Liquidation Basis Accounting

By **Howard B. Levy, CPA**

Until the issuance of Accounting Standards Update (ASU) 2013-07 [which introduced Accounting Standards Codification (ASC) 205-30 and amended other sections, primarily ASC 942-810, 960, 962, and 965-40], GAAP prescribed only the circumstances when the liquidation basis of accounting should be used, but offered little or no presentation guidance. Accordingly, there was considerable diversity in practice.

Basics of Liquidation Accounting

Liquidation is the process by which an entity converts its assets to cash or other assets and settles its obligations with creditors in anticipation of ceasing all operating activities. During liquidation, assets not used to settle creditors' claims are distributed to the entity's owners. Liquidation may occur voluntarily (e.g., based on economic conditions), upon a specified event (as for a limited-life entity), or involuntarily [e.g., by an entity's creditors, a court (as in bankruptcy), or other parties].

As per the expanded guidance introduced in ASU 2013-07, an entity is required to prepare its financial statements using the liquidation basis of accounting whenever liquidation is imminent, that is, when the likelihood is remote that the entity will return from liquidation, and a plan for liquidation is either 1) approved by the person or persons with the authority to make such a plan effective when the likelihood that its execution will be blocked by other parties is remote or 2) imposed by other forces, such as in an involuntary bankruptcy proceeding (ASC 205-30-25-1 and -2). When the decision to liquidate is made by others outside the control of the entity, and it is remote that the entity will return from liquidation, the entity should adopt liquidation basis accounting even without formal board or management approval.

Management must use judgment and should consider seeking the guidance of legal counsel in determining when an involuntary liquidation is imminent.

Four exceptions to the foregoing accounting requirements follow:

- If the expected liquidation is mandated under the governing documents from the entity's inception (e.g., for joint ventures or other limited-life entities), the liquidation basis is applied only if and when the approved plan differs from the one specified in the governing documents (ASC 205-30-25-3).

- In the event of a dissolution of an entity as a result of its being acquired by, or merged into, another entity in its entirety with the expectation of continuing its business, the liquidation basis is not used because such an event is excluded from the definition of “liquidation” in FASB’s Master Glossary.
- Entities that adopted the liquidation basis of accounting in accordance with the limited guidance about when and how to apply the liquidation basis provided by other ASC topics (e.g., ASC 960, 962, and 965-40 for terminating employee benefit plans) prior to the effective date of ASU 2013-07 need not comply with the provisions of ASC 205-30, but instead may continue to apply the provisions of those other ASC topics (as they were prior to the 2013 amendments) during the liquidation period (ASC 205-30-65-1b).
- Investment companies regulated under the Investment Company Act of 1940 are not subject to the provisions of ASC 205-30 (ASC 205-30-15-1).

In the words of FASB:

> Information about the past is usually less useful in assessing prospects for an enterprise’s future if the enterprise is in liquidation or is expected to enter liquidation. Then, emphasis shifts from performance to the liquidation of the enterprise’s resources and obligations. The objectives of financial reporting do not necessarily change if an enterprise shifts from expected operation to expected liquidation, but the information that is relevant to those objectives, including measures of elements of financial statements, may change (Concepts Statement 1, fn. 10).

It should be noted that the liquidation basis of accounting clearly is part of GAAP; it is an alternative to going concern accounting (also part of GAAP) that is to be applied in designated circumstances. It differs from going-concern GAAP principally in that neither the use of the historical cost model nor the presentation of historical operating results, cash flows, or a classified balance sheet are generally considered relevant.

ASC 205-30

Main provisions. The main provisions of the standard are as follows:

- Financial statements prepared using the liquidation basis of accounting are now required by GAAP to include a statement of net assets in liquidation and a statement of changes in net assets in liquidation, as well as all disclosures necessary to present relevant information about an entity’s expected resources in liquidation. Subject to the exception set forth below, the liquidation basis of accounting may be applied only prospectively from the day liquidation becomes imminent, and the initial statement of changes in net assets in liquidation may present only changes in net assets that occurred during the period since that date (ASC 205-30-45-1 and -2).
- Assets are measured at the amount of their expected cash proceeds or other consideration from liquidation, including any assets previously unrecognized under GAAP but that the reporting entity expects to either sell in the course of its liquidation or use in settling liabilities, such as trademarks or other intangibles (ASC 205-30-25-4, ASC 205-30-30-1, and ASC 205-30-50-1). ASC 205-30 does not presume that a fair value measurement pursuant to ASC 820 should be applied to all assets, especially in a forced or hurried liquidation. Such an approach might not be appropriate because it may involve distressed sales of assets (i.e., at “fire sale prices”) without a sufficient period either to market the assets or wait for an illiquid or depressed market to recover or for a highly motivated buyer to appear.
- An entity reporting under the liquidation basis is required to accrue and present separately, without discounting, the estimated disposal and other costs, including any costs associated with sale or settlement of its assets and liabilities and the estimated operating income or loss that it reasonably expects to incur during the remaining expected duration of the liquidation period (ASC 205-30-25-6 and -7 and 205-30-30-2 and -3).
- Liabilities may not be adjusted to estimated fair values (as was commonly the case prior to ASU 2013-07), but rather recognized in all respects in accordance with other GAAP (as they would have been under the going-concern basis) without providing for any expected extinguishments in advance of legal releases from the reporting entity’s primary obligation by either a court or creditors (ASC 205-30-25-5 and ASC 405-20-40-1). Thus, they may not be reduced to expected settlement values prior to settlement.

- Minimum disclosure requirements include 1) a statement that the financial statements are prepared using the liquidation basis; 2) the facts and circumstances surrounding the adoption of the liquidation basis and the entity's determination that liquidation is imminent; 3) a description of the entity's plan for liquidation, including the manner by which it expects to dispose of its assets and settle its liabilities; 4) the expected date by which the entity expects to complete its liquidation; 5) the methods and significant assumptions used to measure assets and liabilities (with any subsequent changes therein); and 6) the type and amount of costs and income accrued in the statement of net assets in liquidation and the period over which those costs are expected to be paid or income earned (ASC 205-30-50-2).
- All other disclosures required by other GAAP should continue to be made in liquidation-basis financial statements if relevant and material.

Consolidation issues. Because the liquidation basis of accounting is applied at the reporting level only for an entity in liquidation, consolidated financial statements for an entity not in liquidation, but with a subsidiary that has adopted the liquidation basis of accounting for its stand-alone financial statements, must continue to be prepared on a going-concern basis, no matter how significant the subsidiary in liquidation, and the subsidiary's financial statements should be adjusted back to the going-concern basis for inclusion in the consolidated financial statements. In such cases, the status of a subsidiary in liquidation and a summary of the likely future effects of its liquidation on the consolidated financial statements should be disclosed if material. Nevertheless, it should be considered whether the subsidiary in liquidation requires deconsolidation due to loss of control, for example due to an involuntary bankruptcy, or qualifies under GAAP for treatment as a discontinued component.

On the other hand, in the case of a reporting entity using the liquidation basis, but with a subsidiary that is not in liquidation, if the reporting entity intends to retain its controlling interest in the subsidiary until said interest and the cash proceeds of its liquidation are distributed to the owners, the subsidiary's net assets must continue to be included in the consolidated financial statements on the going-concern basis without adjustment (ASC 810-10-55-4A).

Supplemental guidance. The standard provides no illustrative financial statements or disclosures. Accordingly, sample financial statements and a sample transitional note are provided in Exhibits 1, 2, and 3, and some practical, nonauthoritative guidance is provided below.

Exhibit 1
Sample Consolidated Statement of Net Assets in Liquidation

XYZ Company
Consolidated Statement of Net Assets in Liquidation
At December 31, 20X2
(Dollars in thousands)

ASSETS	
Cash and cash equivalents	$ 900
Accounts receivable	1,900
Estimated operating income to be earned during liquidation	900
Inventory	1,440
Intangibles	500
Property, plant, and equipment	8,620
	14,260
LIABILITIES AND NET ASSETS	
Accounts payable and accrued expenses	360
Estimated operating costs and expenses to be incurred during liquidation	1,000
Estimated disposal and other liquidation costs to be incurred	760
Total liabilities	**2,120**
Net assets in liquidation available for distribution	$ 12,140
See notes to financial statements.	

Exhibit 2
Sample Consolidated Statement of Changes in Net Assets in Liquidation

XYZ Company
Consolidated Statement of Changes in Net Assets in Liquidation
For the Period from April 26, to December 31, 20X2
(Dollars in thousands)

Net assets in liquidation available for distribution as of April 26, 20X2	$ 20,040
Liquidation distribution	(6,000)
Dispositions and reevaluation of assets and liabilities	(1,900)
Net assets in liquidation available for distribution as of December 31, 20X2	$ 12,140
See notes to financial statements.	

Exhibit 3
Sample Transitional Note

The Company's board of directors approved a plan of liquidation on April 25, 20X2, and the Company determined, therefore, that liquidation is imminent. As a result, the Company changed its basis of accounting on April 25, 20X2, from the going-concern basis to a liquidation basis. A summary of changes in the carrying values of assets and liabilities to the liquidation basis as of April 25, 20X2, follows:

	In thousands
Accrual of estimated operating income to be earned during liquidation	$ 2,000
Revaluation of inventory	(550)
Addition of previously unrecorded intangibles	500
Revaluation of property, plant, and equipment	(1,400)
Accrual of estimated operating costs and expenses	
to be incurred during liquidation	(2,300)
Accrual of estimated disposal and other liquidation costs to be incurred	(2,600)
Net adjustment of net assets to liquidation basis	($ 4,350)

The differences in presentation requirements described and illustrated here effectively preclude meaningful presentations of comparative financial statements on a liquidation basis in traditional columnar form with those of pre-liquidation periods prepared on a going-concern basis. When liquidation begins after the start of a fiscal year, it is not necessary to present financial statements on the going-concern basis for the immediately preceding stub period (ASU 2013-07, para. BC18). If deemed necessary to suit the needs of users, accompanying prior stub period or annual financial statements may be presented, preferably separately. Notes, however, would typically be combined.

For practical reasons, the liquidation basis may be adopted as of a date shortly before or after the date the criteria for adoption are met (e.g., the beginning or end of the month or quarter in which such criteria are met), but only if the use of this practical expedient is disclosed and the impact of employing it is not material. The basis for such a materiality assessment should be well documented.

The statement of changes in net assets should separately present the summarized increases and decreases in net assets that are expected to result from the liquidation of net operating activities, including liquidation of dividends. Judgment may be required to segregate these activities in cases where it is difficult to distinguish the effects of liquidation from results of winding down operations during liquidation.

The liquidation basis of accounting does not apply, however, to a planned wind-down of an entity's activities that is expected at the outset to occur indefinitely over time and where the legal entity will be kept active and may continue (or increase) operations in an improved business climate. When the liquidation process is expected to occur indefinitely over a lengthy period that will likely include significant future operating decisions, the entity should carefully consider whether it has met the GAAP requirements for using liquidation accounting. In such circumstances, it may be difficult for an entity to assert that the likelihood it will return from liquidation is remote.

Because assets are measured at the amount of cash the entity expects to collect upon sale, material gains or losses on asset dispositions would be provided for in advance based on estimates, and therefore not be expected in liquidation basis financial statements. Deferred charges and other assets that will not be converted to cash or contra liabilities (e.g., deferred debt issuance costs) should be written off at the date of adoption of liquidation-basis accounting, and there should be no accumulated depreciation or amortization shown.

Pursuant to GAAP (ASC 405-20-40-1), it is not appropriate to reduce a liability that is based on contractual provisions to the extent of assets available, unless a legally binding settlement agreement has been executed with the related creditor or a court has ordered such reduction; to do so would constitute an inappropriate, premature extinguishment (rather than a revaluation) of the liability. Liabilities such as accruals measured based on estimated settlement amounts (and timing, if discounted) and without contractually specified amounts should be adjusted periodically to incorporate all changes to assumptions that are affected by the entity's decision to liquidate. Particularly when liabilities exceed the aggregate estimated liquidation value of an entity's assets, or when the estimated period of liquidation is long, there may be significant uncertainty to warrant mention in a discretionary emphasis-of-matter paragraph in an audit report.

Although technically not a change in basis, which is generally defined in the authoritative literature as a widely used alternative to U.S. GAAP and referred to as a "special purpose framework," a change from the going-concern to the liquidation basis is an accounting change consisting of the adoption of GAAP requirements necessary to recognize events or transactions that are clearly different in substance from those previously occurring. Thus, they are not considered to be "changes in accounting principle," as defined in ASC 250-10-45-1, which effectively consist solely of 1) changes prescribed or permitted by new GAAP, 2) the use of an allowable alternative accounting principle that can be justified on the basis that it is preferable, or 3) an election by a private entity of certain simplified GAAP alternatives made available only to it. Changes from the going-concern to the liquidation basis do not fit into any of these three categories and, unlike most changes in accounting principle, may never be applied retrospectively.

Transitional accounting adjustments necessary to apply the liquidation basis should not be reflected in the initial statement of changes in net assets in liquidation, since these adjustments do not reflect events or transactions of the initial liquidation period. If an entity presents financial statements for a period prior to adopting liquidation accounting (i.e., when still a going concern), the adjustments to adopt the liquidation basis of accounting also should be excluded, except to reflect asset impairments as appropriate (e.g., for goodwill). Whether the prior period is presented or not, it would be appropriate for an entity to disclose these adjustments in the year of adoption of the liquidation basis, if material, along with the fact that the preceding period was prepared on the going-concern basis even though it is not considered a "change in accounting principle" per se.

GAAP that would otherwise be applicable to the presentation of discontinued operations (or assets held for sale) does not apply when the financial statements of the reporting entity are presented on the liquidation basis.

When the threshold of imminence is met after the balance sheet date but prior to the release of the financial statements, the financial statements should continue to be prepared on a going-concern basis, with appropriate disclosure about management's plans to liquidate and consideration of pro forma subsequent events information, as if the liquidation basis of accounting had been employed in the earlier period recommended.

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