifiable intangible assets not previously recognized. If part of the reorganization value cannot be attributed to specific tangible or identifiable intangible assets of the emerging entity, that amount is recognized as goodwill. [852-10-45-20]

Adjustments to the carrying amounts of the entity's assets and liabilities and the effects of debt forgiveness are presented in the predecessor entity's financial statements as reorganization items. [852-10-45-21]

The effects of fresh-start reporting are illustrated in [section 5.3.30](#), but are generally presented in a table in the notes to the financial statements, showing: [852-10-50-7]

- predecessor entity (balance sheet just before confirmation of the plan);
- plan effect adjustments;
- fresh-start adjustments; and
- successor entity (closing balance of predecessor entity).

Question 5.3.50 Do total assets of an entity that qualifies for fresh-start reporting equal its reorganization value on emergence?

Interpretive response: Generally, yes. Reorganization value is an estimate of the value of an emerging entity's *gross* assets, before considering liabilities. In contrast, the consideration transferred in a business combination represents the price paid for the *net* assets of the business, because when an acquirer obtains control of a business, it acquires all of that business's assets and assumes all of its liabilities. [852-10 Glossary]

Accordingly, when fresh-start reporting is applied, both total assets and total liabilities and equity generally equal reorganization value.

However, we believe it is acceptable for total assets recognized under Subtopic 805-20 to exceed reorganization value (see [Question 5.3.70](#)).

Question 5.3.60 How does an entity account for reorganization value greater than the fair value of identifiable assets of the emerging entity?

Interpretive response: If any portion of the reorganization value cannot be attributed to specific tangible or identifiable intangible assets of the emerging entity, the excess reorganization value is recognized as goodwill. [852-10-45-20]

Question 5.3.70 How does an entity account for reorganization value less than the fair value of identifiable assets of the emerging entity?

Interpretive response: An entity emerging from bankruptcy does not recognize a bargain purchase gain. Instead, the entity first confirms that the fair values of its assets and its reorganization value have been appropriately determined. [805-30-25-4, 30-5]

If a difference remains, we believe there are two acceptable approaches to accounting for the difference.

Approach 1: Recognize difference as a credit to opening additional paid-in capital

This approach analogizes to the guidance on bargain purchase gains in pushdown accounting. Under this approach, the emerging entity's total assets exceed its reorganization value, with the difference recognized as a credit to additional paid-in capital. [805-50-30-11]

Approach 2: Allocate difference to certain nonfinancial assets on a relative fair value basis

Under this approach, the emerging entity's total assets equals its reorganization value, and the difference is allocated to certain assets. We believe the allocation should be done by analogy to the superseded cost allocation guidance for bargain purchase amounts in FASB Statement No. 141.

Under that guidance, the difference is allocated on a pro rata basis to all assets except for: [FAS 141.44]

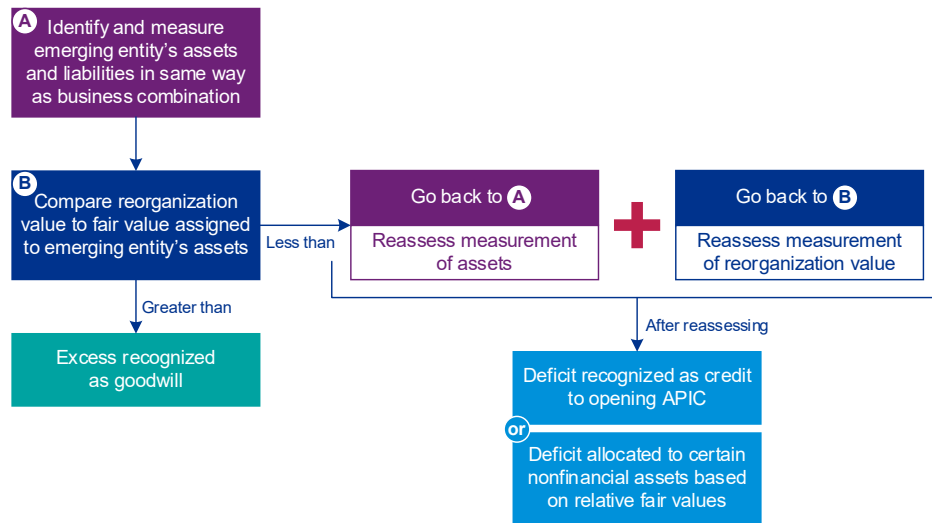
- financial assets other than equity method investments;
- assets that are classified as held-for-sale. An asset that is acquired and that will be sold (rather than held and used) is held-for-sale if the sale is probable and expected to be completed within one year of the emergence date, and all other held-for-sale criteria are probable of being met within a short period following the emergence (usually within three months); [360-10-45-12]
- deferred tax assets;
- postretirement benefit plan assets; and
- other current assets, including inventory.

In addition, we also do not expect adjustments to be allocated to:

- contract assets recognized under Topic 606 (revenue); and
- indemnification assets.

We do not believe it is appropriate to use a residual method to allocate value to nonfinancial assets, such as identifiable intangible assets or unproved oil and gas properties.

The following diagram summarizes the process followed in applying fresh-start reporting.



Example 5.3.20 Allocating a deficit on a relative fair value basis

On November 30, Year 1, ABC Corp. emerges from bankruptcy and applies fresh-start reporting. ABC determines that its reorganization value is \$150 and the sum of the fair values of all of its identifiable assets is \$158. ABC reviews its determination of reorganization value and the fair values of its assets and concludes that they were properly measured. ABC elects to allocate the \$8 difference as a pro rata reduction of the carrying amount of its nonfinancial assets as follows.

Asset class	Fair value	Assets in allocation	% of Total	Allocation of deficit	Fresh-start amount
Cash	18	-	-	-	18
Other current assets	20	-	-	-	20
Building	70	70	58.3%	(4)	66
Equipment	40	40	33.3%	(3)	37
Patent	10	10	8.4%	(1)	9
Total	158	120	100.0%	(8)	150

Alternatively, ABC could have elected to recognize the \$8 difference as a credit to additional paid-in capital.

Measurement period

Question 5.3.80 Can an entity use a measurement period for fresh-start reporting?

Interpretive response: Generally, no. Although in a business combination the acquirer may record provisional amounts for the assets acquired and liabilities assumed and then adjust them during the measurement period, no such concept exists in fresh-start reporting. All accounting for fresh-start reporting must be completed by the next reporting date after emerging from bankruptcy.

In a business combination, management of the acquirer does not have access to all the information needed to account for the business combination until the acquisition takes place. In contrast, in fresh-start reporting, management has full access to all information required to remeasure the entity's assets and liabilities, and in many cases the values of those assets and liabilities are extensively discussed, debated and ultimately agreed on with advisors and creditors.

A subsequent adjustment to an amount initially recognized is included in income in the period in which the adjustment is determined, and is separately disclosed.

Disposition of liabilities subject to compromise

When an entity emerges from bankruptcy, it settles its prepetition liabilities usually with cash, new notes payable, new debt, new equity or some combination thereof. An entity applying fresh-start reporting recognizes the gain from the settlement of prepetition liabilities as a reorganization item in the predecessor period. [852-10-45-21]

Example 5.3.30 Lifecycle of a liability subject to compromise

Continuing [Example 4.3.10](#), ABC Corp. filed a petition for bankruptcy on July 1, Year 1. At the time of the petition filing, ABC owed Lender \$500 for an unsecured loan.

The claim was allowed by the Court and, at the time of preparing its September 30 financial statements, ABC estimated the allowed claim to be \$500. ABC reclassified the \$500 payable to Lender from loans payable to liability subject to compromise on its September 30 balance sheet.

On November 1, ABC recognized a \$25 reduction to the liabilities subject to compromise after being informed by the Court that a \$25 late payment fee was disallowed. The \$25 reduction was recognized as a reorganization item in ABC's December 31 statement of operations.

On January 30, Year 2, ABC emerges from bankruptcy and applies fresh-start reporting. As part of the settlement with Lender, ABC provides the following forms of consideration to satisfy Lender's claim.

Note payable	200
Senior debt	75
Subordinated debt	100
Common stock	50
Cash paid	5
Total consideration	430

ABC records the following journal entry as part of its fresh-start reporting (reorganization adjustment).

	Debit	Credit
Liabilities subject to compromise	475	
Note payable		200
Senior debt		75
Subordinated debt		100
Common stock		50
Cash		5
Reorganization items (gain on debt discharge)		45
<i>To record debt discharge upon reorganization.</i>		

Preconfirmation contingencies

Question 5.3.90 How are adjustments to pre-confirmation contingencies that continue to exist on emergence accounted for?

Interpretive response: We believe that an adjustment to a pre-confirmation contingency as a result of a change in estimate or settlement of a contingent asset or liability after fresh-start reporting should be recognized in the statement of operations in the period following emergence.

Although superseded by Topic 805, we believe the guidance in AICPA Practice Bulletin No. 11 remains informative when considering pre-confirmation contingencies that continue to exist on an entity's emergence from bankruptcy. Under PB 11, the resolution of a pre-confirmation contingency after fresh-start reporting is recognized in the statement of operations of the emerged entity, rather than as an opening balance sheet adjustment. [PB 11.08]

Example 5.3.40 Resolution of a pre-confirmation contingency

ABC Corp. is a calendar year-end entity and its plan of reorganization was confirmed on January 31, Year 1. At the time of the bankruptcy filing, ABC had been engaged in negotiations with a state environmental agency to settle an environmental matter. The agency filed a claim in the bankruptcy case that was stayed by the Court in order to postpone legal proceedings. In fresh-start reporting, ABC recognized a liability for the matter at its estimated fair value of \$120.

In July Year 1, ABC negotiates a final settlement with the state agency for its obligation at the site of \$100. ABC recognizes the \$20 difference between the estimated amount and the actual amount paid to settle the obligation in its statement of operations in the post-emergence period.

Debt issuance costs

Question 5.3.100 Should debt issuance costs related to new debt issued on emergence be written off in fresh start?

Interpretive response: No. We believe that direct costs associated with new debt issued when an entity emerges from bankruptcy should not be expensed or written off when applying fresh start. They should be accounted for as debt issuance costs in accordance with Subtopic 835-30 and accounted for in the post-emergence financial statements.

Our view is based on the perspective that the new debt is a new liability of the successor company, as opposed to an assumed liability of an 'acquired company'.

Leases

Under fresh-start reporting, an emerging entity's leases are treated the same as in a business combination. For relevant guidance under Topic 842, see chapter 11 of KPMG Handbook, [Leases](#).

Assigning goodwill to reporting units on emergence

Question 5.3.110 How is goodwill allocated to the emerging entity?

Interpretive response: Goodwill representing the excess reorganization value over the fair values of the identified assets recognized should be allocated to

reporting units in the same manner as in a business combination. [350-20-35-41 – 35-44]

For guidance on accounting for goodwill in a business combination, see section 8 of KPMG Handbook, [Business combinations](#).

Derivatives and hedge accounting

Under Subtopic 805-20, the emerging entity reassesses whether embedded derivatives must be separated from their host instruments, and redesignates derivative instruments as hedging instruments (e.g. as a cash flow hedge). Redesignation is required for all derivative contracts. [805-20-25-7]

For additional guidance, see section 7 of KPMG Handbook, [Business combinations](#).

Share-based payments

When an entity emerges from bankruptcy, it may issue share-based payment awards related to the emerged entity. This often happens on emergence and the plan of reorganization requires awards issued by the predecessor entity to be canceled. See [Question 4.10.70](#) for a discussion on accounting for awards during bankruptcy.

Question 5.3.120 How does an entity account for share-based payment awards on emergence?

Background: When the plan of reorganization is confirmed by the Court, shares of the entity existing at that time are typically canceled (and therefore rendered valueless), which results in cancellation of the share-based payment awards as well.

Interpretive response: The cancellation of an employee share-based payment award by the Court as part of the plan of reorganization generally is treated as a cancellation under Topic 718. In bankruptcy proceedings, canceling the award is often not accompanied by the concurrent grant of a replacement award.

Share-based payment awards that the post-emergence entity awards are often granted in amounts that are not proportionate to the previous awards. They are also not generally made concurrently with the process of emerging from bankruptcy. Therefore, the entity applies the guidance in Topic 718 for cancellations and recognizes remaining unrecognized compensation cost in its predecessor statement of operations within reorganization items.

The post-emergence entity typically treats new share-based payments as new grants under Topic 718. However, in other more limited scenarios where the awards have value, the Court may approve new awards that are granted on emergence that are considered replacement awards. In this case, the cancellation of an award and the concurrent grant of a replacement award is accounted for as a modification. [718-20-35-8 – 35-9]

Pension and other postretirement benefits

Question 5.3.130 How are postretirement benefit plans recognized when applying fresh-start reporting?

Interpretive response: Under Subtopic 805-20, the emerging entity recognizes an asset or liability for the funded status of a single-employer defined benefit pension or other postretirement benefit plan. The measurement of the benefit obligation and plan assets are based on current assumptions (such as discount rate(s) and mortality) at the emergence date. [805-20-30-15]

Defined benefit pension and other postretirement plans may be amended as part of the plan of reorganization. The net gain or loss resulting from the adjustment, settlement or curtailment of the benefit obligations under the plan of reorganization is presented as a reorganization item in the predecessor's statement of operations. Planned or expected changes to benefit plans that are not part of the plan of reorganization are accounted for on a prospective basis in the usual way. [805-20-30-15, 852-10-45-21]

For further discussion on accounting and presentation for postretirement benefit plans, see KPMG Handbook, [Employee benefits](#).

Equity

Question 5.3.140 How is the cancellation of the predecessor equity accounted for?

Interpretive response: We believe the cancellation of the predecessor's equity (including preferred stock) should be recognized directly in equity under fresh-start reporting; this is consistent with Example 2 in Subtopic 852-10. The effect should not be included in reorganization items because it does not result from an adjustment to the reported amounts of assets or liabilities, or from the forgiveness of debt. [852-10-45-21, 55-10]

See [section 5.3.30](#) for an illustrative example of applying fresh-start reporting.

Question 5.3.150 How are amounts remaining in AOCI accounted for on emergence?

Interpretive response: In applying fresh-start reporting on emergence from bankruptcy, the balance in AOCI is reset to zero because the new reporting entity at emergence has no beginning balance for AOCI. [852-10-45-21]

We are aware of diversity in practice with some entities recording the offset of this adjustment as a reorganization item of the predecessor entity, while others record the offset directly against retained earnings. We believe that either approach is acceptable.

Question 5.3.160 How does an entity measure multiple classes of securities issued in the reorganization?

Background: An entity may issue multiple classes of securities (e.g. preferred stock and common stock) to settle its prepetition liabilities on emergence.

Interpretive response: In fresh-start reporting, we believe the initial value ascribed to each series of new equity securities issued should be determined consistent with the entity's enterprise value. Usually an enterprise value approved by the Court includes a value for each class of security issued. Ordinarily, we believe it is acceptable to use that value in fresh-start reporting.

If there have been changes in the value of newly issued debt between the date that enterprise value was calculated and the date the entity emerges from bankruptcy (e.g. because fixed-rate debt was issued and interest rates changed), a pro rata adjustment to the value of each class of equity security would be necessary to ensure that the total for all liabilities and equity equals the entity's reorganization value (see [Questions 5.3.50](#) and [5.3.70](#)).

Question 5.3.165 How does an entity account for contingently issuable shares upon emergence?

Background: An entity may emerge from bankruptcy, but be required under the plan to hold back shares that will be issued to former creditors after certain contingencies are resolved. For example, the court may need to resolve the allocation of a certain number of shares among several classes of creditors.

Interpretive response: We believe these financial instruments should be evaluated under Topic 480 and Subtopic 815-40 to determine if they are liability- or equity-classified financial instruments. Depending on the classification, the reorganization value is allocated to those items consistent with similar liabilities or equity instruments.

If the instruments are liability-classified, the liability is adjusted to fair value each period until settled, with changes in the fair value being recorded in earnings. Equity-classified instruments are not remeasured and their subsequent settlement is accounted for within equity.

For in-depth discussion on evaluating the classification and accounting for these instruments, see KPMG Handbook, [Debt and equity financing](#).

Income taxes

Excerpt from ASC 852-740

> Fresh-Start Reporting in a Chapter 11 Reorganization

45-1 For entities that meet the paragraph 852-10-45-19 requirements for fresh-start reporting, deferred taxes shall be reported in conformity with generally accepted accounting principles (GAAP). If not recognizable at the plan

confirmation date, initial recognition (that is, by elimination of the valuation allowance) of tax benefits realized from preconfirmation net operating loss **carryforwards** and deductible temporary differences shall be reported as a reduction of income tax expense.

For guidance on accounting for income taxes in fresh-start reporting, see section 10 of KPMG Handbook, [Accounting for income taxes](#).

Discontinued operations on emergence

Question 5.3.170 Does a successor entity that reports discontinued operations recast the predecessor periods?

Interpretive response: Yes. The SEC staff has indicated that the predecessor financial statements of a registrant that has emerged from bankruptcy and applies fresh-start reporting should be restated to reflect the impact of a successor's presentation of discontinued operations. [\[SEC FRM 13210.2, SEC Regs Comm 04/2004\]](#)

We believe this approach should also be followed by non-SEC registrants. This is because Subtopic 205-20 does not provide an exception to retrospectively recasting prior periods for discontinued operations. [\[205-20-45-10\]](#)

Example 5.3.50 Discontinued operations in predecessor entity financial statements

ABC Corp. is a calendar year-end company that has been operating under Chapter 11 bankruptcy. In negotiating its plan of reorganization with its creditors, ABC agreed to sell Component X to a third party.

ABC emerged from bankruptcy on August 14, Year 2 and met the requirements to apply fresh-start reporting. On that date, Component X qualified to be reported in discontinued operations. ABC presents its financial statements on a comparative basis. As of December 31, Year 1, Component X did not meet the criteria to be reported in discontinued operations.

In its December 31, Year 2 financial statements ABC recasts its predecessor financial statements for the year ended December 31, Year 1 and the stub-period through emergence on August 14, Year 2 to report the results and cash flows of Component X in discontinued operations, and the assets and liabilities of Component X as held-for-sale.

Contract assets and contract liabilities (deferred revenue)

Question 5.3.180 How are contract assets and liabilities accounted for?

Interpretive response: An entity is required to assign its reorganization value to its assets, liabilities and equity using the business combination acquisition method principles in Subtopic 805-20. Therefore, an emerging entity applies the same guidance to contract assets and liabilities in fresh start accounting as it does in a business combination. [852-10-45-20]

In October 2021, the FASB issued ASU 2021-08, Accounting for Contract Assets and Contract Liabilities from Contracts with Customers, which provides an exception to the general fair value principle in Topic 805 for contract assets and contract liabilities arising from acquired customer contracts in a business combination. Section 17 of KPMG Handbook, [Business combinations](#), discusses the accounting for contract assets and contract liabilities before and after the adoption of ASU 2021-08.

We believe this ASU also applies to the accounting for contract assets and liabilities in fresh-start financial statements.

The emerging entity recognizes and measures contract assets and contract liabilities using the principles in Topic 606 (revenue) as if the emerging entity had originated the contract. That is, the emerging entity applies the accounting policies of the emerging entity (see [Question 5.3.190](#)) to each contract (or portfolio of contracts in certain cases) to determine the amount of a contract asset or liability to record upon emergence.

Any changes in the contract assets or liabilities are presented as reorganization items in the predecessor period – e.g. because of differences in accounting policies between the predecessor and successor entities.

Accounting policies of the successor entity

Question 5.3.190 Can an entity change its accounting policies on emerging from bankruptcy?

Interpretive response: Yes. The emerging entity is considered a new reporting entity for financial reporting purposes, and therefore the financial statements for periods after emerging from bankruptcy (successor periods) are not comparable with the financial statements of the periods before emerging (predecessor periods). Accordingly, the emerging entity's accounting policies are not required to be consistent with those of the predecessor entity.

We do not believe that the emerged entity needs to assess whether any new accounting principle is preferable, and consequently a preferability letter is not required for public entities. [250-10-45-2(b)]

The accounting policies of the predecessor and successor entities should be clearly described in the notes to the financial statements. We do not believe it is necessary to make the change in accounting policy disclosures required by Topic 250 if the change occurs as part of applying fresh-start reporting.

Question 5.3.200 In applying a retrospective change in accounting principle in a period after fresh-start reporting, does an entity recast predecessor periods?

Interpretive response: No. Because the financial statements prepared by an emerging entity are effectively those of a new entity, they are not comparable with those of the predecessor periods. Therefore, we believe an entity is not required to retrospectively apply a new accounting principle to the periods before emerging from bankruptcy. [852-10-45-26]

However, we believe the financial statements of the predecessor periods should be retrospectively recast for:

- discontinued operations (see [Question 5.3.170](#)); and
- segment disclosures to reflect a change in reportable segments (see [Question 5.5.20](#)).

Question 5.3.210 Can an entity adopt a new Accounting Standards Update that is not yet effective?

Interpretive response: Only if the new ASU permits early adoption. In fresh-start reporting, an entity is permitted, but not required, to adopt new ASUs that are not yet effective if they allow early adoption. An entity is not permitted to early adopt an ASU in fresh-start reporting if early adoption is specifically prohibited. [FSP SOP 90-7-1.6]

5.3.30 Financial statement presentation and disclosure

Excerpt from ASC 852-10

> Financial Reporting When Entities Emerge from Chapter 11 Reorganization and Adopt Fresh-Start Reporting

50-7 Paragraph 852-10-45-21 requires additional information to be disclosed in the notes to the initial fresh-start financial statements when fresh-start reporting is adopted. That additional information consists of all of the following:

- a. Adjustments to the historical amounts of individual assets and liabilities
- b. The amount of debt forgiveness
- c. Significant matters relating to the determination of **reorganization value**, including all of the following:

1. The method or methods used to determine reorganization value and factors such as discount rates, tax rates, the number of years for which cash flows are projected, and the method of determining **terminal value**
2. Sensitive assumptions—that is, assumptions about which there is a reasonable possibility of the occurrence of a variation that would have significantly affected measurement of reorganization value
3. Assumptions about anticipated conditions that are expected to be different from current conditions, unless otherwise apparent.

> Illustrations

- > Example 2: Fresh-Start Reporting and Illustrative Notes to Financial Statements

55-4 This Example illustrates the fresh-start-related guidance in paragraphs 852-10-45-19 through 45-27 and uses the same hypothetical XYZ Company as in Example 1 (see paragraph 852-10-55-2). Illustrative accounting and associated note disclosures follow.

55-5 The Bankruptcy Court confirmed XYZ's plan of reorganization as of June 30, 19X2. It was determined that XYZ's reorganization value computed immediately before June 30, 19X2, the date of plan confirmation, was \$1,300,000, which consisted of the following.

Cash in excess of normal operating requirements generated by operations	\$ 150,000
Net realizable value of asset dispositions	75,000
Present value of discounted cash flows of the emerging entity	1,075,000
Reorganization value	<u>\$ 1,300,000</u>

55-6 XYZ Company adopted fresh-start reporting because holders of existing voting shares immediately before filing and confirmation of the plan received less than 50% of the voting shares of the emerging entity and its reorganization value is less than its postpetition liabilities and allowed claims, as shown in the following table.

Postpetition current liabilities	\$ 300,000
Liabilities deferred pursuant to Chapter 11 proceeding	1,100,000
Total postpetition liabilities and allowed claims	1,400,000
Reorganization value	(1,300,000)
Excess of liabilities over reorganization value	<u>\$ 100,000</u>

55-7 The reorganization value of the XYZ Company was determined in consideration of several factors and by reliance on various valuation methods, including discounting cash flow and price/earnings and other applicable ratios. The factors considered by XYZ Company included all of the following:

- a. Forecasted operating and cash flow results that gave effect to the estimated impact of both of the following:
 1. Corporate restructuring and other operating program changes
 2. Limitations on the use of available net operating loss carryovers and other tax attributes resulting from the plan of reorganization and other events.

- b. The discounted residual value at the end of the forecast period based on the capitalized cash flows for the last year of that period
- c. Market share and position
- d. Competition and general economic considerations
- e. Projected sales growth
- f. Potential profitability
- g. Seasonality and working capital requirements.

55-8 After consideration of XYZ Company's debt capacity and other capital structure considerations, such as industry norms, projected earnings to fixed charges, earnings before interest and taxes to interest, free cash flow to interest, and free cash flow to debt service and other applicable ratios, and after extensive negotiations among parties in interest, it was agreed that XYZ's reorganization capital structure should be as follows

Postpetition current liabilities	300,000
Internal Revenue Service (IRS) note	50,000
Senior debt	275,000 ^(a)
Subordinated debt	175,000
Common stock	350,000
Reorganization capital structure	<u>\$ 1,150,000</u> ^(b)

(a) Due \$50,000 per year for each of the next 4 years, at 12% interest, with \$75,000 due in the fifth year.

(b) See the table in paragraph 852-10-55-10 for the balance sheet adjustments required to reflect XYZ Company's reorganization value as of the date of plan confirmation.

55-9 The following entries record the provisions of the plan and the adoption of fresh-start reporting.

Entries to record debt discharge:

Liabilities subject to compromise	\$ 1,100,000	
Senior debt—current		\$ 50,000
Senior debt—long-term		225,000
IRS note		50,000
Cash		150,000
Subordinated debt		175,000
Common stock (new)		86,000
Additional paid-in capital		215,000
Gain on debt discharge		149,000

Entries to record exchange of stock for stock:

Preferred stock	325,000	
Common stock (old)	75,000	
Common stock (new)		14,000
Additional paid-in capital		386,000

Entries to record the adoption of fresh-start reporting and to eliminate the deficit:

Inventory	50,000	
Property, plant and equipment	175,000	
Goodwill (new)	175,000	
Gain on debt discharge	149,000	
Additional paid-in capital	351,000	
Goodwill (old)		200,000
Deficit		700,000

55-10 The effect of the plan of reorganization on XYZ Company's balance sheet, as of June 30, 19X2, is as follows.

	Adjustments to Record Confirmation of Plan			XYZ Company's Reorganized Balance Sheet
	Preconfirmation	Debt discharge	Exchange of stock Fresh start	
Assets:				
Current Assets				
Cash	\$ 200,000	\$ (150,000)		\$ 50,000
Receivables	250,000			250,000
Inventory	175,000		\$ 50,000	225,000
Assets held for sale	25,000			25,000
Other current assets	25,000			25,000
	<u>675,000</u>	<u>(150,000)</u>	<u>50,000</u>	<u>575,000</u>
Property, plant and equipment	175,000		175,000	350,000
Assets held for sale	50,000			50,000
Goodwill (old)	200,000		(200,000)	
Goodwill (new)			175,000	175,000
	<u>\$ 1,100,000</u>	<u>\$ (150,000)</u>	<u>\$ 200,000</u>	<u>\$1,150,000</u>
Liabilities and Shareholders' Deficit:				
Liabilities Not Subject to Compromise				
Current Liabilities				
Short-term borrowings	\$ 25,000			\$ 25,000
Current maturities of senior debt		\$ 50,000		50,000
Accounts payable trade	175,000			175,000
Other liabilities	100,000			100,000
	<u>300,000</u>	<u>50,000</u>		<u>350,000</u>
Liabilities Subject to Compromise				
Prepetition liabilities	1,100,000	(1,100,000)		
IRS note		50,000		50,000
Senior debt, less current maturities		225,000		225,000
Subordinated debt		175,000		175,000
Shareholders' deficit:				
Preferred stock	325,000		\$ (325,000)	
Additional paid-in capital		215,000	386,000	\$ 250,000
Common stock—old	75,000		(75,000)	

Common stock—new		86,000	14,000		100,000
Retained earnings (deficit)	(700,000)	149,000		700,000 (149,000)	
	(300,000)	450,000	–	200,000	350,000
	\$ 1,100,000	\$ (150,000)	\$ –	\$ 200,000	\$1,150,000

55-11 The following illustrative disclosure discusses the details of XYZ Company's confirmed plan of reorganization. In this illustration a tabular presentation entitled Plan of Reorganization Recovery Analysis is incorporated in the note disclosure. The plan of reorganization recovery analysis may alternatively be presented as supplementary information to the financial statements.

Note X - Plan of Reorganization

On June 30, 19X2, the Bankruptcy Court confirmed the Company's plan of reorganization. The Company accounted for the reorganization using fresh-start reporting. Accordingly, all assets and liabilities are adjusted to fair value under accounting requirements for business combinations under Topic 805. The excess of reorganization value over the fair value of tangible and intangible assets was recorded as "Goodwill (new)." The confirmed plan provided for the following:

Secured Debt—The Company's \$300,000 of secured debt (secured by a first mortgage lien on a building located in Nashville, Tennessee) was exchanged for \$150,000 in cash and a \$150,000 secured note, payable in annual installments of \$27,300 commencing on June 1, 19X3, through June 1, 19X6, with interest at 12% per annum, with the balance due on June 1, 19X7.

Priority Tax Claims—Payroll and withholding taxes of \$50,000 are payable in equal annual installments commencing on July 1, 19X3, through July 1, 19X8, with interest at 11% per annum.

Senior Debt—The holders of approximately \$275,000 of senior subordinated secured notes received the following instruments in exchange for their notes: \$87,000 in new senior secured debt, payable in annual installments of \$15,800 commencing March 1, 19X3, through March 1, 19X6, with interest at 12% per annum, secured by first liens on certain property, plants, and equipment, with the balance due on March 1, 19X7; \$123,000 of subordinated debt with interest at 14% per annum due in equal annual installments commencing on October 1, 19X3, through October 1, 19X9, secured by second liens on certain property, plant, and equipment; and 11.4% of the new issue of outstanding voting common stock of the Company.

Trade and Other Miscellaneous Claims—The holders of approximately \$225,000 of trade and other miscellaneous claims received the following for their claims: \$38,000 in senior secured debt, payable in annual installments of \$6,900 commencing March 1, 19X3, through March 1, 19X6, with interest at 12% per annum, secured by first liens on certain property, plants, and equipment, with the balance due on March 1, 19X7; \$52,000 of subordinated debt, payable in equal annual installments commencing October 1, 19X3, through October 1, 19X8, with interest at 14% per annum; and 25.7% of the new issue of outstanding voting common stock of the Company.

Subordinated Debentures—The holders of approximately \$250,000 of subordinated unsecured debt received, in exchange for the debentures, 48.9% of the new issue outstanding voting common stock of the Company.

Preferred Stock—The holders of 3,250 shares of preferred stock received 12% of the outstanding voting common stock of the new issue of the Company in exchange for their preferred stock.

Common Stock—The holders of approximately 75,000 outstanding shares of the Company's existing common stock received, in exchange for their shares, 2% of the new outstanding voting common stock of the Company.

The following table (Plan of Reorganization Recovery Analysis) summarizes the adjustments required to record the reorganization and the issuance of the various securities in connection with the implementation of the plan.

	Recovery									
	Elimination of Debt and Equity	Surviving Debt	Cash	IRS Note	Senior Debt	Subordinated Debt	Common Stock ^(a)		Total Recovery	
							%	Value	\$	%
Postpetition liabilities <i>Claim or Interest</i>	\$ 300,000		\$ 300,000						\$ 300,000	100%
Secured debt	300,000		\$ 150,000		\$ 150,000				300,000	100
Priority tax claim	50,000			\$ 50,000					50,000	100
Senior debt	275,000	\$ (25,000)			87,000	\$ 123,000	11.4%	\$ 40,000	250,000	91
Trade and other miscellaneous claims	225,000	(45,000)			38,000	52,000	25.7	90,000	180,000	80
Subordinated debentures	250,000	(79,000)					48.9	171,000	171,000	68
	<u>1,100,000</u>									
Preferred stockholders	325,000	(283,000)					12.0	42,000	42,000	
Common stockholders	75,000	(68,000)					2.0	7,000	7,000	
Deficit	(700,000)	700,000								
Total	\$1,100,000	\$200,000	\$ 300,000	\$150,000	\$50,000	\$275,000	\$ 175,000	100.0%	\$350,000	\$1,300,000

(a) The aggregate par value of the common stock issued under the plan is \$100,000.

Question 5.3.215 What disclosures are required when fresh-start reporting is applied?

Interpretive response: When fresh-start reporting is adopted, additional disclosures are required, including: [852-10-50-7]

- adjustments to the historical amounts of individual assets and liabilities;
- the amount of debt forgiveness;
- significant matters relating to the determination of the reorganization value, including all of the following:
 - the method(s) used to determine the reorganization value, and factors such as discount rates, tax rates, the number of years for which cash flows are projected, and the method of determining terminal value;
 - sensitive assumptions when there is a reasonable possibility of a variation that would significantly affect the measurement of the reorganization value; and
 - assumptions about anticipated conditions that are expected to be different from current conditions, unless otherwise apparent.

Question 5.3.220 What additional disclosures should an entity consider?

Interpretive response: We believe an entity applying fresh-start reporting should consider the following disclosures in addition to the specific requirements of Subtopic 852-10.

- Labeling periods before emerging from bankruptcy and applying fresh-start reporting as 'Predecessor' and those after emerging as 'Successor', with separation via a black line.
- A detailed discussion of emerging from bankruptcy, such as:
 - how the entity will conduct its business;
 - how the entity's capital is structured on emergence;
 - how many and what kind of equity securities were distributed to creditors; and
 - which businesses were ceased or subsidiaries were sold.
- The convenience date used to implement fresh-start reporting (if applicable).
- The entity's estimated reorganization value.

Additionally, fresh-start reporting may affect other areas of the financial statements and disclosures may be required under other applicable US GAAP, including updates to significant accounting policies, fair value of investments, income taxes, commitments and contingencies, employee benefits, debt and shareholders' equity. [852-10-50-1]

Example 5.3.60 Financial statements on emerging from bankruptcy

ABC Corp. is a calendar year-end company that filed a petition for bankruptcy on July 1, Year 1. ABC emerged from bankruptcy on January 30, Year 2. For convenience, because the effect on both the predecessor and successor periods was immaterial (see [Question 5.3.20](#)), ABC applied fresh-start reporting on January 31, Year 2.

ABC presents financial statements for one comparative period. ABC's consolidated balance sheet and statement of operations are as follows as of and for the years ended December 31, Year 2 and Year 1.

ABC Corporation		
Consolidated Balance Sheets		
(000s)		
	Successor	Predecessor
	December 31,	
	Year 2	Year 1
Assets		
Cash	\$900	\$1,650
Other current assets	225	200
Intangible assets	45	50
Property, plant and equipment, net	900	1,500
Goodwill	300	-
Total assets	\$2,370	\$3,400
Liabilities and equity		
Current liabilities	\$340	\$310
Long-term debt	320	340
Liabilities subject to compromise	0	4,800
Total liabilities	660	5,450
Common stock – predecessor	-	5
Additional paid-in capital – predecessor	-	2,795
Common stock – successor	8	-
Additional paid-in capital – successor	1,102	-
Retained earnings (accumulated deficit)	600	(4,850)
Total shareholders' equity (deficit)	1,710	(2,050)
Total liabilities and shareholders' equity	\$2,370	\$3,400

The successor and predecessor periods are clearly delineated both in the column heading and also by separation via a black line.

ABC Corporation			
Consolidated Statement of Operations			
(000s)			
	Successor	Predecessor	
	Period from February 1, Year 2 through December 31, Year 2	Period from January 1, Year 2 through January 31, Year 2	Year Ended December 31, Year 1
Net sales	\$25,500	\$1,800	\$21,000
Cost of goods sold	(18,250)	(1,350)	(16,500)
Gross margin	7,250	450	4,500
Operating expenses			
Selling, general and administrative expenses	(4,400)	(440)	(5,000)
Restructuring and impairment charges	(900)	(80)	(900)
Other expenses	(600)	(50)	(600)
Total operating expenses	(5,900)	(570)	(6,500)
Income (loss) before interest, reorganization items, and income taxes	1,350	(120)	(2,000)
Interest expense	(425)	(20)	(275)
Reorganization items, net	-	2,200	(850)
Income (loss) before income tax benefit and discontinued operations	925	2,060	(3,125)
Income tax (expense) benefit	(200)	(700)	-
Income (loss) before discontinued operations	725	1,360	(3,125)
Discontinued operations:			
Loss from operations of a discontinued component	-	-	(300)
Net income (loss)	\$725	\$1,360	\$(3,425)

The results of operations of the predecessor entity are separately presented for all periods before emergence. In addition, the successor and predecessor periods are clearly delineated both in the column heading and by using a black line.

Example 5.3.70 Fresh-start reporting illustration

ABC Corp. emerged from bankruptcy as of March 31 and qualified for fresh-start reporting. ABC's financial statement disclosures included the following balance sheet reconciliation to present the reorganization adjustments and fresh-start adjustments applied to the predecessor entity's balance sheet as of March 31.

	Predecessor	Reorg. adjustments	Fresh-start adjustments	Successor
Assets				
Cash	1,950	(1,770) A	-	180
Other current assets	100	-	10 C	110
Intangible assets	20	-	120 C	140
PP&E net	1,170	-	20 C	1,190
Goodwill	-	-	100 C	100
Total assets	<u>3,240</u>	<u>(1,770)</u>	<u>250</u>	<u>1,720</u> B
Liabilities and equity				
Current liabilities	250	-	-	250
Long-term debt	360	-	-	360
Liabilities subject to compromise	4,800	(4,800) A	-	-
Total liabilities	<u>5,410</u>	<u>(4,800)</u>	<u>-</u>	<u>610</u>
Common stock – predecessor	15	(15) E	-	-
APIC – predecessor	2,785	(2,785) E	-	-
Common stock – successor	-	8 D	-	8
APIC – successor	-	1,102 D	-	1,102
Accumulated deficit	(4,970)	4,720 F	250 G	-
Total shareholders' equity (deficit)	<u>(2,170)</u>	<u>3,030</u>	<u>250</u>	<u>1,110</u>
Total liabilities and shareholders' equity	<u>3,240</u>	<u>(1,770)</u>	<u>250</u>	<u>1,720</u>
Notes:				
A The predecessor's liabilities subject to compromise (\$4,800) were settled with \$1,770 in cash and 100% of the common stock of the emerging entity (\$1,110). See (f) for calculation of the gain on the settlement.				
B ABC's reorganization value (see section 5.2.10).				
C To adjust the predecessor's assets and liabilities to fair value.				
D New common stock and additional paid-in capital issued to creditors to settle the predecessor's liabilities.				
E Cancellation of the predecessor common stock and associated paid-in capital.				
F Gain on the settlement of liabilities subject to compromise [\$4,800 – (\$1,770 + \$8 + \$1,102 – \$15 – \$2,785)]				
G Accumulated deficit resets to zero.				

The first three columns of the table represent accounting by the predecessor entity in the period just before emergence. The fourth column represents the opening balance sheet for the successor entity after the adoption of fresh-start reporting. As described in footnote (B), the total assets on the opening balance sheet of \$1,720 are equal to the reorganization value.

Question 5.3.230 Is disclosure required when an entity applies fresh-start reporting after the reporting date but before the financial statements are issued?

Interpretive response: Yes. An entity that applies fresh-start reporting after the reporting date but before the financial statements are issued (or available to be issued) is required to include appropriate disclosures of the nonrecognized event in its financial statements. [855-10-50-3]

Further, Topic 855 indicates that sometimes a subsequent event is so significant that the best way to convey information about the event may be by providing pro forma financial data. Therefore, an entity may present a pro forma balance sheet in the notes to the financial statements showing the effects of fresh-start reporting on the period-end balances. [855-10-50-3]

In this circumstance, an emerging entity also makes the disclosures required by Subtopic 852-10. [852-10-50-7]

Question 5.3.240 Is a private entity required to include the pre-emergence stub period in its post-emergence financial statements?

Interpretive response: No. A private entity is not required to include the pre-emergence stub period in its post-emergence financial statements unless required by banking or other agreements. Therefore, if a private entity with a calendar year-end emerges from a Chapter 11 bankruptcy on June 30 and applies fresh-start reporting, it is permitted to include only the post-emergence six-month period in its first set of post-emergence financial statements. [205-10-45-2]

5.4 Entities not qualifying for fresh-start reporting

Excerpt from ASC 852-10

• > Reporting by Entities Not Qualifying for Fresh-Start Reporting'

45-29 Entities emerging from Chapter 11 that do not meet the criteria in paragraph 852-10-45-19 do not qualify for fresh-start reporting. Liabilities compromised by confirmed plans shall be stated at present values of amounts to be paid, determined at appropriate current interest rates. Forgiveness of debt, if any, shall be reported as an extinguishment of debt and classified in accordance with Subtopic 220-20.

An entity that does not meet both criteria for fresh-start reporting continues to apply other US GAAP and discontinues applying Subtopic 852-10 on emergence from bankruptcy. The pre- and post-emergence periods are treated as a continuation of the same reporting entity. [852-10-45-29]

Question 5.4.10 Does an entity not qualifying for fresh-start reporting apply the guidance on troubled debt restructurings?

Interpretive response: Generally, no. The guidance on troubled debt restructurings in Subtopic 470-60 does not apply when most of the amount of an entity’s liabilities is restructured in a bankruptcy case and there is a general restatement of the entity’s liabilities, which is usually the case when an entity emerges from bankruptcy. [470-60-15-10, 55-1]

However, if some but not most of the amount of an entity’s liabilities are restructured on emergence, judgment may be required to determine whether an entity should apply the guidance on troubled debt restructurings (see also [Questions 4.4.40](#) and [4.4.50](#)).

Example 5.4.10 General restructuring of liabilities in a bankruptcy

ABC Corp. is a calendar year-end company. On November 15, 20X8, ABC filed a prepackaged bankruptcy under Chapter 11.

Under the arrangement, which was confirmed by the Court, the parties agreed that the existing shareholders would retain control of ABC and that ABC’s debt would be restructured as follows.

	Pre-bankruptcy amount	Restructured amount
Shareholder subordinated debt	65,430	25,000
Revolving line of credit	3,540	2,832
Loan payable	1,350	1,080
Standby letter of credit	375	300
Senior notes payable	5,465	5,465
Total	76,160	34,677

Because most of the amount of ABC’s liabilities is being restructured and the restructuring is subject to Court approval, it is not a troubled debt restructuring and Subtopic 470-60 does not apply. The compromised liabilities are remeasured as of the emergence date at the present value of the amounts to be paid.

Question 5.4.20 Can an entity not qualifying for fresh-start reporting offset its accumulated deficit against paid-in capital?

Interpretive response: No. Offsetting an accumulated deficit against paid-in capital is appropriate only when an entity emerging from Chapter 11 qualifies for fresh-start reporting (see [Question 5.3.150](#)). [852-10-45-29]

Question 5.4.30 How does an entity not qualifying for fresh-start reporting recognize a liability subject to compromise that ultimately was not compromised?

Interpretive response: We believe that the liability should be recognized at an amount equal to what the historical liability amount would have been on emergence if it had never been classified as subject to compromise.

We believe this is consistent with the following requirements in Subtopic 852-10. [852-10-45-6]

- premiums, discounts and debt issuance costs on liabilities that are not subject to compromise are not adjusted (see [Question 4.4.20](#)); and
- liabilities subject to compromise are reclassified to not subject to compromise if new or better information becomes available (see [Question 4.3.20](#)).

The effect of any adjustment is included in reorganization items.

Example 5.4.20 Claim reclassified from subject to compromise to not subject to compromise

ABC Corp. has outstanding debt of \$150 that was issued at a discount of \$10. ABC experienced financial difficulty and filed a petition for Chapter 11 bankruptcy.

Based on the estimated fair value of the collateral securing the debt, ABC believed that the outstanding debt was undersecured and subject to compromise. Therefore, in its financial reporting during the reorganization, ABC recognized the outstanding debt at the expected amount of the allowed claim, which was par value; there was no unpaid interest. ABC derecognized the \$10 discount by recognizing an expense as part of reorganization items (see [Question 4.4.10](#)).

Before ABC's emergence from bankruptcy, ABC experienced a significant increase in the demand for its products. As a result, the outstanding debt was not compromised and remained as a post-emergence obligation at full contract value. ABC did not qualify for fresh-start reporting.

In this example, the debt ultimately was not compromised. Therefore, on emergence, ABC reclassifies the debt out of liabilities subject to compromise

and recognizes a debt discount of \$8 (\$10 less amortization of \$2) equal to the amount that would have been recognized on the date of emergence if the debt had never been classified as a liability subject to compromise. The debt discount is recorded as a reduction to the carrying value of the debt. The effect of reinstating the debt discount is included in reorganization items. The subsequent amortization of the discount is included in interest expense.

Question 5.4.40 Can an entity not qualifying for fresh-start reporting adopt a new Accounting Standards Update that is not yet effective?

Interpretive response: Only if the new ASU permits early adoption. The emerging entity should comply with the transition requirements of the new accounting standard.

Question 5.4.50 Can an entity not qualifying for fresh-start reporting change its accounting policies on emergence?

Interpretive response: Only if the new accounting policy is preferable. We believe an entity emerging from bankruptcy that does not meet the criteria for fresh-start reporting must follow the guidance in Topic 250 when changing an accounting policy. This is because the emerging entity is not considered a new reporting entity. [250-10-45-2]

Question 5.4.60 What disclosures should an entity not qualifying for fresh-start reporting consider?

Interpretive response: Subtopic 852-10 contains no specific disclosure requirements for an entity that does not qualify for fresh-start reporting. Other US GAAP continues to apply. We believe an entity emerging from bankruptcy should consider disclosing the following.

- A detailed discussion of emerging from bankruptcy, such as:
 - how the entity will conduct its business;
 - how the entity's capital is structured on emergence;
 - how many and what kind of equity securities were distributed to creditors; and
 - which businesses were ceased or subsidiaries were sold.
- An explicit statement that the criteria for applying fresh-start reporting on emergence were not met.

- The amount of contractual interest not paid or accrued on prepetition liabilities that were not allowed.
 - Detail and explanation of reorganization items, such as:
 - gain on discharge of prepetition liabilities;
 - professional fees; and
 - adjustments to the carrying amounts of allowed claims.
-

5.5 Considerations regardless of whether fresh-start reporting applies

Question 5.5.10 Can reorganization expenses be recorded in a period after the entity emerges from bankruptcy?

Interpretive response: Yes. Expenses that qualify as reorganization items are presented as such in the accounting periods in which those expenses qualify for recognition under US GAAP. We believe this is consistent with the statement in Subtopic 852-10 that entering Chapter 11 bankruptcy does not change the application of US GAAP. Therefore, if GAAP requires a reorganization item to be expensed in a period after emergence, that timing should not change the fact that it is a reorganization item. [852-10-45-1]

Additionally, certain reorganization expenses such as fees for attorneys and other bankruptcy advisors are often incurred after the emergence date. [852-10-45-9]

Question 5.5.20 Can an entity's segment reporting change after emerging from bankruptcy?

Interpretive response: Possibly. If an emerging entity's organizational structure changes, it should reconsider the criteria for determining its reportable segments. The chief operating decision maker may change or may review new or different information to allocate resources and assess performance after emergence. Similar to presenting discontinued operations, we believe it is appropriate to adjust the segment disclosures retrospectively in the financial statements of the predecessor after applying fresh-start reporting. [280-10-50-34]

5.6 Accounting by group entities that did not file for bankruptcy

Question 5.6.10 Can a subsidiary that was not in bankruptcy apply pushdown accounting upon its parent's emergence from bankruptcy?#

Background: Under Subtopic 805-50, pushdown accounting is allowed, but not required, when a change-in-control event occurs. [805-50-25-4 – 25-9]

Parent has a wholly owned subsidiary. Parent files for bankruptcy and on emerging from bankruptcy applies fresh-start reporting. The subsidiary did not file for bankruptcy. Parent continues to control the subsidiary post-emergence, but no single entity, creditor or shareholder obtained control of Parent on emerging from bankruptcy.

Interpretive response: Yes, we believe a subsidiary that did not file for bankruptcy may elect to apply pushdown accounting provided the parent company (or any intermediate parent company) meets the criteria for fresh-start reporting. We believe that pushdown accounting can be applied when a parent meets the criteria to apply fresh-start reporting because the parent is considered a 'new' reporting entity post-emergence.

This same conclusion would also apply even if the subsidiary also filed for bankruptcy, but did not qualify for fresh-start reporting on its own. As long as the parent qualifies to apply fresh-start reporting, pushdown accounting can be applied to the controlled subsidiary.

See additional guidance on pushdown accounting in section 27 of KPMG Handbook, [Business combinations](#).

Question 5.6.20 How does a non-bankrupt parent account for a deconsolidated bankrupt subsidiary when the subsidiary emerges from bankruptcy?

Background: A parent entity usually deconsolidates a subsidiary that files for bankruptcy; this is regardless of whether it had a controlling financial interest through the voting interest entity model or variable interest entity model (see [Questions 4.11.40](#) and [4.11.50](#)).

Interpretive response: If the parent previously deconsolidated the subsidiary while in bankruptcy, the parent should first evaluate whether the emerging entity is a VIE and, if so, whether the parent is the primary beneficiary. If the emerging entity is not a VIE, the parent should evaluate whether it controls the entity using the voting interest entity model. In either case, if the parent is required to consolidate the emerged entity and that entity meets the definition of a business, the parent should apply the acquisition method under Topic 805. [805-10-25-1, 810-10-05]

5.7 Additional requirements for SEC registrants

The financial statement disclosure requirements are determined under Subtopic 852-10, but additional disclosure of certain information outside of the primary annual and interim financial statements is required under Regulation S-K on emerging from bankruptcy.

An entity is required to file an Item 1.03 Form 8-K within four business days of the approval of its plan of reorganization or liquidation by a court or governmental authority.

The Form 8-K should disclose: [\[Form 8-K Item 1.03\]](#)

- the identity of the Court or governmental authority;
- the date that the order confirming the plan was entered into by the Court or governmental authority;
- a summary of the material features of the plan and a copy of the confirmed plan (pursuant to Item 9.01);
- the number of shares or other units of the registrant or its parent issued and outstanding, the number reserved for future issuance in respect of claims and interests filed and allowed under the plan, and the aggregate total of such numbers; and
- the assets and liabilities of the registrant or its parent as of the date that the order confirming the plan was entered, or a date as close thereto as practicable (i.e. an audited balance sheet).

Section 1141 of the Code states that a confirmed plan of reorganization is binding on all parties at the confirmation date, defined as the date the Court approves the plan of reorganization. The effective date is the date the plan of reorganization goes into effect, usually within a short period of time after confirmation of the plan when all conditions precedent are met. See discussion in [section 5.3.10](#).

Therefore, the date the Court confirms the plan of reorganization is generally the date that should be used to apply the Form 8-K reporting requirements because it is the date that the respective governmental authority having jurisdiction in the matter has confirmed the plan of reorganization, thereby making it binding on all parties.

A registrant is required to file a Form 8-K in connection with an amendment to a material definitive agreement. A modification, exchange or extinguishment of debt either before or on emergence from bankruptcy may trigger this requirement.

Description of business

A registrant is required under Item 101 of Regulation S-K to include information in the Form 10-K and most registration statements about the development of the registrant's business during the past five years, including any bankruptcy. This information should include the effect a bankruptcy has had on the registrant's structure and capitalization. Other items for consideration in the business discussion section in Form 10-K may include: [\[Reg S-K Item 101\]](#)

- background information regarding the bankruptcy with an emphasis on the plan of reorganization;
- distributions provided for under the Plan of Reorganization confirmed by the Court; and
- any other information, such as ceased operations and sold subsidiaries.

Results of operations

A registrant is required to analyze the periods covered by the financial statements in its MD&A. This analysis should include a discussion of trends and changes based on the financial statements included in the filing. If on emergence from bankruptcy a registrant qualifies for fresh-start reporting, it presents its financial statements for the predecessor and successor periods. The registrant should not combine the predecessor and successor periods within its MD&A. [Reg S-K Item 303]

Pro forma financial information

A registrant is required to provide investors with pro forma financial information if events or transactions have occurred or are probable for which disclosure of pro forma financial information would be material, such as applying fresh-start reporting on emerging from bankruptcy. [SEC FRM 3160.1]

A registrant that emerged from bankruptcy may provide supplemental pro forma results for the combined reporting period and discuss and analyze those results by comparing them to the pro forma results for the immediately preceding period. Generally, the SEC staff would not expect a registrant to provide pro forma results for earlier periods, other than perhaps revenue and cost of sales. If a registrant believes that additional details for prior periods are necessary to understand the implications of fresh-start reporting, it is encouraged to discuss the issue with the SEC staff before filing. [SEC FRM 9220.7 – 9220.8]

Pro forma adjustments

A registrant's pro forma statement of operations should reflect adjustments to eliminate nonrecurring costs directly related to the bankruptcy and not reflective of continuing operations. These adjustments may include legal and professional fees directly related to the bankruptcy, fees for claims administration, changes to allowed claims compared to previously recognized amounts and debt issuance costs related to debtor-in-possession financing. Although not included in the pro forma statement of operations, these amounts should be reflected in historical liabilities and retained earnings in the pro forma balance sheet. [SEC FRM 3230.4]

The SEC staff believes the pro forma adjustments should exclude the reversal of previously recognized impairment losses because they are unrelated to resolution of the bankruptcy, even though after applying fresh-start reporting those impairment charges likely would not have been necessary.

Question 5.7.10 Does a registrant evaluate whether fresh-start reporting will apply before it emerges from bankruptcy?

Interpretive response: Generally, yes. The sooner a registrant knows fresh-start reporting will likely apply, the more time it will have to prepare pro forma financial statements. Whether fresh-start reporting actually applies is not finally determined until the emergence date, so an entity will need to project its reorganization value, allowed claims and postpetition liabilities, and update those projections as the bankruptcy case progresses and more information becomes available.

Question 5.7.20 Does pro forma financial information in connection with a registration statement reflect the effect of fresh-start reporting?

Background: On July 15, Year 2, ABC emerged from bankruptcy. ABC met the criteria to apply fresh-start reporting on emerging from bankruptcy. In September Year 2, ABC filed a registration statement in connection with issuing debt securities.

Interpretive response: Yes. Emerging from bankruptcy is generally an event that would be material to investors that requires:

- a pro forma condensed balance sheet as of the end of the most recent period for which a consolidated balance sheet is required; and
- pro forma condensed statements of operations for the most recent fiscal year and for the period from the most recent fiscal year-end to the most recent interim date.

Therefore, in the background example, ABC includes in its registration statement:

- a pro forma condensed balance sheet as of June 30, Year 2; and
- pro forma condensed statements of operations for the year ended December 31, Year 1 and for the six months ended June 30, Year 2.

The pro forma financial information is prepared by applying adjustments to historical financial statements that give effect to the plan of reorganization and fresh-start reporting, as if the emergence date had occurred on January 1, Year 1 for the pro forma statement of operations and on June 30, Year 2 for the pro forma condensed balance sheet.

When preparing the pro forma condensed statement of operations for the year-ended December 31, Year 1 and for the six-months ended June 30, Year 2, ABC should include the effect of:

- issuing the debt securities; and
- the reorganization and fresh-start adjustments as if they had occurred on January 1, Year 1 – i.e. on the first day of the period presented. Common pro forma adjustments include removing reorganization adjustments related

to the plan of reorganization and revising historical interest expense for the entity's post-emergence debt position.

The pro forma condensed balance sheet as of June 30, Year 2 includes reorganization and fresh-start adjustments, such as adjustments to reflect the debt issued as part of the reorganization and to remove liabilities subject to compromise that were settled as part of the reorganization.

While the effect of fresh-start reporting is not related (directly or indirectly) to issuing debt securities, we believe the effect of the fresh-start adjustments is so significant to the results of operations for Year 1 that it is appropriate to include the pro forma effect of the fresh-start adjustments. Giving effect to the fresh-start adjustments in the pro forma statement of operations provides information on a consistent basis of accounting – as opposed to giving effect to highly judgmental estimates of how historical management practices and operating decisions may or may not have changed. We believe this presentation provides more meaningful information to the reader of the pro forma financial information than solely giving pro forma effect to issuing the debt securities.

Subtopic 852-10 glossary

Excerpt from ASC 852-10

Absolute Priority Doctrine

A doctrine that provides that if an impaired class does not vote in favor of a plan, the court may nevertheless confirm the plan under the **cram-down provisions** of the **Bankruptcy Code**. The absolute priority doctrine is triggered when the cram-down provisions apply. The doctrine states that all members of the senior class of creditors and equity interests must be satisfied in full before the members of the second senior class of creditors can receive anything, and the full satisfaction of that class must occur before the third senior class of creditors may be satisfied, and so on.

Administrative Expenses

Claims that receive priority over all other unsecured claims in a bankruptcy case. Administrative expenses (sometimes referred to as administrative claims) include the actual, necessary costs and expenses of preserving the estate, including wages, salaries, or commissions for services rendered after the commencement of the case. Fees paid to professionals for services rendered after the petition is filed are considered administrative expenses.

Allowed Claim

The amount allowed by the **Bankruptcy Court** as a claim against the estate. This amount may differ from the actual settlement amount.

Automatic Stay Provisions

Provisions causing the filing of a petition under the **Bankruptcy Code** to automatically stay virtually all actions of creditors to collect prepetition debts. As a result of the stay, no party, with minor exceptions, having a security or adverse interest in the debtor's property can take any action that will interfere with the debtor or the debtor's property, regardless of where the property is located or who has possession, until the stay is modified or removed.

Bankruptcy Code

A federal statute, enacted October 1, 1979, as title 11 of the United States Code by the Bankruptcy Reform Act of 1978, that applies to all cases filed on or after its enactment and that provides the basis for the current federal bankruptcy system.

Bankruptcy Court

The United States Bankruptcy Court is an adjunct of the United States District Courts. Under the jurisdiction of the District Court, the Bankruptcy Court is generally responsible for cases filed under Chapters 7, 11, 12, and 13 of the Bankruptcy Code.

Chapter 11

A reorganization action, either voluntarily or involuntarily initiated under the provisions of the **Bankruptcy Code**, that provides for a reorganization of the

debt and equity structure of the business and allows the business to continue operations. A debtor may also file a plan of liquidation under Chapter 11.

Chapter 7

A liquidation, voluntarily or involuntarily initiated under the provisions of the **Bankruptcy Code** that provides for liquidation of the business or the debtor's estate.

Claim

As defined by Section 101(4) of the **Bankruptcy Code**, a right to payment, regardless of whether the right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, secured, or unsecured, or a right to an equitable remedy for breach of performance if such breach results in a right to payment, regardless of whether the right is reduced to a fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured right.

Confirmed Plan

An official approval by the court of a plan of reorganization under a **Chapter 11** proceeding that makes the plan binding on the debtors and creditors. Before a plan is confirmed, it must satisfy 11 requirements in section 1129(a) of the **Bankruptcy Code**.

Consenting Classes

Classes of creditors or stockholders that approve the proposed plan.

Cram-Down Provisions

Provisions requiring that for a plan to be confirmed, a class of **claims** or interests must either accept the plan or not be impaired. However, the **Bankruptcy Code** allows the **Bankruptcy Court** under certain conditions to confirm a plan even though an impaired class has not accepted the plan. To do so, the plan must not discriminate unfairly and must be fair and equitable to each class of claims or interests impaired under the plan that have not accepted it. The Bankruptcy Code states examples of conditions for secured claims, unsecured claims, and stockholder interests in the fair and equitable requirement.

Debtor-in-Possession

Existing management continuing to operate an entity that has filed a petition under **Chapter 11**. The debtor-in-possession is allowed to operate the business in all Chapter 11 cases unless the court, for cause, authorizes the appointment of a **trustee**.

Disclosure Statement

A written statement containing information approved as adequate by the court. It is required to be presented by a party before soliciting the acceptance or rejection of a plan of reorganization from creditors and stockholders affected by the plan. Adequate information means information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor's records, that would enable a

hypothetical reasonable investor typical of holders of **claims** or interests of the relevant class to make an informed judgment about the plan.

Emerging Entity

An entity (sometimes referred to as the reorganized entity), that has had its plan confirmed and begins to operate as a new entity.

Impaired Claim

In determining which class of creditors' claims or stockholders' interests must approve the plan, it is first necessary to determine if the class is impaired. A class of creditors' **claims** or stockholders' interests under a plan is not impaired if the plan leaves unaltered the legal, equitable, and contractual right of a class, cures defaults that lead to acceleration of debt or equity interest, or pays in cash the full amount of the claim, or for equity interests, the greater of the fixed liquidation preference or redemption price.

Liquidating Bank

A bank with a substantial amount of nonperforming assets may transfer some or all of those assets to a newly created bank whose stock will be distributed to existing shareholders or to new investors. The newly created bank will be a liquidating bank; that is, it will manage the assets it receives and collect cash from loan repayments or dispositions of assets. All cash remaining after paying expenses and debt service, if any, will be distributed to the shareholders of the liquidating bank. The liquidating bank will likely be in the process of liquidation for several years.

Nonconsenting Class

A class of creditors or stockholders that does not approve the proposed plan.

Obligations Subject to Compromise

Includes all prepetition liabilities (**claims**) except those that will not be impaired under the plan, such as claims in which the value of the security interest is greater than the claim.

Petition

A document filed in a court of bankruptcy, initiating proceedings under the **Bankruptcy Code**.

Plan of Reorganization

An agreement formulated in **Chapter 11** proceedings under the supervision of the **Bankruptcy Court** that enables the debtor to continue in business. The plan, once confirmed, may affect the rights of undersecured creditors, secured creditors, and stockholders as well as those of unsecured creditors. Before a plan is confirmed by the Bankruptcy Court, it must comply with general provisions of the **Bankruptcy Code**. Those provisions mandate, for example, that the plan is feasible, the plan is in the best interest of the creditors, and, if an impaired class does not accept the plan, the plan must be determined to be fair and equitable before it can be confirmed.

Postpetition Liabilities

Liabilities incurred after the filing of a petition that are not associated with prebankruptcy events. Thus, these liabilities are not considered **prepetition liabilities**.

Prepetition Liabilities

Liabilities that were incurred by an entity before its filing of a petition for protection under the **Bankruptcy Code** including those considered by the **Bankruptcy Court** to be prepetition **claims**, such as a rejection of a lease for real property.

Reorganization Items

Items of income, expense, gain, or loss that are realized or incurred by an entity because it is in reorganization.

Reorganization Proceeding

A **Chapter 11** case from the time at which the petition is filed until the plan is confirmed.

Reorganization Value

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

Secured Claim

A liability that is secured by collateral. A fully secured **claim** is one in which the value of the collateral is greater than the amount of the claim.

Terminal Value

A component of **reorganization value**.

Reorganization value calculated based on the discounting of cash flows normally consists of three parts; the discounted cash flows determined for the forecast period, the residual value or terminal value, and the current value of any excess working capital or other assets that are not needed in reorganization. Terminal or residual value represents the present value of the business attributable to the period beyond the forecast period.

Trustee

A person appointed by the **Bankruptcy Court** in certain situations based on the facts of the case, not related to the size of the entity or the amount of unsecured debt outstanding, at the request of a party in interest after a notice and hearing.

Undersecured Claim

A **secured claim** whose collateral is worth less than the amount of the **claim**. Sometimes referred to as an undersecured claim liability.

Unsecured Claim

A liability that is not secured by collateral. In the case of an undersecured creditor, the excess of the **secured claim** over the value of the collateral is an unsecured claim, unless the debtor elects in a **Chapter 11** proceeding to have the entire **claim** considered secured. The term is generally used in bankruptcy to refer to unsecured claims that do not receive priority under the **Bankruptcy Code**. Sometimes referred to as an unsecured claim liability.

Index of changes

This index lists the significant additions and changes made in this edition to assist you in locating recently added or updated content. Items that have been significantly updated or revised in this edition are identified with #.

5. Emerging from Chapter 11 bankruptcy

Question

Question 5.6.10 Can a subsidiary that was not in bankruptcy apply pushdown accounting upon its parent's emergence from bankruptcy?#

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- Debt and equity financing
- Derivatives and hedging
- Discontinued operations and held-for-sale disposal groups
- Earnings per share
- Employee benefits
- Equity method of accounting
- Fair value measurement
- Financial statement presentation
- Foreign currency
- GHG emissions reporting
- Going concern
- IFRS® compared to US GAAP
- Impairment of nonfinancial assets
- Income taxes
- Internal control over financial reporting
- Inventory
- Investment companies
- Investments
- Leases
- Long-duration contracts
- Non-GAAP financial measures
- Reference rate reform
- Research and development
- Revenue recognition
- Revenue: Real estate
- Revenue: Software and SaaS
- Segment reporting
- Service concession arrangements
- Share-based payment
- Software and website costs
- Statement of cash flows
- Tax credits
- Transfers and servicing of financial assets

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