Liquidation Basis of Accounting

A Guide to its Relevance & Application
Authoritative Sources Used

- PPC’s Guide to Preparing Financial Statements: Section 1906, *Entities That Have Elected Liquidation*

- FASB Update 2013-07: Topic 205, *Presentation of Financial Statements-Liquidation Basis of Accounting*
When does it become necessary for an entity to prepare financial statements in accordance with the *Liquidation Basis of Accounting (LBOA)* in order to be GAAP-compliant?
When Does It Apply?

- When Liquidation is **IMMINENT**.

  - As stated in Topic 205, *Presentation of Financial Statements-Liquidation Basis of Accounting*, FASB update No. 2013-07, clause 205-30-25-1: “an entity shall prepare financial statements in accordance with the requirements of this Subtopic **when liquidation is imminent** unless the liquidation follows a plan for liquidation that was specified in the entity’s governing documents at the entity’s inception.”
When is liquidation deemed **imminent**, in turn, triggering the need for measurement under LBOA?
When a plan of liquidation has been **APPROVED OR IMPOSED**.

- As stated in Topic 205, *Presentation of Financial Statements-Liquidation Basis of Accounting*, FASB update No. 2013-07, clause 205-30-25-2: “liquidation is imminent when EITHER of the following occurs:
  - A plan for liquidation has been **approved** by the person or persons with the authority to make such a plan effective AND the likelihood is remote that any of the following will occur:
    - execution of the plan will be blocked by other parties (for example, those with shareholder rights) and
    - entity will return from liquidation
  - A plan for liquidation is **imposed** by other forces (for example, involuntary bankruptcy) and the likelihood is remote that the entity will return from liquidation.”
Determining the Need for Liquidation-Basis of Accounting (LBOA)

- Is the entity a “limited-life” entity; (i.e. was it known at inception that the entity would be liquidated?)
  - Y: LBOA should not be used.
  - N
    - Has a liquidation plan been approved? (1)
      - Y: Is there remote likelihood of blockage or return from liquidation?
        - Y: LBOA is required for conformity with GAAP.
        - N
      - N
        - Has a liquidation plan been imposed (i.e. involuntarily)? (1)
          - Y: Is there remote likelihood that the entity will return from liquidation?
            - Y: LBOA is required for conformity with GAAP.
            - N
          - N

(1) Liquidation is deemed to be IMMINENT if either of these two conditions is present.
When Does It Apply?

- What is the purpose for this distinct measurement?
To present a **MORE RELEVANT** financial position.

- Presentations of assets and liabilities at their historical bases are no longer relevant to liquidating entities, and therefore, financial statements of liquidating entities are adjusted to reflect amounts expected in liquidation. This translates into measuring assets at net realizable value (NRV) and liabilities at net settlement value (NSV).
To present ONLY RELEVANT financial statements.

- As stated in 1906.6, “there is no authoritative guidance on the presentation of financial statements of a liquidating entity. However, the financial statement references in the sample auditors’ reports in Interpretation 1 at AU-C 9700.04 imply that the statements of results of operations and cash flows presented for a going concern are unnecessary. While financial position certainly is relevant for liquidating entities, results of operations and cash flows are not. Activities consist entirely of winding down and there is no profit to report, only changes in estimated values.” [Note: As stated in 1906.5, “At the end of each reporting period, estimated values should be changed based on available information, and the changes should flow through net income.”]
Suggested Financial Statements: Pre & Post Date of Liquidation

- As stated in 1906.7, “when deciding which statements to present for the year in which the conversion occurs, the authors recommend preparing” the following statements for and as of the reporting periods, as follows:
  
  - 1/1/12-Date of Liquidation
    - Statements of Income & Retained Earnings AND
    - Statement of Cash Flows
  
  - Date of Liquidation-12/31/12
    - Statement of Changes in Net Assets in Liquidation
  
  - Date of Liquidation-12/31/12
    - Statement of Net Assets in Liquidation
**Asset Valuation**

- Measured at *Net Realizable Value*.
  
  - Net realizable value is generally equal to the selling price less the selling costs (completion and disposal). It is *expected* sales price less selling costs (e.g. repair and disposal costs). Since third-party fees, such as finder’s fees for disposing of equipment, brokerage fees, and collection agency fees, are often required in a liquidation, they should be considered in the estimates.

  In the United States, a finder's fee is the compensation given to an intermediary in a business transaction. Usually, there is a causal relationship between the one party and the intermediary (the finder), another relationship between the finder and the second party, and the two parties of the transaction would not have met if it weren't for the work of the finder. Such compensation is common in business and is regulated by contractual agreements and law in the United States. A finder's fee can also be a gift from one party of the transaction, who feel morally obligated that the profits of the transaction be shared with the finder for making that transaction possible.
Liabilities’ Valuation

- Measured at *Net Settlement Value*.
  - Estimating the settlement amounts requires judgment, but consulting with lawyers and others who have worked with liquidating entities normally provides useful information.
Adjustments to Estimates

- Estimates are rarely perfect and changes in estimated values occur. Those changes should be recognized when management becomes aware of them instead of when they are realized.

- At the end of each reporting period, estimated values should be changed (if necessary) based on available information, and the changes should flow through net income.
Equipment

- Often, used markets do not exist for specialized equipment, and a liquidating entity's only alternative may be to sell the equipment to another entity in the same industry. If the number of potential buyers is small enough, selling the equipment during the liquidation period may not be possible, and selling for scrap value may be necessary.
Differences from Going Concern GAAP to LBOA GAAP by Area

- **Assets**
  - Presentation is in order of realizability (from assets expected to be realized soonest to latest). -1906.9c.
  - No distinction between current and non-current assets. -1906.9b.

- **Liabilities**
  - Presentation is in order expected to be settled (from liabilities expected to be settled soonest to latest). -1906.9c.
  - No distinction between current and non-current assets. -1906.9b.

- **Net Assets**
  - There is no use of conventional equity titles; rather use one of two titles: 1) “Net Assets In Liquidation” or 2) “Deficiency in Net Assets.” -1906.9d.