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Everything Must Go! FASB Issues Guidance on the Liquidation Basis of Accounting

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On April 22, 2013, the FASB issued ASU 2013-07,[1] which provides guidance on when and how to apply the liquidation basis of accounting and on what to disclose. The ASU is intended to increase the consistency and comparability of financial statements prepared under the liquidation basis of accounting. Before the ASU's issuance, there had been limited guidance on this topic under U.S. GAAP. The ASU applies to both public and nonpublic entities; however, investment companies regulated under the Investment Company Act of 1940 are excluded from its scope.

Editor's Note: The FASB initially established its project on the liquidation basis of accounting in conjunction with its going-concern project; however, the Board ultimately decided to consider the two topics separately. According to the FASB's technical plan, the Board expects to issue an exposure draft on the going-concern project in the second quarter of 2013.

Overview

Under the ASU, an entity is required to use the liquidation basis of accounting to present its financial statements when it determines that liquidation is imminent, unless the liquidation is the same as the plan specified in an entity's governing documents created at its inception. According to the ASU, liquidation would be considered imminent in either of the following situations:

a. 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:
   1. Execution of the plan will be blocked by other parties (for example, those with shareholder rights)
   2. The entity will return from liquidation.

b. 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.

The ASU indicates that an entity's liquidation plan differs from the plan specified in its governing documents if the entity must dispose of its assets for a value other than fair value. In determining whether the current plan is the same as or different from the plan in the governing documents, an entity should consider factors such as whether the current liquidation date is different from that originally expected, but "only to the extent that [such factors] affect whether the entity expects to receive consideration in exchange for its assets that is not commensurate with fair value."

[1] FASB Accounting Standards Update No. 2013-07, *Liquidation Basis of Accounting.*

An entity's financial statements prepared under the liquidation basis of accounting should contain information about its resources and obligations upon liquidation. When applying the liquidation basis of accounting, an entity would initially measure its assets to reflect the amount it expects to receive in cash or other consideration. In certain circumstances, if the expected consideration to be collected approximates the fair value of an asset, the entity may measure the asset at fair value. Under the liquidation basis of accounting, the entity would be required to recognize and measure previously unrecognized assets that it intends to sell during the liquidation (e.g., trademarks). The entity would present — separately from the measurement of the assets or other items anticipated to be sold in liquidation — the expected aggregate liquidation and disposal costs to be incurred during the liquidation process. To measure liabilities (excluding accruals recorded in liquidation for disposal costs and ongoing expenses), the entity would use other applicable U.S. GAAP adjusted for changes in assumptions resulting from its decision to liquidate (e.g., a change in the timing of payments); however, the entity's liabilities should not be reduced on the basis of the assumption that the entity will be legally released from its obligation. In addition, the entity would estimate and accrue the expected future costs and income to be incurred or realized during the course of liquidation, such as payroll expense or "income from preexisting orders that the entity expects to fulfill during liquidation," if and when the entity has a reasonable basis for estimating these amounts. The entity would remeasure all balances as of each subsequent reporting period.

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Editor's Note: Paragraph BC13 of the ASU's Basis for Conclusions notes that financial statements prepared under the liquidation basis of accounting are intended to report "the amount of cash or other consideration that an investor might reasonably expect to receive after liquidation." The FASB concluded that an entity should therefore record any assets it may not have previously recognized in its going-concern financial statements. An entity is permitted to present these items in the aggregate but must separately record any expected disposal or selling costs.

Presentation and Disclosures

Under the ASU, an entity must present, at a minimum, (1) a statement of net assets in liquidation and (2) a statement of changes in net assets in liquidation. An entity must also present disclosures required under U.S. GAAP that are relevant to a user's understanding of the liquidation basis financial statements. In addition, the entity must include expanded disclosures in its financial statements for the reporting period in which the entity determines that liquidation is imminent. The ASU states that at a minimum, an entity must disclose all of the following:

a. That the financial statements are prepared using the liquidation basis of accounting, including the facts and circumstances surrounding the adoption of the liquidation basis of accounting and the entity's determination that liquidation is imminent.

b. A description of the entity's plan for liquidation, including a description of each of the following:

    1. The manner by which it expects to dispose of its assets and other items it expects to sell that it had not previously recognized as assets (for example, trademarks)

    2. The manner by which it expects to settle its liabilities

    3. The expected date by which the entity expects to complete its liquidation.

c. The methods and significant assumptions used to measure assets and liabilities, including any subsequent changes to those methods and assumptions.

d. 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.

Editor's Note: The ASU's Basis for Conclusions clarifies that an entity that adopts the liquidation basis of accounting as of an interim date is not required to present going-concern financial statements for the period before liquidation becomes imminent, nor is an entity required to present a statement of net assets as of the date of adoption; however, since an entity is required to present a statement of changes in net assets in liquidation as of the first reporting period after liquidation becomes imminent, it would be necessary for the entity to determine the initial net asset balances at adoption. For example, if a calendar-year-end public entity determines that liquidation is imminent as of June 1, under the ASU the entity would not be required to present "stub-period" going-concern financial statements for the period January 1 through May 31. The entity would need to calculate the net asset balances as of June 1 and present a statement of changes in net assets in liquidation for the period June 1 through June 30 as well as a statement of net assets as of June 30. While the ASU does not require presentation of a going-concern stub period, an entity should consider its regulator's requirements or the needs of its financial statement users to determine whether it should present stub-period financial information.

Effective Date and Transition

The standard is effective for an entity that determines liquidation is imminent during annual reporting periods beginning after December 15, 2013, and interim reporting periods therein. Early adoption is permitted. The guidance in the ASU is to be applied prospectively from the date liquidation is imminent. If an entity is reporting on the liquidation basis of accounting as of the effective date and is using other guidance on when and how to apply the liquidation basis of accounting (e.g., terminating employee benefit plans), it does not need to apply the guidance in this ASU. However, all other entities that report liquidation basis financial statements as of the effective date would be required to recognize a cumulative-effect adjustment as of the date of adoption for differences resulting from applying the ASU.

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