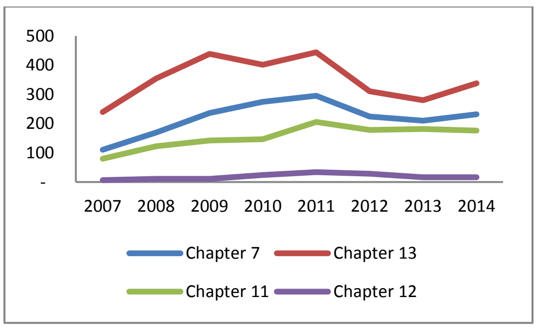
Kevane Grant Thornton

An instinct for growth™

Advisory Alert: Life after bankruptcy begins with a "fresh start" — Fresh start valuation and accounting

Commercial filings under federal bankruptcy law in Puerto Rico during calendar year 2014 totalized 762[1] filings, an increase of 76 filings or 10.6%, when compared to 2013.

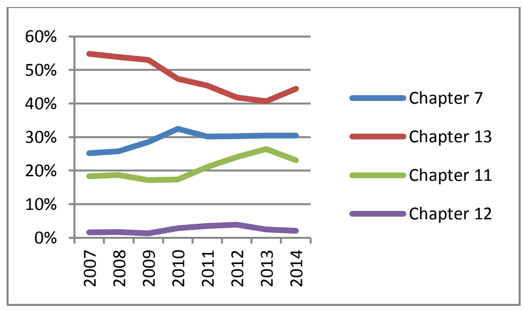
The following graph presents trends in commercial bankruptcy number of filings from 2007 to 2014, by filing type.



As seen above, after downward trends during 2012 and 2013, commercial chapter 7 (liquidation) and commercial chapter 13 (primarily reorganization of DBA's) filings increased during 2014.

Also, after increases in 2007 through 2011, the number of Chapter 11 commercial filings has remained relatively steady since 2012.

As a percentage of total commercial filings, Chapter 11 filings during 2014 show a decrease, however the percentage continues above 20% since the end of 2011, as illustrated in the following graph:



Valuation plays a central role in Chapter 11 bankruptcy negotiations and is key to a fresh start.

Let's examine the following questions:

What happens after the filing of the Chapter 11 bankruptcy petition, and how does valuation serve as the touchstone in the process?

In Chapter 11 reorganization, the objective of management and its advisors is developing a plan of reorganization (the "Plan") that will be confirmed by the Bankruptcy Court, leading to emergence from bankruptcy protection and a return to competitive operations — life after bankruptcy.

[1] Source: Boletín de Puerto Rico.

Contact us

For assistance in this matter, please contact us via ojel.rodriguez@pr.gt.com

January 19, 2015

At its simplest, Chapter 11 reorganization is a formal, court- supervised process to:

- provide temporary protection from creditors;
- maximize the value of the company, primarily through eliminating excess debt, exiting unprofitable operations, and/or revising contractual relationships;
- establish the value of the reorganized company; and
- allocate that value among the various parties having a claim against the company.

In a successful reorganization, the debtor company and its advisors prepare the Plan and a disclosure statement that groups the creditors into classes and includes an estimate of company value. The Plan becomes effective if, and when, the debtor solicits a sufficient number of votes in support of the Plan.

Central to the reorganization objective and confirmation of the Plan is the **reorganization value**, or the estimated enterprise value of the debtor company — the economic measure of what the market believes the ongoing operation is worth. Central to the reorganization value are issues such as:

- What is future cash flow capacity of the firm?
- What is the future risk profile of the firm, represented by the discount rate applied to future cash flows?
- What are the appropriate valuation multiples to be applied to firm measures such as revenue and EBITDA?

The reorganization value is crucial to creditors, since it indicates who will be paid, and how much will be paid. When the reorganization value is determined, it will establish whether or not:

- a primary secured creditor will obtain periodic payments on its restructured loan, or equity in the reorganized firm;
- general unsecured creditors might receive some return on their pre- petition claims; and
- holders of former equity interests will retain any continuing stake in the reorganized firm.

Although it is the responsibility (and exclusive right for a specified period) of the debtor's management to file the Plan and disclosure statement, in rare cases, other parties in interest (typically creditors) may petition to file an alternate reorganization plan. Generally, competing plans arise from differing views on what the company is worth.

Fresh start valuation and accounting – what is it and why is it important?

Confirmation of the Plan leads to another requirement for valuation in the bankruptcy process – fresh start valuation and accounting. Upon emergence from bankruptcy, management is required to apply the provisions of fresh start accounting to its financial statement in accordance with Generally Accepted Accounting Principles ("GAAP"). Under fresh start accounting, a new reporting entity, the "successor company," is created, and the recorded amounts of assets and liabilities are adjusted to reflect their fair value. As a result, the historical financial statements of the pre-bankruptcy firm are generally not comparable to those of the successor company.

Entities, whether public or private, must comply with Section 852 of the Financial Accounting Standards Board's ("FASB") Accounting Standards Codification ("ASC"), Reorganizations. Fresh start accounting was previously covered under the AICPA's Statement of Position 90-7 ("SOP 90-7"), Financial Reporting by Entities in Reorganization under the Bankruptcy Code.

Section 852 calls for reorganizing entities to apply fair value concepts to determine both the reorganization value and new basis of financial, tangible, and intangible[2] assets in financial reporting.

For financial accounting purposes, the reorganized firm is treated similarly to a newly acquired entity. The reorganization value is allocated to company assets in compliance with ASC Section 805, Business Combinations (previously Statement of Financial Accounting Standards ["SFAS"] No. 141R). Determination of asset values also must integrate the concepts of ASC Section 820, Fair Value Measurements and Disclosures (formerly SFAS 157).

Of particular importance, though, is that determining the fair value of assets can be complicated in circumstances where a company is invested in tangible assets of a declining or displaced industry, which could be impacted by functional or economic obsolescence, or when the distress encountered by the company prior to and during bankruptcy could have created negative associations that would impact intangible value. Valuation involving these factors must be robust to withstand review by third parties.

Fresh start valuation and accounting follows the reorganization process and establishes the financial reporting foundation that will serve as the company's blueprint for life after bankruptcy. The quality of the valuation can make a significant impact on the determination of value and not all valuations are created equal.

What are the implications of "fresh start" valuation?

Although the firm will assume a financial reporting position that will maximize depreciation and amortization through a re-set of the tangible and intangible asset basis, the de facto stock acquisition treatment for tax reporting in fresh start will likely result in differences between financial and tax reporting. Previously fully depreciated assets used in operations will again have a depreciable tax basis that throws off depreciation. Previously unrecognized internally developed intangible assets will be recorded on the balance sheet and generate prospective amortization. After completion of the fresh start valuation, the generation of a deferred tax liability could result in the creation of goodwill on the reorganized company's balance sheet.

---

[2] On December 23, 2014, the FASB issued ASU 2014-18, which provides alternative accounting for a **private company** that recognizes or considers the fair value of identifiable intangible assets upon the adoption of fresh-start accounting. The accounting alternative is effective prospectively upon the first eligible transaction entered into in an annual period beginning after December 15, 2015 (with early adoption permitted), and will apply to all future transactions after the adoption date. The alternative will help private companies reduce the cost and complexity of accounting for a business combination and other eligible transactions because many customer-related intangible (CRI) assets and all non-compete agreements (NCAs) would not be recognized separately and would be subsumed into goodwill.

Of additional concern is the circumstance where the entity's operations encompass more than one reporting unit. The fresh start valuation must then proceed to establish the fair values of the tangible and intangible assets in a manner that is cognizant of the future impairment testing of long- lived assets or goodwill under ASC 360- 10-30, *Property, Plant and Equipment*, or ASC 350, *Intangibles - Goodwill and Other*, respectively

Several factors will also impact the cost structure of the post-bankruptcy company. During reorganization, the company has the opportunity to shed itself of leases with financially unfavorable terms, a true advantage where lease costs are material.

Interest expense, a significant pre-bankruptcy cost, may be significantly reduced, leading to cash preservation. Unprofitable operations may be exited. The post-emergence company will be newly competitive in a manner that may lead rival companies that forestalled bankruptcy to find themselves in a condition of "bankruptcy envy." Perhaps, however, the lingering damage of bankruptcy to customers' perceptions will weed out the formerly weak performers. Every bankruptcy cycle presents these same questions – what value remains in distressed and/or over- levered companies, and how will the market respond to reorganization?

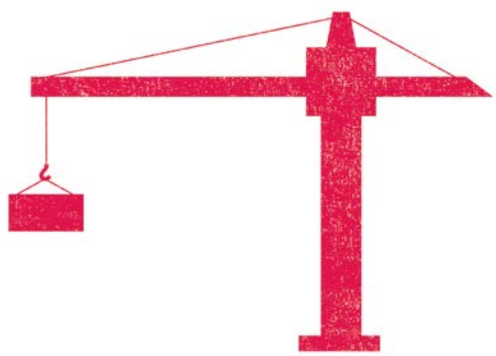
The bottom line

Bankruptcies have been and most likely will continue to be on the rise for some time, and while this unprecedented environment is challenging, it presents many opportunities for those who understand how to strategically manage the process. In some cases, post-bankruptcy companies gain a competitive advantage as they emerge in a solvent position.

Insightful valuation analytics during this process are key to the best possible outcome and provide a solid foundation for a fresh start.

There are many tough questions presented by the bankruptcy process that can best be addressed by trusted advisors who specialize in restructuring, reorganization and valuation.

Our advisory services professionals stand ready to help you address the issues of life before, during and after the bankruptcy process. We help our clients with today's toughest business issues and offer the experience and expertise of fully cross-functional teams to help get you back on the road to opportunity.



Call us to make an appointment with one of our experienced advisors. Consultations are completely confidential.