FASB Finalizes Standard on Liquidation Basis of Accounting

Amended guidance on FASB ASC Topic 205, Presentation of Financial Statements, the Liquidation Basis of Accounting was issued in April 2013. This guidance is designed to help companies and other entities understand how to prepare financial statements when they expect to cease all of their activities and liquidate their assets. The purpose of financial statements prepared on this basis is to help investors and other claimants estimate how much they can reasonably expect to recover from the liquidation. The amended requirements take effect for financial statements of public companies, private companies, not-for-profit organizations and employee benefit plans starting no later than annual reporting periods beginning after December 15, 2013, and interim reporting periods included therein.

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To help companies apply the FASB’s guidance, this Substance of the Standard summarizes the new requirements and provides examples of when the liquidation basis should be applied.

Requirements

The amended guidance fills in a void that became more evident in the difficult economic times of 2009 through 2011 due to unusual levels of business failures or near-failures. At the time, US generally accepted accounting principles offered minimal guidance resulting in diverse practices for when and how companies and other organizations used the liquidation basis of accounting for financial reporting. ASU 2013-07 introduced consistent requirements to address three key questions:

1. When should an entity transition to the liquidation basis of accounting?

   • For most entities, the transition to the liquidation basis of accounting is required when liquidation is considered imminent (meaning the likelihood of a return from liquidation is remote) and one of the following events occurs:
     - Approval of a plan for liquidation by one or more persons with the authority to make the plan effective, provided the likelihood is remote that others can effectively block the plan.
     - Imposition of a plan for liquidation by other forces, (such as involuntary bankruptcy).
   
   • Special cases:
     - An exception is provided for a limited-life company, (such as a partnership formed to complete a particular project), that has had a liquidation plan specified in its governing documents from its inception. These companies are required to apply the liquidation
basis of accounting only if the approved plan for liquidation differs from the plan originally specified. This represents a change from the guidance in the proposed ASU which attempted to define the term “imminent” differently for entities with contractually limited lives (see MHM Messenger 15-12).

2. How should assets, liabilities, and other items (such as trademarks) be measured under the liquidation basis of accounting?

• Assets are measured at the amount of the expected cash proceeds from liquidation. This would be the amount the entity expects to collect from the disposal of the assets or the settlement of certain items, such as accounts receivable. In some cases, the entity may need to recognize assets that were not previously recognized under US GAAP, such as trademarks or patents, so that the net assets reflect all expected proceeds. These items should be measured at their gross amounts, with the expected selling costs included in the accrual of estimated disposal costs, rather than offset against the asset values.

• Liabilities are recognized and measured in accordance with the US GAAP that would otherwise apply to those liabilities. This principle means the entity should not anticipate that it will be legally released from being the primary obligor for its liabilities, either judicially or by the creditors. Liabilities are not written down until they are legally forgiven. When this principle is applied to employee benefit plans, it means that a plan terminated by the plan sponsor would not need to recognize participant account balances as liabilities, even though those assets would be distributed in liquidation.

• The entity is required to accrue costs to sell its assets. In addition, the entity is required to accrue any income that it expects to collect during liquidation, provided it has a reasonable basis for estimating that income.

3. What information should an entity disclose in financial statements prepared using the liquidation basis of accounting?

• Since the measurements required for the liquidation basis of accounting will likely require judgment, entities need to provide a number of disclosures, including the following:
  - A disclosure that the statements are prepared using the liquidation basis of accounting, including the facts and circumstances surrounding the adoption of this basis and the entity’s determination that liquidation is imminent.
  - A description of the entity’s plan for liquidation, (including the manner in which it expects to dispose of its assets and other items that had not been previously recognized, the manner in which it expects to settle its liabilities, and the date by which the entity expects to complete the liquidation).
  - The methods and significant assumptions used to measure the assets and liabilities.
  - The type and amount of costs and income accrued, including the time horizon of the accrual.

At a minimum, the financial statements must include a statement of net assets in liquidation and a statement of changes in net assets in liquidation. Although the accounting standard does not specifically require a statement of net assets as of the date the liquidation becomes imminent, this information is needed to prepare the statement of changes in net assets in liquidation for the first period in which liquidation becomes imminent.

Transition guidance and effective date

When an entity applies the guidance for the first time, it should apply the guidance prospectively as of the date the liquidation becomes imminent. The transition guidance differs depending on whether the entity is already using the liquidation basis of accounting as of the effective date or depending on whether it prepares financial statements for the stub period.
The requirements introduced in ASU 2013-07 are effective for financial statements of public companies, private companies, not-for-profit organizations and employee benefit plans starting no later than annual reporting periods beginning after December 15, 2013 and interim reporting periods included therein. Early adoption is permitted.

For more information

If you have any specific questions or concerns, please share them with Keith Peterka or Hal Hunt of MHM’s Professional Standards Group or your MHM service professional. Keith can be reached at 610-862-2744 or kpeterka@cbiz.com. Hal can be reached at 913-234-1102 or hhunt@cbiz.com.

Examples

The following examples are adapted from the examples provided in ASU 2013-07.

Example No. 1 - Unplanned liquidation

Facts: A manufacturing company began experiencing financial difficulties in early 2009 due to declining market demand for its products. The company’s board of directors approved a plan for liquidation on Sept. 11, 2009. The board had the authority to make the plan effective, and there were no other parties who could block the execution of the plan. The likelihood that the company would return from the liquidation was remote.

Question: When should the company begin applying the liquidation basis of accounting?

Answer: As of Sept. 11, 2009, the date the board approved the plan.

Example No. 2 – Liquidation plan that differs from the originally specified plan

Facts: The governing documents of a limited-life entity specify its contractual life will end in Year 10. On March 11, 2009, which was Year 6 of the entity’s life, the entity’s board of directors determined that the entity would not be able to meet its debt obligations, and the board voted to begin liquidating the entity. Approval from a third party was required to make the plan effective. That approval was obtained on April 11, 2009. No other parties could block the execution of the plan, and the likelihood that the entity would return from the liquidation was remote. Because of the sense of urgency, the board felt the proceeds received from the sale of the assets would be less than the fair value of the assets.

Question: When should the entity begin applying the liquidation basis of accounting?

Answer: As of April 11, 2009, the date the entity obtained all the approvals needed to make the plan of liquidation effective.