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Re: Exposure Draft: Proposed Accounting Standards Update – *The Liquidation Basis of Accounting* (the “Exposure Draft”), File Reference No. 2012-210

The Association of Insolvency and Restructuring Advisors (“AIRA”) is a nonprofit professional association whose approximately 4,000 members serve as financial advisors, accountants, crisis managers, business turnaround consultants, lenders, investment bankers, attorneys, trustees, and in other positions involved in the fields of business turnaround, restructuring, bankruptcy, and insolvency. From these positions, our membership has significant experience with matters involving the accounting and reporting requirements of companies in reorganization and liquidation, and in the gray area between the two.

Members of AIRA’s technical committee have deliberated the above referenced exposure draft and have the following comments. If you would like additional discussion with AIRA, please contact Grant Newton, Executive Director, AIRA at 541-858-1665, [gnewton@aira.org](mailto:gnewton@aira.org).

AIRA agrees that there is a need for additional guidance as to when an entity should apply liquidation basis accounting and for principles to be applied in measuring assets and liabilities under the liquidation basis of accounting, as well as required disclosures. This guidance should be applicable to both public and non-public entities in liquidation.

## **Amendments to the Master Glossary**

Liquidation – the last section of the definition referring to acquisition or merger is unclear. As worded, the statement implies the perspective of an acquirer not the seller or liquidator. In addition, as discussed below under “Recognition”, the practice of liquidating an enterprise while still under court supervision in a Chapter 11 proceeding under the Bankruptcy Code does not lend itself to liquidation basis accounting. We believe that the same factors cited for the treatment of limited life entities apply to debtors in a Chapter 11 proceeding and that the statement should be worded along the following: “Dissolutions that may commence under Chapter 11 of the Bankruptcy Code before the confirmation of a plan or conversion to a case under Chapter 7 do not qualify as liquidations. Dissolutions through a going concern merger and acquisition sale of assets or businesses do not qualify as liquidations.”

The definitions of the major statements (Statement of Changes in Net Assets in Liquidation and Statement of Net Assets in Liquidation) refer to “net assets available for distribution to investors and other claimants”. This language is at odds with the priority of distribution in most situations and with the language contained in the definition, “Liquidation”. Many liquidations to which the proposed standard would apply are carried out through post-bankruptcy trusts. These trusts do not have investors but rather beneficiaries. We suggest the definition incorporate language along the following: “net assets available to creditors, other claimants, and the entity’s owners or beneficiaries”.

The definition of Statement of Net Assets in Liquidation implies that the statement would not include entities’ obligations that existed prior to commencing the plan of liquidation. For example, assume that an entity has assets with a going concern value of \$100 and an amount owed to a vendor of \$75. The entity enters into a plan of liquidation valuing its assets at \$70, estimating the cost to liquidate those assets at \$10, and expecting to incur administrative costs in the wind-down of \$10. Does the entity report Net Assets in Liquidation of \$50 (\$70 minus \$10, minus \$10) that are available to distribute on its obligation to the vendor of \$75, or does the entity report Net Assets in Liquidation of \$(25)?

Considering the different capital structures/beneficiaries that entities in liquidation could have, depending on whether the liquidation is occurring within a court proceeding (Chapter 7, state court receivership, etc.) or out of court (orderly wind-down, an assignment for the benefit of creditors,

liquidating trust, etc.), we believe the Statement of Net Assets in Liquidation should present the estimated liquidation value of an entity's assets offset by the costs to liquidate and the costs to administer the liquidation (the costs described in 205-30-30-2 and 205-30-30-3 of the Exposure Draft).

In order to provide information that parties in interest require to interpret the anticipated results of liquidation either in a separate statement or in footnote disclosure, the following details should be provided in the financial statements:

- In situations where the entity has secured debt, secured obligations should be segregated from unsecured obligations. The assets comprising the security for the debt should be segregated and identified as comprising security for the related debt.
- All other liabilities should be classified according to priority of payment under applicable law or other agreement. If there are differences between the entity's estimate of allowed claims and liabilities to be satisfied from liquidation proceeds and the claims asserted by creditors and other parties in interest, the amount of those differences should be disclosed.
- Items such as preferred stock with preference in liquidation should be stated at the amount of the liquidation preference.
- After the initial measurement period, the disclosures discussed above should be accompanied by an explanation of the changes in the amounts disclosed since the prior reporting period.

### **Recognition**

205-30-25-2 b. references the example of involuntary bankruptcy. This example should be revised along the following: "for example, the entry of either a voluntary or involuntary order under Chapter 7 of the Bankruptcy Code". An involuntary bankruptcy filing by creditors may request an entry of an order under either Chapter 11 (the reorganization section of the Bankruptcy Code) or under the liquidation provisions of Chapter 7 of the Bankruptcy Code. In either case, the debtor has a period to respond to the court to consent to or to seek to amend the order or to seek to have the petition dismissed.

Accordingly, it is only after the debtor's response (which may also seek to have the petition under Chapter 7 converted to an order under Chapter 11) and the court's order that the liquidation basis of accounting might be required.

Many large and complex Chapter 11 cases are conducted as what are commonly referred to as "Liquidating Elevens". These are Chapter 11 cases during which the debtor's businesses or other assets are sold through going concern M&A procedures, auction, and sales following procedures under section 363 of the Bankruptcy Code (so called "363 sales"). An example of such a case would be the current Chapter 11 bankruptcy of Nortel Networks Inc. ("NNI") in the District of Delaware. Since 2009 NNI has been liquidating its businesses and assets through 363 sales approved by the bankruptcy court. NNI has operated its businesses as going concerns and has maintained operations in support of the transition of the businesses sold. Eventually, NNI expects to confirm a plan which may result in a liquidating trust to wrap up the litigation and affairs remaining from the bankruptcy. Given the complex nature of NNI's operations, litigation and settlement activity to address, among other things, employee commitments, and issues with multi-jurisdictional insolvency proceedings, application of liquidation basis accounting to NNI's reporting would not be meaningful or reasonably feasible.

Although the accounting prescribed in ASC Section 852-10-05-2 indicates that it only applies to "entities that have filed petitions...and expect to reorganize as going concerns", NNI applied the requirements of ASC Section 852 to its financial reporting because to do otherwise would not have provided meaningful information to the many parties in interest to the NNI bankruptcy cases.

Even in the case of a Liquidating Eleven, some form of reorganized entity may result. Prior to selling its patent portfolio, NNI contemplated reorganizing around a new company which would license its technology. Despite the sale of most of its businesses and intellectual property, there are still options available to NNI to emerge from bankruptcy with a reorganized entity.

In light of examples such as NNI, we believe that no case in Chapter 11 prior to either the effective date of a confirmed plan or conversion to a case under Chapter 7 should qualify for liquidation basis of accounting. Only upon the confirmation of a plan providing for liquidation or the conversion of a Chapter 11 case to a Chapter 7 case should liquidation be considered imminent.

Accepting this premise, ASC Section 852-10-05-02 should be amended to indicate that the reorganization subtopic applies to all entities that have filed petitions with the bankruptcy court under Chapter 11 of the Bankruptcy Code.

205-30-25-4 requires prospective recognition with a cumulative-effect adjustment to the statement of changes in net assets in liquidation. This is inconsistent with the treatment required for entities emerging from Chapter 11 and meeting the requirements of “fresh-start” accounting specified in ASC Section 852-10-45-21, “...the effects of the adjustments on the reported amounts of individual assets and liabilities resulting from the adoption of fresh-start reporting...shall be reflected in the predecessor entity’s final statement of operations.” Recognizing the effects of commencing a plan of liquidation is more similar than not to the recognition of the effects of implementing a plan of reorganization. Both from an economic view and a practical presentation view, the adjustments transitioning the entity from going concern accounting to liquidation basis accounting should be reflected in the entity’s final statement of operations. The decision to adopt a plan of liquidation belongs to the period prior to the commencement of the liquidation. Presenting a statement of changes in net assets available for liquidation that begins with assets and liabilities presented on a going concern basis is inconsistent with measuring the effects of changes in the net assets available for liquidation. We believe that the cumulative effect of adopting liquidation basis accounting should be reflected in the final statement of operations of the reporting entity.

### **Initial Measurement**

Liabilities should not be measured to reflect the estimated amount of cash or other consideration that the entity expects to pay. The absence of available assets to settle liabilities does not absolve the entity of its obligations. Liabilities should be measured on the same basis or analogous to the requirements of ASC Section 852-10-45-5. Liabilities affected by the plan of liquidation should be reported at the amount of the entity’s legal obligation or such amount subject to a definitive settlement agreement. ASC Section 852-10-45-6 should also be considered in the initial and subsequent measurement of liabilities.

From a practical standpoint, many entities undergoing liquidation may not have the financial wherewithal to undertake a comprehensive valuation of their historic going concern balance sheets. While many assets lend themselves to reasonably accurate estimates of liquidation values obtained on a reasonably cost effective basis, the value in liquidation of some assets, such as intellectual property, can be so speculative that any number applied could be equally misleading. In such cases the guidance here should allow for the continued presentation of assets that are not “valued” and require that those assets be identified along with the reasons therefore for the accounting treatment.

205-30-30-2 and 205-30-30-3: We believe it would be helpful in classifying the costs and income discussed in these two sections if those items were referred to by defined terms. The costs described in 205-30-30-2 may be defined in the Glossary as “Disposal Costs”, and the expenses and income described in 205-30-30-3 may similarly be defined as “Liquidation Administration” income and expense. Providing defined terms would provide additional guidance on identifying and classifying these elements.

While 205-30-30-2 provides that the costs to dispose of assets should be accrued and disclosed in aggregate separately from the measurement of those assets, the nature of the accrued costs is important information for the users of liquidation financial statements. The estimate of commission costs on the recovery of accounts receivable differs greatly from the carrying costs, taxes and commissions that could be expected to accompany the liquidation of real estate assets. Disclosure of the breakdown of the aggregate disposal costs should be required in the footnotes to the financial statements. In addition, certain disposal costs may be more appropriately classified as part of the net valuation of the related asset. In situations where the liquidation effort is outsourced, such as in the case of receivable collections to a collection agency, the more appropriate disclosure would be the net cash expected to be received from the collection agency.

### **Disclosure**

In addition to those disclosures outlined in the Exposure Draft, we believe the following are both meaningful and necessary for users of liquidation basis financial statements:

- A statement, if applicable, that the actual values realized in liquidation may be different from the estimated values in the current financial statements.
- While it may be implied in the plan and valuation description requirements of 205-30-50-1, the disclosures should specifically identify whether the anticipated liquidation and the basis for valuation reflect a forced sale of assets or an orderly liquidation. The addition of such a requirement may require the Master Glossary to include definitions of the terms “forced liquidation” and “orderly liquidation”.
- In the financial statements for a liquidating trust or other vehicle created pursuant to a confirmed Chapter 11 plan, continuing disclosure regarding the pre-discharge amount of liabilities or interests (the estimated amount of claims expected to be allowed in the Chapter 11 case), the priority of each class of liabilities or interests and the ongoing recovery claimants have received to date from the liquidating trust as a percentage of their allowed claims.

### **Other matters**

The Exposure Draft is silent on the applicability of discontinued operations accounting to Liquidation Basis financial presentations. We query whether the final standards update should include a statement that the requirements of ASC Section 205-20, *Discontinued Operations*, do not apply to liquidation basis accounting.

In connection with the preparation of a disclosure statement for a plan of reorganization, management and/or the advisors to the debtor will prepare a hypothetical liquidation analysis to estimate what creditors might otherwise receive if the debtor was to be liquidated under Chapter 7 rather than reorganized under Chapter 11 in accordance with the provisions of section 1129(a) of the Bankruptcy Code. This liquidation analysis, often referred to as the best interest of creditors’ test, is used to support the determination that creditors are receiving more under a plan proposed under Chapter 11 than they would receive if the debtor were to be liquidated under Chapter 7. This analysis is not dissimilar from the initial statement of net assets in liquidation. We believe that the final standard should contain some reference to the development of the hypothetical liquidation statement and clarify that while the



guidance contained in the standard may be useful to developing the hypothetical liquidation statement used in bankruptcy proceedings, differences exist between the hypothetical statement and a statement of net assets in liquidation and that all of the guidance in the standard may not be applicable to various bankruptcy situations.

We would be more than happy to answer any questions you may have about these comments.

Very truly yours,



Grant W. Newton, CPA, CIRA  
*Executive Director*