Avoiding Pitfalls in Business Combinations

Common valuation issues with fresh start accounting

From a valuation perspective, it would appear that there is little difference between fresh start accounting and a traditional business combination. However, in reality, the process can be very different. This document provides a brief overview of factors to consider when performing a valuation for fresh start accounting purposes.

Relevant accounting guidance

When a company emerges from bankruptcy, it must apply the accounting guidance that is commonly referred to as "Fresh Start Accounting". Pursuant to Financial Accounting Standards Board Topic No. 852-10 (Reorganizations – Overall), the reorganization value should be assigned to the entity's assets and liabilities in conformity with the procedures specified by ASC Topic 805.

From an accounting perspective, the application of ASC Subtopic 852-10 is often considered the same as business combination accounting articulated in ASC Topic 805. The notable difference between Subtopic 852-10 and Topic 805 is that the process reconciles to the reorganization value, rather than consideration transferred.

Despite the accounting similarities noted above, there are certain valuation complexities that are more prevalent in fresh start valuations. These include (i) data challenges, (ii) potential for bargain purchase gains, (iii) economic obsolescence, and (iv) inventory valuations.

Data challenges

Valuation analyses typically require a significant amount of financial, operational and other inputs that can prove difficult to obtain from companies that are undergoing, or have recently emerged from, a bankruptcy. Oftentimes these companies are focused on "running the business" and "keeping the lights on" and less on ensuring that the quality of their financial data and internal controls is strong.

As a result, gathering the information needed for the valuation exercise can be difficult. It is important to understand how to best prioritize and synthesize the information available for purposes of putting together a quality valuation that is required by financial statement users, auditors, and other stakeholders. Common data issues include the following:

- Management turnover creates data gathering challenges
- Historical information is not readily available
- Fixed asset information tends to be incomplete, or inaccurate
- Original acquisition values for fixed assets are sometimes unavailable
- Customer turnover isn't tracked or not comparable due to changes at the entity
- Key performance indicators (for example, growth and profitability) are volatile.

The companies that are most successful with their fresh start accounting are the ones that begin the process early (ideally before entering bankruptcy). Additionally, teaming with valuation and accounting advisers that are experienced in assisting companies through the fresh start process can also improve the likelihood of a successful outcome.

Bargain purchase gains

A bargain purchase gain occurs when the fair value of the net assets (defined as assets acquired less liabilities assumed) exceeds the purchase consideration (or in the case of an entity applying ASC 852-10, the reorganization value). When this occurs, the excess is recorded as a bargain purchase gain.

Bargain purchase gains do not necessarily occur more frequently in fresh start analyses. If the reorganization value was properly determined and reflective of the current and prospective economics of the business, then it is unlikely a bargain purchase would be present.

However, it is not uncommon for bargain purchase gains to be erroneously identified in transactions involving companies with low profit margins, which is often the case for companies emerging from bankruptcy. This can occur if economic obsolescence is not appropriately considered in the valuation of the subject assets. This issue most commonly arises when multiple appraisal firms are engaged to value different asset groupings and there is a lack of overall coordination of the valuation engagements.

Given the rare occurrence of bargain purchases, management should apply a high degree of professional skepticism when they arise. Further, management should consider if economic obsolescence has been properly applied to the subject assets.

In situations where there appears to be a strong case for a bargain purchase, documentation will be key. Management should be in a position to support this conclusion with market evidence (valuation multiples, IRR) as well as a strong qualitative description on how the bargain purchase occurred.

Economic obsolescence

Economic obsolescence should be considered in most fresh start valuations due to the financial and operational challenges present in most companies emerging from bankruptcy. Economic obsolescence is defined as an incurable loss in value caused by factors external to the asset such as a decline in the industry's outlook or changes in legislation.

Often the quantification of economic obsolescence becomes an iterative exercise based on the value of the entity, the degree to which other assets support the value of the fixed assets, and other assumptions used when valuing the entity's fixed assets. This can be time consuming and often necessitates dynamic spreadsheet modeling skills.

Inventory

Traditional methods of valuing inventory may need modifications when there is obsolete or slow-moving inventory. Cost of disposal assumptions can be challenging when inventory isn't turning, or when liquidators are being used to reduce obsolete or slow-moving inventory. Further, any fair value step-ups or step-downs from book value could impact the income statement during the periods that the inventory is sold.

Summary

Despite the similarities between fresh start accounting and accounting for business combinations, there are several differences that need to be considered when performing fresh start valuations. The best way to manage potential audit risk is to start the process early and involve valuation and accounting advisers with fresh start accounting experience.

Why KPMG?

The KPMG Valuation & Business Modeling Services practice assists companies in the areas of valuation, financial projections, financial analysis, and model support. In the United States, we employ more than 400 professionals located in over 20 markets. When clients need advice outside the United States, we can access more than 1,200 valuation and business modeling professionals residing in over 70 countries throughout the global network of KPMG International member firms. Our connection to these member firm professionals gives us access to one of the largest valuation and business modeling networks in the world.

Through our industry specialization, we understand the issues, value drivers, leading practices, and trends that shape the future of a particular industry, company, or business problem.

Additional resources

For additional insight into fresh start accounting and business combinations, be sure to check out these resources:

— Accounting for Bankruptcies

— KPMG Business Combinations Guide

— Avoiding Pitfalls in Business Combinations

— Financial Reporting Valuations

Contact us

For more information, contact your local KPMG adviser.

James Weaver
Principal
Valuation & Business Modeling Services
T: 404-222-3291
E: jcweaver@kpmg.com

Frederik Bort
Managing Director
Department of Professional Practice
T: 212-954-2980
E: frederikbort@kpmg.com

Some or all of the services described herein may not be permissible for KPMG audit clients and their affiliates or related entities.

kpmg.com/socialmedia