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INSOLVENCY—LIQUIDATION AND REORGANIZATION

LEARNING OBJECTIVES

1. Distinguish between a Chapter 7 and a Chapter 11 bankruptcy.
2. Describe the five priority categories of unsecured claims and list the order in which they are settled.
3. Distinguish between a voluntary and involuntary bankruptcy petition.
4. Distinguish among fully secured, partially secured, and unsecured claims of creditors.
5. Describe contractual agreements that the debtor and its creditors may enter into outside of formal bankruptcy proceedings to resolve the debtor's insolvent position.
6. Describe the ways debt may be restructured in a reorganization.

IN THE NEWS

"It's bankrupt. Its reputation is in tatters. And it has been forced from its plush headquarters building. Yet working for Lehman Brothers Holdings Inc.—what remains of it—has become one of the hottest jobs on Wall Street. That's because Lehman, though a shadow of its former self after selling many of its businesses . . . retains a broad patchwork of assets."[1]

During November 2008, the CEOs of General Motors (GM), Ford, and Chrysler flew in separate corporate jets to Washington, D.C., to request $25 billion in federal bailout loans. This event turned into a public relations nightmare for the auto companies seeking relief from poor economic times. For the third quarter of 2008, GM posted a $2.5 billion loss. General Motors stated in its quarterly report that during the first half of the next year (2009), its liquidity would fall significantly short of the amount needed to continue operations. GM announced a 10% cut in salaried employment costs, staffing reductions, and incentive pay cuts. Further steps to save cash included cutting planned capital expenditures by $2.4 billion. Clearly, GM hoped to weather the downturn on a government bailout. When the CEOs returned to Washington in December, the GM CEO drove a hybrid Chevrolet Malibu. On December 11, 2008, the Senate rejected legislation that would have provided $14 billion in federal loans to keep GM afloat.

On June 1, 2009, General Motors (GM) filed for Chapter 11 reorganization in the Manhattan, New York, federal bankruptcy court. The filing reported $82.29

[1] *Wall Street Journal*, "Now Hiring: Lehman," by Peter Lattman, p. A1, February 2, 2008.

billion in assets and $172.81 billion in debt. This was the 4th largest bankruptcy in U.S. history. GM was organized into the "new" GM with the U.S. and Canadian governments owning a little over 70% of the company. Brands such as Hummer, Pontiac, and Saturn were discontinued and others such as SAAB were sold. The number of dealerships was reduced by over 15% with long-term intentions to reduce the number by 30%.

After filing for Chapter 11, GM qualified for "fresh start" reporting (ASC 852-10-45-19). The new GM reported on February 24, 2011, that the company had returned to profitability with reported earnings of $4.7 billion, and had achieved four consecutive quarters of profitability. In addition, cash from operations was $6.8 billion.

Previous chapters have treated problems relating to the expansion of business activity through mergers and stock acquisitions, as well as the procedures followed in reporting the effects of the expanded operations. But just as some companies expand, others face financial circumstances that cause contraction or cessation of business activities. Every year many businesses, small and large, encounter financial difficulties, and many are forced to seek relief through accommodations with creditors or some form of reorganization in order to survive. Those that are unable to obtain such relief generally terminate operations by liquidating the business unit.

This chapter deals with the various relief procedures available to an insolvent debtor. ***Insolvency*** refers to the inability of a debtor to pay its obligations as they become due. Our discussion includes relief procedures not requiring court actions, as well as the legal procedures available under the Bankruptcy Reform Act of 1978, relevant provisions of which are discussed in later sections of this chapter. Although the Bankruptcy Reform Act provides for relief of all types of insolvent debtors, including individuals, our discussion will concentrate on the provisions of the act dealing with insolvent business entities.

IN THE NEWS

A new view of insolvency, sometimes referred to as deepening insolvency, focuses on the cases where (a) a company incurs debt that would be beyond its ability to repay in the future—cash flow insolvency, or (b) a company engages in a transaction or business that its capital base cannot support—low capital insolvency.[2]

RELATED CONCEPTS

This view could fuel added scrutiny of the auditor's role in assessing *going concern* likelihood.

When a business becomes insolvent, it generally has three possible courses of action: (1) the debtor and its creditors may enter into a contractual agreement, outside of formal bankruptcy proceedings; (2) the debtor or its creditors may file a bankruptcy petition, after which the debtor is liquidated under Chapter 7 of the Bankruptcy Reform Act; or (3) the debtor or its creditors may file a petition for reorganization under Chapter 11 of the Bankruptcy Reform Act.

CONTRACTUAL AGREEMENTS

LO5 Contractual agreements.

A business that is unable to pay its obligations as they mature may attempt to reach an accommodation with its creditors without recourse to legal action. The procedures are relatively simple. The debtor and its creditors meet and develop a voluntary agreement or plan for settlement of obligations. The possibilities generally include (1) an

[2] *"Deepening Insolvency: An Emerging Threat?"* by Kelly Hnatt, *Journal of Accountancy*, February 2008, p. 41.

extension of payment periods, (2) composition agreements, (3) formation of a creditors' committee, or (4) a voluntary assignment of assets.

Extension of Payment Periods

When the insolvency results from temporary financial difficulties and the debtor is expected to operate profitably in the future if it receives some minor relief, its creditors may find it advantageous in the long run to extend the period of payment of outstanding debts. In this situation, the debtor continues to manage the business with the expectation of obtaining sufficient profitability and financial strength to settle existing debts in full. Such an agreement is often effective for a business with few creditors. No particular accounting problem is encountered, in that interest on the debt normally continues at the originally contracted rate(s) and is paid or accrued periodically. No accounting entries are needed to reflect the extension of the payment period(s), although the nature of the new agreement should be disclosed in notes to the financial statements. FASB ASC paragraph 470–50–40–6 provides that where a debt restructuring involves only a modification of terms of payment, the debtor should account for the effects of the restructuring *prospectively* from the time of restructuring and should not change the carrying amount of the payable, unless the carrying amount exceeds the total future cash payments of principal and interest specified by the new terms.[3] Thus, no gain is recognized when the restructuring involves an extension of the payment period only.

Composition Agreements (Creditors Accept Less Than Full Amount)

A composition agreement is an agreement between the debtor and its creditors under which the creditors agree to accept less than the full amount of their claims. In addition, accrued interest is sometimes canceled or the interest rate lowered. Creditors are often given some immediate cash payment, and the amount of the remaining debts and their interest rates are renegotiated. The benefit to the creditors is that they receive an immediate cash payment and expect to eventually receive more than they would if the debtor were forced to liquidate. The benefit to the debtor, of course, is that it can continue to operate with the expectation of returning to profitable operations and, therefore, survive.

Formation of a Creditors' Committee

The debtor and its creditors may agree to the formation of a creditors' committee that is responsible for managing the debtor's business affairs for the period during which plans are developed to rehabilitate, reorganize, or liquidate the business. Often, an extension of payment periods for debtor obligations is agreed to while the committee deliberates the ultimate disposition of the business. If the decision is to rehabilitate the business, the agreement may include the cancellation or restructuring of existing debts and possible infusion of new capital by the creditors. When the rehabilitation plan is completed, operating control of the business is generally returned to the debtor. If the decision is to reorganize or liquidate the business, the debtor's property may be turned over to a trustee who is responsible for conducting the affairs of the business during the period of reorganization or liquidation.

[3] FASB ASC paragraph 470–60–35–5 (*Statement of Financial Accounting Standards No. 15*, "Accounting by Debtors and Creditors for Troubled Debt Restructurings" (Norwalk, CT.: FASB, 1997), par. 16).

Voluntary Assignment of Assets

A debtor may elect to place its property under the control of a trustee for the benefit of its creditors. The purpose of the assignment is to permit the trustee to sell the property and distribute the proceeds among the creditors. If the creditors agree, the assignment results in the full discharge of the debtor's obligations to them. If there are proceeds remaining after payment of the creditors, they are returned to the debtor.

IN THE NEWS

Chrysler said the company would likely have to file for Chapter 11 protection if it doesn't get additional loans from the government and concessions from unions, creditors, and dealers. Chrysler said it would need $24 billion in financing if the company were to file for bankruptcy. Company officials, however, did not believe that Chapter 11 filing was necessary for Chrysler's survival.[4]

IN THE NEWS

The number of failed banks in 2008 totaled 25 equaling then cumulative number of bank failures since 2001. In addition, the FDIC included 27 more financial institutions on a "problem list," which totaled 117 by the end of the second quarter of 2008. The FDIC also noted that, in the second quarter of 2008, insured institutions added twice as much in loan-loss provisions than they actually wrote off but that the amount of loss provisions still grew at a smaller rate than noncurrent loan balances.[5]

IN THE NEWS

Personal Bankruptcy Filings by State
Top and Bottom Four States[6]

State	Change from 2009 to 2010
Tennessee	−7.2%
West Virginia	−7.1%
South Carolina	−4.1%
Iowa	−3.6%
Arizona	23.9%
Utah	24.4%
California	25.0%
Hawaii	28.9%

BANKRUPTCY

Article I, Section 8 of the U.S. Constitution gives the Congress authority to enact uniform bankruptcy laws. Congress passed the first bankruptcy law in 1800 and has repealed and enacted new laws on several occasions since that time. The most significant revision is the Bankruptcy Reform Act of 1978 (hereafter referred to as the Reform Act), which became effective in October 1979. The Bankruptcy Act was amended in 1984, 1988, 1990, and 1994. The Reform Act consists of eight chapters:

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[4] *WSJ*, Wednesday February 18, 2009, 'GM to End Brands, Cut 47,000 More Jobs,' page A1.

[5] *FDIC Quarterly* 2, no. 3, 2008.

[6] National Bankruptcy Research Center, *WSJ*, January 3, 2011, "Personal Bankruptcies in 2010, by State."

Chapter 1	General Provisions
Chapter 3	Case Administration
Chapter 5	Creditors, the Debtor, and the Estate
Chapter 7	Liquidation
Chapter 9	Adjustment of Debts of a Municipality
Chapter 11	Reorganization
Chapter 12	Adjustment of Debts of Family Farmers with Regular Income
Chapter 13	Adjustment of Debts of an Individual with Regular Income[7]

Chapters 1, 3, and 5 cover general issues, a description of the administrative process, and definitions of various terms that apply to bankruptcy proceedings. The Reform Act provides that a bankruptcy petition may be filed under one of Chapters 7, 9, 11, 12, or 13. Chapter 9, which applies to municipalities seeking voluntary relief, and Chapter 13, which applies to bankruptcy petitions by individuals, will not be discussed here. We will concentrate on petitions by business entities under Chapter 7 (Liquidation) and Chapter 11 (Reorganization).

Provisions of the Reform Act apply to individuals, corporations, and partnerships, all of which are referred to as ***persons***, as well as to municipalities seeking voluntary relief from their creditors (municipalities cannot be forced into bankruptcy proceedings). Insurance companies and most financial institutions are excluded because they are covered by other specific statutes.

As mentioned earlier, when a business is unable to pay its obligations as they mature, it may attempt to negotiate some type of contractual agreement with its creditors without initiating a bankruptcy proceeding. If a satisfactory agreement cannot be reached, a legal petition for bankruptcy will be initiated by either the debtor (a voluntary petition) or its creditors (an involuntary petition). The Reform Act uses the single term ***debtor*** to refer to the subject of a bankruptcy proceeding.

IN THE NEWS

In 2004, approximately 1.6 million debtors—representing 70% of all bankruptcies—filed for Chapter 7 relief. They walked away from literally billions of dollars of debt. A new law passed in 2005 requires debtors to first undergo a "means" test and credit counseling before they are permitted to file under Chapter 7. The result is likely to be a decrease in Chapter 7 filings and an increase in Chapter 13 filings, which require the debt to be repaid over time.[8]

IN THE NEWS

The 2005 revision of the bankruptcy statute was designed to make it more difficult for consumers to shed their debts. It aimed to steer more debtors into Chapter 13, where debtors work out a repayment plan, instead of Chapter 7, where filers forfeit their assets and their debts are forgiven. But only about a third of debtors file under Chapter 13.

The bankruptcy law was passed prior to the housing slump and the deep recession that pushed unemployment to nearly 10%. Combined with tightened access to consumer credit, which tends to spur a rise in bankruptcies, the downturn has pushed filings to levels higher than backers of the law anticipated.[9]

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[7] Several revisions to the bankruptcy statute over time have resulted in the elimination of some chapters by their consolidation with others. For example, Chapters VIII, X, XI, and XII (before the Reform Act, Roman numerals were used) were consolidated into Chapter 11 of the Reform Act.

[8] *Journal of Accountancy*, "Bankruptcy Reform Is Here," by Lawrence Clark, Randall Hanson, and James Smith, 11/05, p. 51.

[9] *WSJ*, "Bankruptcy Filings Leapt 9% Last Year," by Sara Murray, 1/4/11.

In April 2005, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 was signed; it became effective in October 2005. The aim of this law is to protect creditors from abuses related to Chapter 7 bankruptcies. Most debts have been discharged completely under Chapter 7 in past years; while attractive to struggling debtors, creditors view this leniency as an invitation to abuse. The alternatives under Chapters 11 and 13 focus instead on helping the debtor to work out realistic payment plans and become financially stable rather than discharging their debts with ease. However, the major changes under the 2005 act relate to individual debtors rather than to businesses.

Voluntary Petitions

LO3 Voluntary vs. involuntary petitions.

A debtor may file a voluntary petition with a bankruptcy court for liquidation under Chapter 7 or for reorganization under Chapter 11. Filing of a voluntary or involuntary petition constitutes an ***order for relief,*** which prohibits the start or continuation of legal action against the debtor by its creditors. The bankruptcy judge, however, may refuse a voluntary petition if refusal is considered to be in the best interest of the creditors.

The bankruptcy petition (either voluntary or involuntary) is an official form that initiates bankruptcy proceedings and establishes an ***estate*** consisting of the debtor's assets. The debtor must file a form listing all its property (at current market values) and its debts. This form, called a Statement of Assets and Liabilities, consists of the following separate schedules:

Schedule A. Statement of All Liabilities of Debtor

Schedule A-1.	Creditors Having Priority (with amount of claims)
A-2.	Creditors Holding Security (with market value of security and amount of claims)
A-3.	Creditors Having Unsecured Claims without Priority (with amount of claims)

Schedule B. Statement of All Property of Debtor.

Schedule B-1.	Real Property (with market values)
B-2.	Personal Property (with market values)
B-3.	Property Not Otherwise Scheduled (property discovered later)
Schedule B-4.	Property Claimed as Exempt (pertains to individuals only)

In addition, the debtor must complete a questionnaire, called a Statement of Affairs, containing questions concerning all aspects of its financial condition and operations.

IN THE NEWS

The expected bankruptcy filing, which is believed to be more than 1,000 pages long, will list WorldCom's top 20 creditors, although the list will be subject to revision. Bondholders are the dominant creditors and will have one of the lou dest voices in determining the company's fate. Major bondholders are believed to include pension funds, insurance companies, mutual funds, and distressed-debt investors.[10]

[10] *WSJ*, "WorldCom Plans Bankruptcy Filing," by Shawn Young, Carrick Mollenkamp, Jared Sandberg, and Henny Sender, 7/22/02, p. A3.

Involuntary Petitions

In an involuntary proceeding, creditors initiate the action by filing a petition for liquidation or reorganization with the bankruptcy court. If there are 12 or more creditors, the petition must be signed by 3 or more such creditors whose claims aggregate at least $13,475 more than the value of any liens on the property of the debtor.[11] If there are fewer than 12 creditors, the petition may be filed by one or more such creditors whose claims aggregate at least $10,000 more than the value of any liens on the debtor's property. Involuntary petitions may be filed under either Chapter 7 or Chapter 11 of the Reform Act. The bankruptcy court will generally enter an order for relief against the debtor only if evidence indicates that the debtor, in fact, has not been paying its debts as they become due.

Secured and Unsecured Creditors

LO4 Secured and unsecured creditors.

Creditors are classified by law as ***secured*** or ***unsecured***. Secured creditors are those whose claims are secured by liens or pledges of specific assets. If the proceeds from the sale of a pledged asset(s) exceed the secured claim, the excess proceeds are available for distribution to unsecured creditors. If the secured claim exceeds the proceeds from the sale of a pledged asset(s), the remaining claim constitutes an unsecured claim. Unsecured creditors do not have claims to proceeds received from the sale of specific assets but are paid from whatever total money remains after secured creditors have been satisfied. That is, secured creditors are paid first with the proceeds from the sale of specific assets upon which they have liens. Thereafter, unsecured creditors, including those having priority, are paid from whatever proceeds remain from the realization process. Thus, it is probably better to classify claims as fully secured, partially secured, or unsecured. Fully secured claims are those with liens against assets whose realizable value is equal to or in excess of the claim. Partially secured claims are those with liens against assets whose realizable value is less than the amount of the claim.

LO2 Five priority categories for unsecured claims.

The Reform Act assigns priorities to certain claims, and each rank must be satisfied in full before the next-lower rank is paid. The following order of priority for ***unsecured*** creditors is specified as follows:

1. Administration expenses, fees, and charges incurred in administering the bankrupt's estate.
2. Unsecured claims for wages, salaries, or commissions earned by an employee within 90 days before the date of filing of the petition, but limited to the extent of $4,650 per employee.
3. Unsecured claims for contributions to employee benefit plans from services rendered within 180 days before the date of the filing of the petition, but subject to certain limitations.
4. Unsecured claims of individuals, to the extent of $2,100 for each such individual, arising from the deposit of money in connection with the purchase, lease, or rental of property or services that were not delivered or performed.
5. Unsecured claims of governmental units for unpaid taxes.

After all these priorities have been satisfied, any remaining unsecured creditors participate pro rata in any remaining realization proceeds. The distribution to unsecured creditors is termed a ***dividend*** and is generally expressed in terms of the

[11] Section 104 provides for an adjustment every three years.

percentage of the total unsecured claims that will be paid. For example, if $100,000 of proceeds remains after all secured claims and claims having priority have been paid, and total unsecured claims amount to $400,000, each unsecured creditor will receive a 25% dividend.

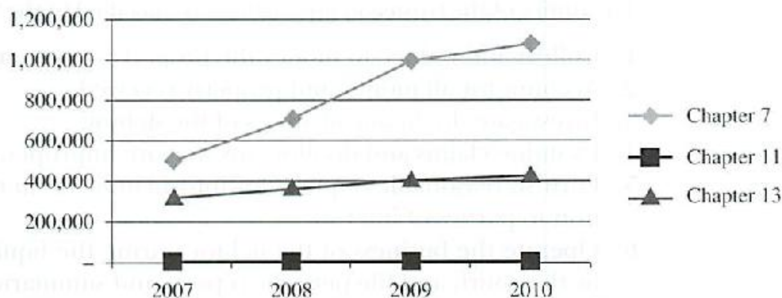
Ten Largest Bankruptcies

Company	*Date Filed*	*Assets*
Lehman Brothers Holdings	09/15/08	$691 billion
Washington Mutual	09/26/08	$327.9 billion
WorldCom	07/21/02	$103.9 billion
General Motors	06/01/09	$91 billion
CIT	11/01/09	$71 billion
Enron	12/02/01	$65.5 billion
Conseco	12/17/02	$61 billion
Chrysler	04/30/09	$39 billion
Thornburg Mortgage	05/01/09	$36.5 billion
Pacific Gas and Electric Co.	04/06/01	$36 billion

Source: "The 10 Largest U.S. Bankruptcies: From Lehman to Texaco: The Mighty Have Fallen, Taking Down Billions and Billions with Them," by Christopher Tkaczyk, money.cnn.com (*Fortune*), 6/1/09.

In Figure 10-1, the number of non-business bankruptcies filed between 2007 and 2010 are listed.

FIGURE 10-1
Non-Business Bankruptcies by Chapter



	Chapter 7	*Chapter 11*	*Chapter 13*
2007	500,433	617	320,720
2008	714,380	1,605	368,017
2009	999,867	2,288	411,126
2010	1,091,435	2,697	433,978

LIQUIDATION (CHAPTER 7)

LO1 Chapter 7 versus Chapter 11.

RELATED CONCEPTS

A primary underlying concept in accounting has traditionally been historical cost. This principle only makes sense if the going concern assumption is met. For instance, depreciation allocations do not make sense if the firm is not expected to continue to exist.

In addition to a voluntary assignment of assets, which constitutes a liquidation without bankruptcy proceedings, a voluntary or involuntary petition for liquidation may be filed under Chapter 7 of the Reform Act. Upon filing, the bankruptcy court must decide whether to accept or dismiss the petition. Although dismissals occur infrequently, the debtor may dispute an ***involuntary petition***, in which case a trial will be held to determine whether the petition should be dismissed.

If the petition is accepted, an order for relief is entered and the bankruptcy court will appoint an interim trustee to oversee activities until a permanent trustee is selected. In addition, the court must call a meeting of the debtor's creditors, who will select a trustee and elect a creditors' committee to assist the trustee in the administration of the estate. If the creditors cannot agree on a trustee, the interim trustee becomes the trustee. Only creditors who have filed a claim at or before the meeting are entitled to vote. The interim trustee examines the claims and accepts them or, if improper, disallows them. The debtor must attend the creditors' meeting to answer questions by the creditors and the trustee, to clarify the contents of the Statement of Affairs included with the petition, and to generally assist the trustee in the preparation of an inventory of property and the examination of claims.

IN THE NEWS

VisionAire Corp., the Chesterfield company that has spent millions of dollars to develop a cheaper business jet but hasn't sold a plane, admitted that it's in a cash crunch after creditors filed an involuntary petition last week to force the company into Chapter 7 bankruptcy. The five creditors, who filed the petition at U.S. District Court in St. Louis, have had court judgments against VisionAire, or they are seeking reimbursement on a letter of credit. They are owed nearly $686,000, the filing said. VisionAire has until August 6 to file a response.[12]

Duties of the Trustee

The duties of the trustee in liquidation are specified in the Reform Act. The trustee shall:

1. Collect and reduce to money the property of the estate.
2. Account for all money and property received.
3. Investigate the financial affairs of the debtor.
4. Examine claims and disallow any that are improper.
5. Furnish reasonable requests for information about the estate and its administration to parties of interest.
6. Operate the business of the debtor during the liquidation period if authorized by the court, and file periodic reports and summaries of operations.
7. Pay creditors as promptly as possible, giving due regard to secured claims and priorities.
8. File a final report on the administration of the estate, including a statement of receipts and disbursements.

In addition, the trustee has the authority to hire attorneys, accountants, appraisers, and other professionals to assist in carrying out his or her duties.

[12] *St. Louis Dispatch*, "Five Creditors Seek to Force VisionAire into Bankruptcy," by Chern Yeh Kwok, 7/25/02, p. C1.

REORGANIZATION UNDER THE REFORM ACT (CHAPTER 11)

LO 1 Chapter 7 versus Chapter 11.

Creditors of an insolvent debtor may believe that their long-range interests would be better served by rehabilitating or reorganizing the debtor than by having it liquidated. In such a case, the creditors and debtor may agree to a plan for reorganization without recourse to the judicial process by employing one or more of the contractual agreements discussed earlier in this chapter. Alternatively, the debtor or creditors may prefer to file with the bankruptcy court a petition for reorganization under Chapter 11 of the Reform Act. The company has the exclusive right to develop its reorganization plan within the first 120 days, after which any interested parties may propose a bankruptcy plan. The court can extend the exclusivity period, but the exclusivity period cannot extend beyond 18 months.

The Reform Act provides that, as soon as practicable after the acceptance of a petition for reorganization, the court shall appoint a committee of creditors holding unsecured claims, ordinarily consisting of those holding the seven largest claims against the debtor. The court may appoint additional committees of creditors or of stockholders if necessary to assure adequate representation of creditors and stockholders. If a committee of stockholders is appointed, it will normally consist of the persons who hold the seven largest amounts of equity securities.

The committee appointed by the court has the following powers and duties:

1. Select and authorize the appointment of one or more attorneys, accountants, or other agents, to represent or perform services for the committee.
2. Consult with the trustee or debtor concerning the administration of the case.
3. Investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan.
4. Participate in the formulation of a plan, advise those represented by the committee of the committee's recommendations as to any plan formulated, and collect and file with the court acceptances of a plan.
5. Request the appointment of a trustee if a trustee has not previously been appointed in the case.[13]
6. Perform such other services as are in the interest of those represented.

The court may permit the debtor to maintain possession of its assets and conduct the affairs of the business, or it may appoint a trustee. If a trustee is appointed, his or her primary duties in reorganization are:

1. Be accountable for all property received.
2. Examine claims and object to the allowance of any claim that is improper.
3. Furnish such information concerning the estate and the estate's administration as is requested by a party in interest.
4. If the business of the debtor is authorized to be operated, file with the court and with any governmental unit charged with responsibility for collection of any tax arising out of such operation, periodic reports and summaries of the operation of the business.
5. If the debtor has not done so, file with the court a list of creditors, a schedule of assets and liabilities, and a statement of the debtor's financial affairs.

[13] A trustee must be appointed if the debtor's debts (other than debts for goods, services, or taxes) exceed $5,000,000.

6. File a plan of reorganization.
7. After confirmation of a plan, file such reports as are required by the court.

The reorganization plan may propose the alteration of legal, contractual, and equity interests of any class of creditors or equity security holders. Unsecured creditors will generally accept payment of a portion of their claims and cancellation of the remainder of their claims. The plan must be equitable to all parties by providing for the same treatment for each claim or interest of a particular class. The plan must also contain adequate means for its own execution; that is, it must contain specific provisions for such things as (1) the retention of any property by the debtor, (2) the transfer of property to other entities, (3) the merger or consolidation of the debtor with another company, (4) the sale of property or the distribution of property to parties of interest, and (5) the issuance of securities of the debtor for cash, property, or existing securities of the debtor. After the plan is filed with the court, it must be accepted by two-thirds in amount and one-half in number of the allowed claims of each class of creditors, and by two-thirds in amount of the allowed interests of each class of stockholders. In addition, the court must approve of the overall fairness of the plan before it will be accepted.

When a firm files for bankruptcy, one of the first things that it will do is to ask the bankruptcy-court judge to approve a loan in the form of senior secured debtor-in-possession financing. This type of debt provides the banks a 'superiority' status, which means that they will be paid for new loans before anyone else.[14]

Chapter 11 Proceedings

"Accounting Standards Codification (ASC) 852, 'Reorganizations', is applicable to entities operating under Chapter 11 of the Bankruptcy Code. ASC 852 generally does not affect the application of U.S. GAAP followed to prepare prior consolidated financial statements, but it does require specific disclosures for transactions and events that were directly related to the Chapter 11 proceedings, as well as transactions and events that resulted from ongoing operations."[15]

TEST YOUR KNOWLEDGE

NOTE: Solutions to *Test Your Knowledge* questions are found at the end of each chapter before the end-of-chapter questions.

Multiple Choice

1. The highest priority for payment of unsecured claims in a bankruptcy proceeding is
   a. Wages up to $4,650 earned within three months before the petition
   b. Unpaid federal income taxes
   c. Administrative expenses of the bankruptcy
   d. Wages owed to an insolvent employee

[14] *WSJ*, "WorldCom Plans Bankruptcy Filing," by Shawn Young, Carrick Mollenkamp, Jared Sandberg, and Henny Sender, 7/22/02, p. A3.

[15] GM 10-K, 12/31/10, p. 154.

True or False

2. __________ Insolvency means that a debtor has more current liabilities than current assets.

3. __________ If an insolvent debtor has more than 12 creditors, an involuntary petition must be signed by at least 3 of those creditors.

4. __________ Unsecured creditors with priority will receive full satisfaction before secured creditors are paid.

5. __________ Either a debtor or its creditors may file a petition for reorganization under Chapter 11 of the Reform Act.

Fresh Start Accounting and Quasi Reorganization

In 1990, the AICPA released *Statement of Position (SOP) 90-7* providing guidance on reporting standards for firms in bankruptcy and emerging from bankruptcy (now incorporated in FASB ASC topic 852 [Reorganizations]). When firms emerge from bankruptcy (also referred to as confirmation of the plan of reorganization), FASB ASC paragraphs 852–10–45–19 to 20 provide for ***fresh start*** accounting. Basically, the implication is that a new firm exists. Because of this, assets and liabilities are reported at fair values and beginning retained earnings is reported at zero (the prior balance, positive or negative, is eliminated). Two conditions must exist before fresh start accounting can be used. The fair value of the assets must be less than the post liabilities and allowed claims, and the original owners must own less than 50% of the voting stock after reorganization.

While fresh start accounting applies only to firms emerging from bankruptcy, a less formal procedure, know as quasi reorganization, is often applied in periods of declining prices. Three steps are required:

1. Authorization from creditors and stockholders is required.
2. All assets are revalued to fair values with losses recorded in retained earnings.
3. The deficit in retained earnings is eliminated by charging to (reducing) paid-in capital.

If paid-in capital is not sufficient to eliminate retained earnings, the capital stock account is reduced, thus causing a reduction in the par value of the stock. No retained earnings can be created in a quasi reorganization, and retained earnings must be "dated" for 10 years. This means that the firms disclose on the balance sheet that the balance in retained earnings has only been accumulated since the date of the quasi reorganization.

Fresh Start Accounting and General Motors

The first step after filing for Chapter 11 is that the company must reorganize. Then, depending on the circumstances, the firm might qualify for fresh start accounting. *Fresh start accounting* is exactly what the name implies. The company provides a fresh presentation of newly valued assets and adjusted liabilities. Basically, it cleans up the balance sheet, eliminates accumulated losses, and improves the chances of survival for the new company coming out of bankruptcy.

Two conditions must be met in order to qualify for fresh start accounting (FASB ASC paragraph 852-10-45-19):

1. The reorganization value of the assets of the emerging entity immediately before the date of confirmation is less than the total of all postpetition liabilities and allowed claims.

2. The holders of existing voting shares immediately before confirmation receive less than 50% of the voting shares of the emerging entity.

If the firm qualifies, the company's reorganized value is assigned to the entity's assets and liabilities in accordance with FASB ASC subtopic 805-20 (Business Combinations—Identifiable Assets, Liabilities, and any Noncontrolling Interest).

Additionally, the effects of the adjustments on the reported amounts of individual assets and liabilities resulting from the adoption of fresh start reporting and the effects of the forgiveness of debt shall be reflected in the predecessor entity's final statement of operations. Forgiveness of debt, if any, shall be reported as an extinguishment of debt and classified in accordance with FASB ASC subtopic 225-20 (Income Statement—Extraordinary and Unusual Items).

Adopting fresh start reporting results in a new reporting entity with no beginning retained earnings or deficit. When fresh start reporting is adopted, the notes to the initial fresh start financial statements shall disclose the following additional information (FASB ASC paragraph 852-10-50-7):

a. Adjustments to the historical amounts of individual assets and liabilities
b. The amount of debt forgiveness
c. Significant matters relating to the determination of reorganization value, including all of the following:
   1. The method or methods used to determine reorganization value and factors such as discount rates, tax rates, the number of years for which cash flows are projected, and the method of determining terminal value
   2. Sensitive assumptions—that is, assumptions about which there is a reasonable possibility of the occurrence of a variation that would have significantly affected measurement of reorganization value
   3. Assumptions about anticipated conditions that are expected to be different from current conditions, unless otherwise apparent

As a result of fresh start accounting, GM reduced its liabilities by $93.4 billion and increased its assets by $34.6 billion. One interesting (and rather ironic) aspect of GM's fresh start was the creation of additional recorded goodwill of $30.2 billion. This asset results from the application of several accounting rules. For instance, in valuing liabilities, the firm's creditworthiness must be considered. Since GM's creditworthiness was considered somewhat problematic, higher discount rates are used to value liabilities, resulting in lower valuations for liabilities and higher goodwill amounts. Similarly, lower tax asset carrying values (which are lower than market) also contributed to higher goodwill amounts.

Accounting for Reorganizations—Troubled Debt Restructurings

Standards followed in debt restructurings are contained in FASB ASC subtopic 310-40 (debt restructuring by creditors) and FASB ASC subtopic 470-60 (debt restructuring by debtors). The standards deal primarily with valuation problems, the recognition of gain or loss on restructuring, and general disclosure requirements. In general, these subtopics do not apply to bankruptcy cases where there is a general restatement of liabilities; they apply only when dealing with individual creditors or debtors. In the appropriate section below, we highlight the primary differences between a bankruptcy and a nonbankruptcy. FASB ASC subtopic 310-40 dictates the accounting for a creditor in a debt restructuring.

Debt may be restructured in any one (or a combination) of the following methods:

1. The debtor may transfer assets in full settlement of the payable.
2. The debtor may give an equity interest in its firm in full settlement of the payable.
3. The creditor may modify terms of the payable.

LO6 Debt restructuring.

Transfer of Assets A debtor that transfers assets to a creditor in full settlement of a payable recognizes a gain on the restructuring. The gain is measured by the excess of the carrying value of the payable over the fair value of the assets transferred. The *carrying value* of the payable is the face amount increased or decreased by applicable accrued interest and applicable unamortized premium, discount, finance charges, or issue costs. The *fair value* of the assets transferred is the amount that the debtor could reasonably expect to receive in a current sale between a willing buyer and a willing seller, that is, other than in a forced sale. The difference between the fair value and the carrying amount of the assets transferred is a gain or loss on the transfer of assets and is reported as a component of net income for the period of transfer. The gain on restructuring is included in net income in the period of restructuring. Assume, for example, that a debtor transferred land with a cost of $20,000 and a fair value of $15,000 to a creditor in full settlement of a $25,000 payable. Ignoring income tax effects, the debtor would report a $5,000 loss ($20,000 − $15,000) from the transfer of assets and a $10,000 ordinary gain ($25,000 − $15,000) from debt restructuring.

Grant of an Equity Interest A debtor that issues an equity interest in its firm to a creditor in full settlement of a payable shall account for the equity interest at its fair value. The difference between the fair value of the equity interest issued and the carrying amount of the payable is reported as a gain on restructuring. The debtor determines its gain based on undiscounted cash flows.

Modification of Terms A debtor, in a troubled debt restructuring involving only modification of terms of a payable, accounts for the effects of the restructuring *prospectively* from the time of restructuring. The carrying value of the payable is not changed at the time of restructuring unless the carrying value exceeds the total future cash payments specified by the new terms. That is, the effects of changes in the amounts or timing (or both) of future cash payments designated as either interest or face amount are reflected in future periods. Interest expense is computed in such a way that a constant effective interest rate is applied to the carrying value of the payable at the beginning of each period between restructuring and maturity. The new effective interest rate is the discount rate that equates the present value of the future cash payments specified by the new terms with the carrying value of the payable. This is the approach that is followed in bankruptcy regardless of whether the total future cash payments exceed the existing carrying value of the debt plus accrued interest.

If, however, in an nonbankruptcy case, the total future cash payments specified by the new terms, including both payments designated as interest and those designated as face amount, are less than the carrying value of the payable, the debtor should reduce the carrying value to an amount equal to the total future cash payments specified by the new terms and recognize a gain on restructuring. Thereafter, all cash payments under the terms of the payable should be accounted for as reductions of the carrying value of the payable, and no interest expense should be recognized on the payable for any period between the restructuring and maturity.

A restructuring may involve a combination of asset transfer, grant of an equity interest, and modification of terms. In those cases, assets transferred or the equity interest given are treated first and measured as described earlier. The carrying value of the payable is reduced by the total fair value of the assets transferred or equity interest

given, and a gain or loss on the transfer of assets is recognized for the difference between the fair value and carrying value of the assets transferred. A gain on restructuring is then recognized only if the remaining carrying value of the payable exceeds the total future cash payments specified by the terms of the debt remaining unsettled.[16]

A creditor in a modification of the terms computes the loss by discounting all the future cash flows (face value and interest) using the original effective interest rate. If this amount is less than the carrying value of the existing debt (plus accrued interest), the difference is charged to bad debt expense with a credit to a valuation allowance account (less accrued interest). Then, as interest payments are received, the valuation allowance account is amortized and the cash interest receipts are recorded as interest revenue over the remaining life of the debt.

For cash-strapped companies in bankruptcy proceedings caught in the balance between staying open and shutting down, debtor-in-possession loan agreements have become the lifeline that keeps employees paid, vendors delivering, and the doors open.

Such loans, known as DIP financing, have gained more attention as household names in Chapter 11, such as retailer Kmart Corp., with $2 billion in DIP financing, and cable company Adelphia Communications Corp., with a $1.5 billion DIP loan, have secured this type of lending to stay afloat.[17]

Restructuring Illustration

To illustrate the accounting process, assume that Box Company filed a petition for reorganization with the bankruptcy court. The reorganization plan has been approved by the parties of interest and the court. Box Company's balance sheet on April 30, 2009, prior to reorganization, is shown in Illustration 10-1.

ILLUSTRATION 10-1

Box Company Balance Sheet April 30, 2012

Current Assets		
Cash		$ 86,000
Accounts Receivable	$120,000	
Less: Allowance for Uncollectibles	13,000	107,000
Inventories		142,000
Total Current Assets		335,000
Plant and Equipment	680,000	
Less: Accumulated Depreciation	275,000	405,000
Land Held as an Investment		80,000
Total Assets		$820,000
Current Liabilities		
Accounts Payable—Secured by Inventory		$ 60,000
Accounts Payable—Unsecured		134,000
Notes Payable—Unsecured		200,000
Accrued Expenses—with Priority		24,000
Accrued Interest Payable		50,000
Total Current Liabilities		468,000
Bonds Payable—Unsecured		450,000
Total Liabilities		918,000
Stockholders' Equity		
Common Stock, $1 par value	$500,000	
Retained Earnings (deficit)	(598,000)	
Total Stockholders' Deficiency		(98,000)
Excess of Liabilities over Stockholders' Deficiency		$820,000

[16] FASB ASC paragraph 470-60-35-8 (*Statement of Financial Accounting Standards No. 15*, Par. 19).

[17] *The Wall Street Journal*, "Debtor Loans Help Cash-Poor Firms," by Marc Hopkins, 7/24/02, p. B3G.

Provisions of the reorganization plan and the appropriate journal entries to account for the restructuring follow:

1. Creditors represented by the unsecured accounts payable agree to accept the accounts receivable of Box Company in full settlement of their claims. The fair value of the receivables, which is not guaranteed by Box Company, is $100,000. CV indicates carrying value, while FV indicates fair value.

Allowance for Uncollectibles	13,000	
Loss on Transfer of Assets (CV less FV)	7,000	
Accounts Receivable		20,000
To reduce the receivable to fair value.		
Accounts Payable—Unsecured	134,000	
Accounts Receivable (at fair value)		100,000
Gain on Restructuring of Debt		34,000
To record the settlement of the payable with the receivable.		

Notice that a loss on transfer of assets is recognized for the difference between the book value of the receivables ($107,000) and their fair value ($100,000). A gain on restructuring is then recognized for the difference between the carrying value of the payable ($134,000) and the fair value of the receivables ($100,000).

2. Accrued expenses with priority are paid in full.

Accrued Expenses	24,000	
Cash		24,000

3. A creditor holding a $120,000 note from Box Company agrees to accept the land held as an investment in full settlement of the note plus accrued interest of $8,000. The land has a fair value of $95,000.

Land (increase to fair value)	15,000	
Gain on Transfer of Assets (FV less CV)		15,000
Notes Payable (at carrying value)	120,000	
Accrued Interest Payable	8,000	
Land (at fair value)		95,000
Gain on Restructuring of Debt		33,000

The land is increased to its fair value and a gain on transfer of assets is recognized in the amount of $15,000. The land and payable are then written off and a gain on restructuring is recognized for the difference between the carrying value of the payable ($128,000) and the fair value of the land ($95,000).

4. A creditor holding a 14%, $80,000 note from Box Company (on which $4,000 interest has accrued) agrees to extend the maturity date of the note for two years (until April 30, 2014) and reduce the interest rate to 8%.

Note Payable	80,000	
Accrued Interest Payable	4,000	
Restructured Debt		84,000

Since the total future cash payments of $92,800 (principal of $80,000 and interest of $12,800) exceed the carrying value of the debt ($84,000), no gain on restructuring

is recognized. Interest expense is recorded in the future by computing the effective interest rate that, when applied to the carrying amount of the payable at the beginning of the period, will amortize the debt over the period to maturity.

5. Bondholders agree to accept an equity interest in Box Company of 150,000 shares of common stock in exchange for the par value of the bonds. Accrued interest of $38,000 is to be paid in cash by January 1, 2013. The market value of the common stock is $1.25 per share.

Bonds Payable	450,000	
Common Stock (150,000 × $1)		150,000
Other Contributed Capital (150,000 × $.25)		37,500
Gain on Restructuring of Debt		262,500

Since the carrying value of the bonds payable exceeds the fair value of the equity interest given, a gain on restructuring is recognized.

6. Bankruptcy administration expenses totaling $16,000 are paid in cash.

Bankruptcy Administration Expenses	16,000	
Cash		16,000

The net gain on transfer of assets ($15,000 − $7,000) will be reported as a part of operations on the income statement, and the gain on restructuring of debt of $329,500 ($34,000 + $33,000 + $262,500) is reported in net income. If the conditions are met, the gain on restructuring may be reported as an extraordinary item. After giving effect to the reorganization entries, Box Company's balance sheet will be as shown in Illustration 10-2.

Notice that, although the stockholders' deficiency has been eliminated, there is still a retained earnings deficit. If desired by the parties of interest, the reorganization plan could have included a provision to decrease the par value of the common stock and eliminate the accumulated deficit.

ILLUSTRATION 10-2

Box Company Balance Sheet May 1, 2012

Current Assets		
Cash		$ 46,000
Inventories		142,000
Total Current Assets		188,000
Plant and Equipment	$680,000	
Less: Accumulated Depreciation	275,000	405,000
Total Assets		$593,000
Current Liabilities		
Accounts Payable		$ 60,000
Accrued Interest Payable (due 1/1/2013)		38,000
Total Current Liabilities		98,000
Restructured Debt—due 4/30/14		84,000
Total Liabilities		182,000
Stockholders' Equity		
Common Stock, $1 par value	$650,000	
Other Contributed Capital	37,500	
Retained Earnings (deficit) ($598,000 + 16,000 − 8,000 − $329,500)	(276,500)	
Total Stockholders' Equity		411,000
Total Liabilities and Stockholders' Equity		$ 593,000

Midway through 2002, the number of firms converting Chapter 11 bankruptcies into Chapter 7 almost doubled compared to the previous year. Under Chapter 11, debtors have the right to propose a plan of reorganization and this plan can be expensive because of the administration costs and the costs of the professionals needed to help reorganize the firm. Often debtor companies compare the expected cash from Chapter 11 reorganization with the liquidation values expected under Chapter 7. Debtor firms know that once they declare Chapter 7, the prices of the assets decrease as buyers then know that the firm has to sell the assets.[18]

TEST YOUR KNOWLEDGE

NOTE: Solutions to *Test Your Knowledge* questions are found at the end of each chapter before the end-of-chapter questions.

Short Answer

Assume that a debtor owes a creditor a $10,000 note payable with $2,000 accrued interest. Determine the amount of the gain or loss included in ordinary income and/or the amount of the gain or loss from restructuring.

Assume that land with a book value of $8,000 and a fair value of $9,000 is given in full payment of the amount owed.

The "Accounting" Statement of Affairs[19]

The Reform Act provides that a plan for reorganization will not be approved by the court unless it can be shown that creditors will receive at least as much as they would receive if the debtor were liquidated. Consequently, it is important that the estimated amounts to be received by all parties be determined before filing either a liquidation or reorganization petition with the court. The ***Statement of Affairs*** is a report designed to show the estimated amount that would be received by each class of claim in the event of liquidation. It is essentially a balance sheet prepared on the basis of an assumption of liquidation rather than on the going-concern assumption. The appropriate emphasis is no longer one of reporting residual costs, but one of reporting on the legal status of resources and claims against those resources. Thus, assets are reported at their expected realizable values, rather than at book values.

In addition, the current/noncurrent distinction is set aside, and assets are segregated into those that are pledged with fully secured creditors, those that are pledged with partially secured creditors, and those that are essentially "free" and therefore available to settle unsecured claims. Likewise, the current/noncurrent distinction for liabilities is meaningless; that is, if the company liquidates, all liabilities are current. Thus, liabilities are classified on the basis of their legal status as those having priority, those that are fully secured, those that are partially secured, and those that are unsecured.

In summary, the Statement of Affairs is an accounting report that is designed to permit the user to determine the total expected amounts that could be realized on

[18] Dow Jones Corporate Filings Alert, "Conversions of Chapter 11 Cases to Chapter 7 Liquidations on Rise," by Tom Becker, 7/25/02.

[19] This statement is an accounting report and should not be confused with the Statement of Affairs the Bankruptcy Reform Act requires from the debtor company, which is simply a series of questions concerning the debtor company's financial position.

the disposition of the assets, the priorities in the use of the realization proceeds in satisfying claims, and the potential net deficiency that would result if the assets were realized and claims liquidated. In that respect, stockholders' or owners' equity balances have no significance.

Illustration of a Statement of Affairs As an illustration of a Statement of Affairs, assume that the Preston Company had the following balance sheet on April 30, 2012, at which time the company is contemplating filing a petition for liquidation or reorganization.

Additional information concerning estimated realizable values and other balance sheet relationships follows:

1. The notes receivable are expected to be fully realized, and they have been pledged as collateral on a bank note in the principal amount of $20,000 plus accrued interest of $600.
2. Accounts receivable have an estimated collectible value of $28,000.
3. Inventories have a realizable value of $102,280.

Preston Company
Balance Sheet April 30, 2012

Assets	
Cash	$ 8,200
Notes Receivable	24,000
Accounts Receivable (net)	47,000
Inventories	119,000
Prepaid Expenses	1,200
Investment in Beta Company Stock, 1,000 Shares at Market Value	26,500
Land	42,000
Buildings (net)	198,000
Machinery and Equipment (net)	93,000
Total Assets	$558,900
Liabilities and Stockholders' Equity	
Bank Notes Payable	$ 32,000
Accounts Payable	195,000
Accrued Salaries and Wages	13,500
Accrued Interest	
On bank notes	1,100
On mortgage note	8,500
Mortgage Note Payable	200,000
Capital Stock	250,000
Retained Earnings (deficit)	(141,200)
Total Liabilities and Stockholders' Equity	$558,900

4. The recovery value of prepaid expenses is $600.
5. The Investment in Beta Company stock is pledged as collateral on a bank note payable in the principal amount of $12,000 plus accrued interest of $500.
6. Land and buildings have an appraised value of $140,000 and serve as collateral on the mortgage note payable.
7. The machinery and equipment have an estimated disposal value of $38,000.

The Statement of Affairs for Preston Company, along with a ***deficiency account*** summarizing estimated gains and losses on the realization of assets, is presented in Illustration 10-3.

ILLUSTRATION 10-3

Preston Company Statement of Affairs April 30, 2012

Book Value	*Assets*			*Realizable Value*	*Deficiency Account*
	Assets Pledged with Fully Secured Creditors				(Loss)/Gain
$ 24,000	Notes Receivable		$ 24,000		
	Bank Note Payable	$20,000			
	Accrued Interest	600	20,600	$ 3,400	
26,500	Investment in Stock of Beta Company		26,500		
	Bank Note Payable	$12,000			
	Accrued Interest	500	12,500	14,000	
	Assets Pledged with Partially Secured Creditors				
240,000	Land and Buildings		140,000		(100,000)
	Mortgage Note Payable	200,000			
	Accrued Interest	8,500	208,500		
	Unsecured amount (see below)		(68,500)		
	Free Assets				
8,200	Cash			8,200	
47,000	Accounts Receivable			28,000	(19,000)
1,200	Prepaid Expenses			600	(600)
119,000	Inventories			102,280	(16,720)
93,000	Machinery and Equipment			38,000	(55,000)
	Total Net Realizable Value			194,480	
	Liabilities having Priority— Salaries and Wages			13,500	
	Net Free Assets			180,980	
	Estimated Deficiency to Unsecured Creditors (balancing amount)			82,520	
$558,900				$263,500	(191,320)

Book Value	*Equities*		*Unsecured Liabilities*	
	Liabilities Having Priority			
$ 13,500	Accrued Salaries and Wages	$ 13,500		
	Fully Secured Creditors			
32,000	Notes Payable	32,000		
1,100	Accrued Interest	1,100		
	Partially Secured Creditors			
200,000	Mortgage Note Payable	200,000		
8,500	Accrued Interest	8,500		
	Total	208,500		
	Land and Buildings	140,000	$ 68,500	
	Unsecured Creditors			
195,000	Accounts Payable		195,000	
	Stockholders' Equity			
250,000	Capital Stock			250,000
(141,200)	Retained Earnings (deficit)			(141,200)
$558,900			$263,500	$108,800
	Estimated deficiency			$(82,520)

Preston Company
Deficiency Account April 30, 2012

Estimated Losses		*Estimated Gains*	
Accounts Receivable	$ 19,000	Capital Stock	$250,000
Inventory	16,720	Retained Earnings	(141,200)
Prepaid Expenses	600	Estimated Deficiency to Unsecured Creditors	82,520
Land and Buildings	100,000		
Machinery and Equipment	55,000		
Total	$191,320	Total	$191,320

Several comments concerning Illustration 10-3 should be noted:

1. Assets pledged with fully secured creditors—notes receivable and the investment in stock of Beta Company—have realizable values in excess of the secured debts in an amount of $17,400, which becomes available for distribution to unsecured creditors.
2. Assets pledged with partially secured creditors—land and buildings—have a realizable value that is $68,500 less than the total related debt. Thus, mortgage holders have a $68,500 remaining claim that ranks as an unsecured one.
3. Free assets are those that have not been pledged with specific liabilities and are, therefore, available to satisfy general unsecured creditors. Note that the "free" assets include the excess of the realizable value of pledged assets over the related debts of fully secured creditors.
4. In the Deficiency Account, the capital stock and retained earnings deficit are included in the estimated gains column only to indicate the extent to which total potential deficiency is covered by stockholders' equity.
5. The final settlement with the unsecured creditors can be computed by dividing the "net free assets" by the total amount owed to unsecured creditors:

$$\frac{\$180{,}980}{\$263{,}500} = 68.7\%$$

Thus, it is estimated that each unsecured creditor will receive approximately 69% of the amount due under the claim.

IN THE NEWS

In rare cases, DIP (debtor-in-possession) lending is provided by the company buying the assets of the firm in **bankruptcy** proceedings, as in AMR Corp.'s purchase, through its American Airlines unit, of Trans World Airlines for $500 million. "They provided the DIP so they could get the transaction done," said Harvey L. Tepner, an attorney with Loeb Partners Corp., an investment and merchant-banking firm in New York City. "In that case, the exit strategy was [American Airlines] would pay themselves back through the operation of the airline," he said. "**Chapter 11** is a great marketplace for M&A activity."[20]

TRUSTEE ACCOUNTING AND REPORTING

As indicated earlier, a trustee is often appointed to assume the responsibility of managing the debtor's business for the period during which a reorganization plan is developed or the business is liquidated. The trustee takes title to the debtor's assets and is accountable to the court, the creditors, and other parties of interest for the subsequent utilization or realization of the assets. From an accounting standpoint, two main approaches are available to the trustee. He or she may continue to use the debtor's accounting records, which is the approach often used when it is expected that the business will be rehabilitated and returned to the control of the debtor at

[20] *The Wall Street Journal*, "Debtor Loans Help Cash-Poor Firms," by Marc Hopkins, 7/24/02, p. B3G.

some future date or when the business is expected to be sold as an operating unit. Or the trustee may open a new set of books, the approach frequently used when the assets are to be realized and liabilities liquidated. In either case, the better approach is probably to open a new set of books, because it will make it easier to distinguish between the assets and liabilities of the debtor that existed before the appointment of the trustee and those arising after his or her appointment.

When new books are opened, the trustee records, at their book values, the assets (as well as any related valuation accounts) that have been placed under trustee control. The net credit in the entry is to an account normally titled with the name of the debtor company and the term "in receivership," for example, "Axon Company—In Receivership." No existing liabilities are recorded by the trustee, but liabilities incurred later are recorded. Although liabilities existing at the date the trustee takes control are not recorded, the trustee may pay these liabilities in the course of operating the company or as part of the realization and liquidation process. This payment of preexisting debts, of course, reduces the assets for which the trustee is accountable.

The transfer of the assets to the trustee is recorded on the debtor's books by crediting the various asset accounts (with debits to related valuation accounts) and debiting an account in the name of the trustee. Subsequent activities engaged in by the trustee are recorded on the trustee's books with entries on the debtor's books where appropriate, for example, to record the payment of preexisting debts by the trustee.

As an example of the accounting procedures used where the trustee opens a new set of books, assume that Axon Company has the following account balances on October 1, 2012, at which time Gary Trent was appointed trustee.

Cash	$ 6,400
Receivables	32,000
Inventory	48,600
Property and equipment	120,000
Total	$207,000
Allowance for uncollectibles	$ 2,900
Accumulated depreciation	44,100
Accounts payable	75,000
Capital stock	180,000
Retained earnings (deficit)	(95,000)
Total	$207,000

During the period from October 1, 2012, through December 31, 2012, the following transactions occurred:

(1) All Axon Company's assets were transferred to the trustee.

(2) Additional merchandise inventory was purchased by the trustee on account in amount of $26,000.

(3) Sales for the period were: on account, $52,000; cash, $7,000.

(4) Cash was collected by the trustee on	
Accounts receivable (old)	$18,000
Accounts receivable (new)	46,000
(5) Payments were made by the trustee for	
Accounts payable (old)	$43,000
Accounts payable (new)	14,000
Operating expenses	10,500
Trustee's expenses	2,000

(6) Adjusting entries recorded by the trustee on December 31, 2012 were:

Estimated uncollectibles on	
Accounts receivable (old)	$ 3,500
Accounts receivable (new)	400
Accounts receivable written off	
on accounts receivable (old)	4,500
Depreciation expense	7,600

(7) The merchandise inventory balance on December 31 was $42,000.

Entries to record the effect of these transactions on the trustee's and the debtor's books are presented in Illustration 10-4. In order to prepare financial statements for Axon Company on December 31, 2012, the trustee's accounts must be combined with Axon Company's accounts. A combining workpaper for this purpose is presented in Illustration 10-5.

ILLUSTRATION 10-4

Journal Entries

	Trustee's Books			*Axon Company's Books*		
(1)	Cash	6,400		Gary Trent, Trustee	160,000	
	Receivables (old)	32,000		Allowance for Uncollectibles	2,900	
	Inventory	48,600		Accumulated Depreciation	44,100	
	Property and Equipment	120,000		Cash		6,400
	Allowance for Uncollectibles		2,900	Receivables		32,000
	Accumulated Depreciation		44,100	Inventory		48,600
	Axon Company—in Receivership		160,000	Property and Equipment		120,000
(2)	Purchases	26,000		No entry		
	Accounts Payable (new)		26,000			
(3)	Cash	7,000		No entry		
	Accounts Receivable (new)	52,000				
	Sales		59,000			
(4)	Cash	64,000		No entry		
	Accounts Receivable (old)		18,000			
	Accounts Receivable (new)		46,000			
(5)	Axon Company—in Receivership	43,000		Accounts Payable	43,000	
	Accounts Payable (new)	14,000		Gary Trent, Trustee		43,000
	Operating Expenses	10,500				
	Trustee's Expenses	2,000				
	Cash		69,500			
(6)	Bad Debts Expense	3,900		No entry		
	Depreciation Expense	7,600				
	Allowance for Uncollectibles (old)		3,500			
	Allowance for Uncollectibles (new)		400			
	Accumulated Depreciation		7,600			
	Allowance for Uncollectibles (old)	4,500		No entry		
	Accounts Receivable (old)		4,500			
(7)	Sales	59,000		Gary Trent, Trustee	2,400	
	Inventory		6,600	Income Summary		2,400
	Purchases		26,000	Income Summary	2,400	
	Operating Expenses		10,500	Retained Earnings		2,400
	Trustee's Expenses		2,000			
	Bad Debts Expense		3,900			
	Depreciation Expense		7,600			
	Income Summary		2,400			
	Income Summary	2,400				
	Axon Company in Receivership		2,400			

ILLUSTRATION 10-5

Axon Company—in Receivership Combining Workpaper
December 31, 2012

	Trial Balance		*Adjustments and Eliminations*		*Combined*	
Debits	*Trustee*	*Axon Company*	*Dr.*	*Cr.*	*Income Statement*	*Balance Sheet*
Cash	7,900					7,900
Accounts Receivable (old)	9,500					9,500
Accounts Receivable (new)	6,000					6,000
Inventory	48,600			(1) 6,600		42,000
Property and Equipment	120,000					120,000
Purchase	26,000			(1) 26,000		
Operating Expenses	10,500				10,500	
Trustee Expenses	2,000				2,000	
Bad Debts Expense	3,900				3,900	
Depreciation Expense	7,600				7,600	
Cost of Goods Sold			(1) 32,600		32,600	
Gary Trent, Trustee		117,000		(2) 117,000		
Total	242,000	117,000			56,600	185,400
Credits						
Allowance for Uncollectibles (old)	1,900					1,900
Allowance for Uncollectibles (new)	400					400
Accumulated Depreciation	51,700					51,700
Accounts Payable (old)		32,000				32,000
Accounts Payable (new)	12,000					12,000
Capital Stock		180,000				180,000
Retained Earnings (deficit)		(95,000)				(95,000)
Sales	59,000				59,000	
Axon Company, in Receivership	117,000		(2) 117,000			
Total	242,000	117,000	149,600	149,600	59,000	
Net Income					2,400	2,400
Total					56,600	185,400

(1) To adjust inventory and set up cost of goods sold.
(2) To eliminate reciprocal accounts.

REALIZATION AND LIQUIDATION ACCOUNT

When a trustee is appointed to handle the affairs of a company in financial difficulty, the court expects to receive periodic reports summarizing the realization and distribution activities of the fiduciary.[21] Although the traditional financial statements may be prepared by the fiduciary, court officials are interested primarily in the changes that have occurred in the monetary items during a period. The legal form used to report these activities is termed a ***realization and liquidation account***. The report has three main sections—assets, liabilities, and revenues and expenses. The asset section consists of four parts, illustrated as follows:

Assets

Assets to be realized	Assets realized
Assets acquired	Assets not realized

[21] A fiduciary is a person to whom property is entrusted to hold, control, or manage for another.

The ***assets to be realized*** part identifies the individual assets to which the trustee has taken title from the debtor. Cash is not included in the report because it is already realized. Although cash is excluded, the court is given a copy of the cash account of the trustee, which shows the beginning amount received from the debtor, as well as all the individual receipts and disbursements for the period covered. The ***assets acquired*** part itemizes the assets either discovered or received from operating activities during the period. The ***assets realized*** part identifies proceeds received from the conversion of specific assets. The ***assets not realized*** part identifies the assets remaining with the trustee at the end of the reporting period.

In a similar manner, the liabilities section consists of four parts, as indicated below:

Liabilities

Liabilities liquidated	Liabilities to be liquidated
Liabilities not liquidated	Liabilities incurred

The ***liabilities to be liquidated*** part identifies the liabilities that the trustee took responsibility for at the date of appointment. ***Liabilities incurred*** reflect the liabilities incurred by the trustee for operating activities during the period. ***Liabilities liquidated*** identify specific liabilities paid by the trustee, and ***liabilities not liquidated*** reflect those that remain to be paid by the trustee.

The revenues and expenses section of the report lists the supplementary expenses incurred and revenues received by the trustee during the period, as follows:

Revenues and Expenses

Supplementary charges	Supplementary credits

The realization and liquidation account is prepared in the typical account form with debits on the left side and credits on the right side of the account. Any figure needed to balance the account reflects a gain or loss for the reported period.

As an example of a realization and liquidation account, assume Illustration 10-5 concerning the receivership of Gary Trent for Axon Company. The realization and liquidation account is presented in Illustration 10-6.

A copy of the Cash account of the trustee that would be included with the report is presented below:

Cash

Balance, 10/1	6,400	Accounts payable (old)	43,000
Sales	7,000	Accounts payable (new)	14,000
Accounts receivable (old)	18,000	Operating expenses	10,500
Accounts receivable (new)	46,000	Trustee's expenses	2,000
Balance, 12/31	7,900		

Note that the balancing figure (labeled "net gain") in the realization and liquidation account is the same as the $2,400 net income reported for the period October 1 to December 31, 2012, in Illustration 10-5. This is as it should be, since no assets were realized during the period except through normal operating activities. If assets had been realized by other than normal operating activities (for example, the sale of land), any gain or loss would increase or decrease the net gain reported in the Realization and Liquidation account. The transaction could be treated in one of two ways. Assets realized could be reported at the amount received from the

ILLUSTRATION 10-6

Axon Company, Gary Trent, Trustee, Realization and Liquidation Account, October 1, 2009, to December 31, 2012

Assets to Be Realized			**Assets Realized**		
Receivables (old)	$ 32,000		Accounts Receivable (old)		$ 18,000
Less: Allowance for Uncollectibles	2,900	$ 29,100	Accounts Receivable (new)		46,000
Inventory		48,600			
Property and Equipment	120,000		**Assets Not Realized**		
Less: Accumulated Depreciation	44,100	75,900	Accounts Receivable (old)	$ 9,500	
			Less: Allowance for Uncollectibles	1,900	7,600
Assets Acquired			Accounts Receivable (new)	6,000	
Accounts Receivable (new)		52,000	Less: Allowance for Uncollectibles	400	5,600
			Inventory		42,000
Supplementary Charges			Property and Equipment	120,000	
Purchases		26,000	Less: Accumulated Depreciation	51,700	68,300
Operation Expenses		10,500			
Trustee's Expenses		2,000	**Supplementary Credits**		
			Sales		59,000
Liabilities Liquidated					
Accounts Payable (old)		43,000	**Liabilities to Be Liquidated**		
Accounts Payable (new)		14,000	Accounts Payable (old)		75,000
Liabilities Not Liquidated			**Liabilities Incurred**		
Accounts Payable (old)		32,000	Accounts Payable (new)		26,000
Accounts Payable (new)		12,000			
Net Gain		2,400			
Total		$347,500	Total		$347,500

sale of the asset (the traditional approach), or they might be reported at the book value of the asset sold and any gain or loss on the sale reported as a supplemental credit or supplemental charge. For example, assume that the property and equipment account of Axon Company included a parcel of land that cost $25,000 and that the parcel was sold by the trustee for $35,000. The traditional approach would report assets realized at $35,000 with a decrease in assets not realized of $25,000. The $10,000 difference between the two would be reflected as part of a net gain of $12,400, rather than the $2,400 in Illustration 10-6. The items that would be different in Illustration 10-6 are:

Assets Realized		
Property and Equipment		$35,000
Assets Not Realized		
Property and Equipment ($120,000 − $25,000)	$95,000	
Less: Accumulated Depreciation	51,700	43,300
Net Gain		12,400

The basic weakness in this approach is that the components of the "net gain" or "net loss" are not disclosed.

An alternative is to report the sale of the land as assets realized at book value, $25,000, a decrease in assets not realized of $25,000, and a supplementary credit "Gain on sale of land" of $10,000. Although the net gain needed to balance the account is still $12,400, the reader of the report is able to identify the components of

the net gain. The items that would be different in Illustration 10-6 under this approach are:

Assets Realized		
Property and Equipment		$25,000
Assets Not Realized		
Property and Equipment ($120,000 − $25,000)	$95,000	
Less: Accumulated Depreciation	51,700	43,300
Supplementary Credits		
Gain on Sale of Land		10,000
Net Gain		12,400

Similar alternative treatments could be afforded the favorable or unfavorable liquidation of liabilities.

Other items on the realization and liquidation account deserve comment:

1. Note that we have elected to show sales of merchandise as supplementary credits and purchases of merchandise as supplementary charges. As an alternative, the trustee might report sales of merchandise as ***assets realized*** and purchases of merchandise as ***assets acquired***. We believe our treatment is more informative because it separates operating effects from nonoperating effects, although the latter treatment is more common in practice.
2. Expenses representing cost allocations (such as depreciation) and estimated bad debts expense are not reported separately. These expenses are reflected in the report, however, as increases in accumulated depreciation and allowance for uncollectibles in the ***assets not realized*** part of the report. Thus, because the net gain (loss) for the period is a balancing figure, these expenses are factors in the determination of that net gain (loss).

Bankruptcy Prediction Models

RELATED CONCEPTS

One assumption underlying the financial statements is that the firm will continue as a going concern.

Perhaps, one of the most critical tasks of an audit team lies in assessing a client's likelihood of continuing as a going concern. When the auditors deem the likelihood to be low, the opinion issued in conjunction with the audited financial statements must reflect this assessment. Because clients are resistant to such an opinion, guidance for the decision is clearly needed. Furthermore, researches have found frequent errors in both directions; that is, going concern audit reports issued for firms that do not later fail, and client failures where no going concern report was issued by the auditor. SAS No. 59, "*Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*," provides guidance to the auditor in conducting an audit of financial statements in evaluating whether there is substantial doubt about the entity's ability to continue as a going concern. The auditor has a responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern. The auditor's evaluation is based on his knowledge of relevant conditions and events that exist at, or have occurred prior to the completion of fieldwork. Information about such conditions or events is obtained from the application of auditing procedures planned and performed to achieve audit objectives that are related to management's assertions embodied in the financial statements being audited, as described in SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol 1, AU Section 326).

The auditor should evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time in the following manner:

a. The auditor considers whether the results of his procedures performed in planning, gathering evidential matter relative to the various audit objectives, and completing the audit identify conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. It may be necessary to obtain additional information about such conditions and events, as well as the appropriate evidential matter to support information that mitigates the auditor's doubt.

b. If the auditor believes there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, he should (1) obtain information about management's plans that are intended to mitigate the effect of such conditions or events, and (2) assess the likelihood that such plans can be effectively implemented.

c. After the auditor has evaluated management's plans, he concludes whether he has substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. If the auditor concludes there is substantial doubt, he should (1) consider the adequacy of disclosure about the entity's possible inability to continue as a going concern for a reasonable period of time, and (2) include an explanatory paragraph (following the opinion paragraph) in his audit report to reflect his conclusion. If the auditor concludes that substantial doubt does not exist, he should consider the need for disclosure.

The auditor is not responsible for predicting future conditions or events. The fact that the entity may cease to exist as a going concern subsequent to receiving a report from the auditor that does not refer to substantial doubt, even within one year following the date of the financial statements, does not in itself indicate inadequate performance by the auditor. Accordingly, the absence of reference to substantial doubt in an auditor's report should not be viewed as providing assurance as to an entity's ability to continue as a going concern.

Altman's Z-Score Bankruptcy Model

In 1968, Altman developed the most widely used model for bankruptcy prediction, the Altman Z-score model. In estimating this model, Altman started with 22 common ratios from five categories covering liquidity, leverage, profitability, activity, and solvency. Using multiple discriminate analysis, he estimated the best model that distinguished bankrupt firms from nonbankrupt firms. His model was originally estimated for manufacturing firms but is generally applied to all types of firms. His model is:

$$Z = 1.2x_1 + 1.4x_2 + 3.3x_3 + 0.6x_4 + 0.999x_5$$

where:

x_1 = (current assets less current liabilities)/total assets

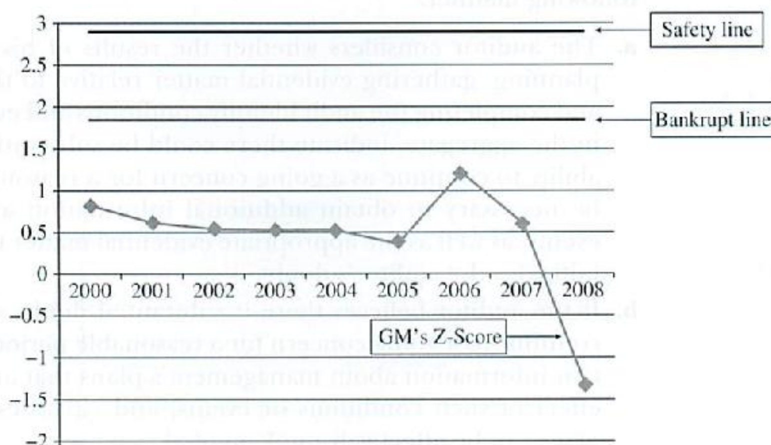
x_2 = retained earnings/total assets

x_3 = earnings before interest and taxes/total assets

x_4 = market value of equity/total liabilities

x_5 = sales/total assets

FIGURE 10-2
General Motors Z-Score 2000–2008



If the calculated z-score is below 1.8, the firm is classified as a distressed firm. Firms with z-scores between 1.1 and 2.675 are considered in the "gray zone," and z-scores above 2.99 are considered safe.

In Figure 10-2, General Motors' z-score is computed for the years 2000 through 2008. The z-score has been decreasing over time (with the exception of 2006) and is in the "bankrupt" zone in virtually every year. GM's market cap in 2008 fell to around $4 billion down from a high of $52 billion in 2000. While there were some modest increases in revenues over this period, the firm earned a net loss every year after 2004.

IFRS

The auditor has a responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. *Reasonable period of time* is defined as a period not to exceed one year beyond the date of the financial statements being audited. Currently, AU Section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, of the AICPA Codification of Statements on Auditing Standards contains the guidance about the going concern assessment. The Public Company Accounting Oversight Board (PCAOB) adopted AU Section 341 on an initial transitional basis.

Conditions and events that may raise a substantial doubt about an entity's ability to continue as a going concern include negative financial trends such as recurring operating losses, working capital deficiencies, negative cash flows from operations, and/or adverse key financial ratios. Other indications of possible financial difficulties might include such events as defaulting on loans, having not paid dividends, seeking new sources of financing, selling assets, or restructuring debt.

FASB issued an exposure draft in October, 2008 on "Going Concern." The Board decided to carry forward the going concern guidance from AU Section 341, subject to several modifications to align the guidance with International Financial Reporting Standards (IFRSs). One modification is to change the time horizon for the going concern assessment. AU Section 341 states that there is "a responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited." International Accounting

Standard (IAS) 1, *Presentation of Financial Statements,* requires that an entity considers "all available information about the future, which is at least, but is not limited to, twelve months from the end of the reporting period" when assessing whether the going concern assumption is appropriate. The Board decided to use the time horizon in IAS 1 because it avoids a bright-line time horizon that might allow significant events or conditions occurring just beyond the one-year time horizon not to be disclosed. The other modifications to align the going concern guidance with IFRSs include using the wording in IAS 1 with respect to the type of information that should be considered in making the going concern assessment (*all available information about the future*) and requiring an entity to disclose when it does not present financial statements on a going concern basis.

SUMMARY

1. *Distinguish between a Chapter 7 and a Chapter 11 bankruptcy.* In a Chapter 7 bankruptcy, the company ceases operations and the assets are generally sold by a trustee. In a Chapter 11 bankruptcy, the business is reorganized and the creditors agree on a plan for payment of their claims.
2. *Describe the five priority categories of unsecured claims and list the order in which they are settled.* The five categories listed in order of priority are: (a) administration expenses, fees, and charges incurred in administering the bankrupt's estate; (b) unsecured claims for wages, salaries, or commissions earned by an employee within 90 days before the date of filing of the petition; (c) unsecured claims for contributions to employee benefit plans from services rendered within 180 days before the date of the filing of the petition; (d) unsecured claims of individuals arising from the deposit of money in connection with the purchase, lease, or rental of property or services that were not delivered or performed; and (e) unsecured claims of governmental units for unpaid taxes.
3. *Distinguish between a voluntary and involuntary bankruptcy petition.* A debtor may file a voluntary petition with a bankruptcy court for liquidation under Chapter 7 or for reorganization under Chapter 11. In an involuntary proceeding, creditors initiate the action by filing a petition for liquidation or reorganization with the bankruptcy court. Filing of a voluntary or involuntary petition constitutes an ***order for relief,*** which prohibits the start or continuation of legal action against the debtor by its creditors.
4. *Distinguish among fully secured, partially secured, and unsecured claims of creditors.* Fully secured claims are those with liens against assets whose realizable value is equal to or in excess of the claim. Partially secured claims are those with liens against assets whose realizable value is less than the amount of the claim. Unsecured creditors, including those having priority, are paid from whatever proceeds remain from the realization process.
5. *Describe contractual agreements that the debtor and its creditors may enter into outside of formal bankruptcy proceedings to resolve the debtor's insolvent position.* These agreements generally include (a) an extension of payment periods; (b) composition agreements where the creditors agree to accept less than the full amount to their claims; (c) formation of a creditors' committee where the parties agree to the formation of a creditors' committee that is responsible for managing the debtor's business affairs for the period during which plans are developed to rehabilitate, reorganize, or liquidate the business; or (d) a voluntary assignment of assets where the debtor may elect to place its property under the control of a trustee for the benefit of its creditors.
6. *Describe the ways debt may be restructured in a reorganization.* In reorganization, debt might be restructured using one of the following: (a) the debtor may transfer assets in full settlement of the payable; (b) the debtor may give an equity interest in its firm in full settlement of the payable; or (c) the creditor may modify terms of the payable.

TEST YOUR KNOWLEDGE SOLUTIONS

10-1 1. c
2. False
3. True
4. False
5. True

10-2 Ordinary gain on revaluation of land is $1,000 and the restructuring gain is $3,000.

QUESTIONS

LO5 1. List the primary types of contractual agreements between a debtor company and its creditors and briefly explain what is involved in each of them.

LO3 2. Distinguish between a voluntary and involuntary bankruptcy petition.

LO4 3. Distinguish among fully secured, partially secured, and unsecured claims of creditors.

LO2 4. Five priority categories of unsecured claims must be paid before general unsecured creditors are paid. Briefly describe what makes up each category.

LO4 5. What are "dividends" in a bankruptcy proceeding?

LO6 6. For each of the following debt restructurings, indicate whether a gain is recognized and, if so, how the gain is measured and reported.
(a) Transfer of assets by the debtor to the creditor.
(b) Grant of an equity interest by the debtor to the creditor.
(c) Modification of the terms of the payable.

LO1 7. What is the purpose of a Statement of Affairs?

LO4 8. One of the officers of a corporation that had just received a discharge in bankruptcy said, "Good, now we don't owe anyone." Is he correct?

LO1 9. What are the duties of a trustee in a liquidation proceeding?

LO1 10. What is the purpose of a combining workpaper prepared by a trustee?

LO1 11. What is the purpose of a realization and liquidation account?

Business Ethics

From an ethical perspective, some believe that it is never justifiable for an individual or business to declare bankruptcy. Others believe that some actions are appropriate only in extreme circumstances. Without question, as stated in the *Journal of Accountancy*, November 2005, page 51, "the ease with which debtors have been able to walk away from debt has frustrated creditors for years."

1. Describe the differences between Chapter 7 (liquidations) and Chapter 11 (reorganizations) from an ethical standpoint. Who is most likely to be hurt by a Chapter 7 bankruptcy?
2. Discuss the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. Do you believe the changes wrought by this act will serve to protect creditors?
3. The Protection Act of 2005 requires individuals, but not businesses, to undergo a "means" test before they can seek Chapter 7 relief. Do you believe this change should be applied to businesses as well? Why or why not?
4. Do you think that you would ever resort to filing for bankruptcy relief yourself? Why or why not?

ANALYZING FINANCIAL STATEMENTS

AFS10-1 **Circuit City versus Best Buy**

In the following table, eight years of data for Best Buy and Circuit City are presented. Evaluate the performance of the two companies over time (see Appendix A in Chapter 1 for a structured approach). In addition, compute the z-score to determine the likelihood of bankruptcy. Comment on your analysis.

Best Buy ($ millions)	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*
Balance Sheet								
Assets	4,839.587	7,375.000	7,663.000	8,652.000	10,294.000	11,864.000	13,570.000	12,758.000
Total Liabilities	3,017.659	4,854.000	4,933.000	5,230.000	5,845.000	6,607.000	7,334.000	8,234.000
Stockholders' Equity	1,821.928	2,521.000	2,730.000	3,422.000	4,449.000	5,257.000	6,236.000	4,524.000
Selected Balance Sheet items								
Market Value of Equity	8,525.333	14,339.485	9,359.552	17,287.506	17,737.035	26,127.378	22,340.844	17,658.960
Current Assets	2,928.663	4,611.000	4,867.000	5,724.000	6,903.000	7,985.000	9,081.000	7,342.000
Current Liabilities	2,714.698	3,730.000	3,793.000	4,501.000	4,959.000	6,056.000	6,301.000	6,769.000
Accounts Receivables	209.031	247.000	312.000	343.000	375.000	506.000	548.000	549.000
Inventory	1,766.934	2,258.000	2,046.000	2,607.000	2,851.000	3,338.000	4,028.000	4,708.000
Long-term Debt	295.949	820.000	829.000	850.000	600.000	596.000	650.000	816.000
Retained Earnings	1,224.296	1,788.000	1,920.000	2,554.000	3,464.000	4,565.000	5,723.000	4,435.000
Income Statement								
Total Revenues	15,326.552	19,597.000	20,946.000	24,547.000	27,433.000	30,848.000	35,934.000	40,023.000
Cost of Goods Sold	12,100.090	14,858.000	15,400.000	17,965.000	20,479.000	22,663.000	26,652.000	29,892.000
Gross Margin	3,226.462	4,739.000	5,546.000	6,582.000	6,954.000	8,185.000	9,282.000	10,131.000
Income before Extraordinary items	395.839	570.000	622.000	800.000	934.000	1,140.000	1,377.000	1,407.000
Net income	395.839	570.000	99.000	705.000	984.000	1,140.000	1,377.000	1,407.000
Selected Income Statement items								
Interest Expense	6.900	20.000	24.000	32.000	44.000	30.000	31.000	62.000
Tax Expense	245.640	366.000	392.000	496.000	509.000	581.000	752.000	815.000
Statement of Cash Flows								
Cash from Operations (CFO)	861.000	1,543.000	746.000	1,387.000	1,981.000	1,695.000	1,762.000	2,025.000
Cash interest paid	7.000	25.000	24.000	22.000	35.000	16.000	14.000	49.000
Cash taxes paid	61.700	139.000	283.000	306.000	241.000	547.000	804.000	644.000

Circuit City ($ millions)	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*
Balance Sheet								
Assets	3452.559	4133.197	3799.117	3633.000	3789.382	4069.044	4007.283	3745.930
Total Liabilities	1195.400	1572.852	1457.542	1409.039	1701.948	2114.411	2216.039	2242.755
Stockholders' Equity	2257.159	2560.345	2341.575	2223.961	2087.434	1954.633	1791.244	1503.175
Selected Balance Sheet items								
Market Value of Equity	3140.493	3733.755	928.001	2279.591	2940.785	4200.180	3243.091	746.357
Current Assets	2354.272	3075.008	3102.910	2919.061	2685.715	2833.341	2883.512	2439.720
Current Liabilities	1065.662	1417.935	1280.069	1176.703	1263.846	1622.330	1714.029	1605.687
Accounts Receivables	451.099	553.273	775.339	579.717	172.995	226.440	425.277	488.715
Inventory	1410.527	1234.243	1409.736	1517.256	1459.520	1698.026	1636.507	1573.560
Long-term Debt	57.530	37.926	12.664	23.806	12.410	81.236	147.549	104.932
Retained Earnings	1597.315	1801.554	1387.515	1199.411	1272.321	1409.027	1361.755	1099.172
Income Statement								
Total Revenues	10458.037	9589.803	10015.946	9778.138	10477.928	11597.686	12429.754	11743.691
Cost of Goods Sold	7809.851	7117.460	7445.736	7320.151	7748.853	8602.915	9319.965	9130.553
Gross Margin	2648.186	2472.343	2570.210	2457.987	2729.075	2994.771	3109.789	2613.138
Income before Extraordinary items	149.247	190.799	41.565	−0.787	59.911	151.112	−10.182	−321.353
Net income	149.247	190.799	106.084	−89.269	61.658	139.746	−8.281	−319.897
Selected Income Statement items								
Interest Expense	9.394	2.158	1.793	1.804	2.066	8.143	9.519	8.980
Tax Expense	70.637	78.446	25.475	−0.453	35.878	87.970	30.510	−32.226
Statement of Cash Flows								
Cash from Operations (CFO)	167.120	837.208	−164.059	−131.676	389.347	364.942	316.341	−45.626
Cash interest paid	25.336	8.929	1.824	2.999	4.900	6.800	1.500	1.200
Cash taxes paid	117.366	−44.926	107.946	36.324	152.800	94.200	74.200	6.000

AFS10-2 Blockbuster versus Netflix

In the following table, nine years of data for Blockbuster Video and Netflix are presented. Evaluate the performance of the two companies over time (see Appendix A in Chapter 1 for a structured approach). In addition, compute the z-score to determine the likelihood of bankruptcy. Comment on your analysis.

Blockbuster ($ millions)	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*
Balance Sheet									
Assets	7752.400	6243.800	4854.900	3863.400	3179.600	3137.200	2733.600	2154.500	1538.300
Total Liabilities	2003.700	2076.800	1605.600	2800.500	2548.000	2394.800	2077.900	1940.200	1852.600
Stockholders' Equity	5748.700	4167.000	3249.300	1062.900	631.600	742.400	655.700	214.300	−314.300
Selected Balance Sheet items									
Market Value of Equity	4455.360	2200.100	3247.155	1699.938	669.510	973.317	720.360	198.882	124.488
Current Assets	716.400	958.900	960.300	1217.700	1423.800	1565.600	1319.200	1258.600	1060.000
Current Liabilities	1268.800	1477.600	1327.800	1449.400	1317.900	1395.300	1288.500	1253.400	934.800
Accounts Receivables	150.000	184.800	183.700	177.800	127.800	133.800	113.100	117.100	79.400
Inventory	202.900	452.100	415.100	516.600	310.300	343.900	343.900	432.800	298.500
Long-term Debt	727.800	541.500	219.900	1145.200	1158.000	984.200	757.800	817.800	963.600
Retained Earnings	−434.100	−2055.600	−2979.800	−4275.600	−4881.100	−4780.800	−4871.400	−5316.000	−5839.200
Income Statement									
Total Revenues	5156.700	5565.900	5911.700	6053.200	5864.400	5522.200	5517.400	5287.900	4062.400
Cost of Goods Sold	2083.100	2358.700	1435.000	1693.400	1775.300	1790.000	1937.300	1883.600	1364.400
Gross Margin	3073.600	3207.200	4476.700	4359.800	4089.100	3732.200	3580.100	3404.300	2698.000
Income before Extraordinary items	−240.300	189.400	−979.500	−1248.800	−588.100	63.700	−74.200	−373.800	−517.600
Net income	−240.300	−1627.600	−983.900	−1248.800	−588.100	50.500	−73.800	−374.100	−558.200
Selected Income Statement items									
Interest Expense	78.200	49.500	33.100	38.100	98.700	101.600	88.700	73.000	111.600
Tax Expense	−56.100	103.000	103.200	−37.300	64.600	−76.400	29.600	25.600	11.800
Statement of Cash Flows									
Cash from Operations (CFO)	1395.100	1451.200	593.700	417.000	−70.500	329.400	−56.200	51.000	29.300
Cash interest paid	79.400	45.800	34.300	23.200	89.500	99.500	77.400	71.200	68.400
Cash taxes paid	0.000	0.000	98.100	44.400	11.200	−2.200	29.900	26.600	21.500

Netflix ($ millions)	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*	*2007*	*2008*	*2009*
Balance Sheet									
Assets	41.630	130.530	176.012	251.793	364.681	608.779	647.020	617.946	679.734
Total Liabilities	30.304	41.174	63.304	95.510	138.429	194.568	216.271	270.791	480.591
Stockholders' Equity	11.326	89.356	112.708	156.283	226.252	414.211	430.749	347.155	199.143
Selected Balance Sheet items									
Market Value of Equity	210.121	247.131	1390.493	650.186	1481.697	1774.306	1727.984	1759.385	2944.010
Current Assets	19.552	107.075	138.946	187.346	243.691	428.418	416.532	361.447	411.013
Current Liabilities	26.208	40.426	63.019	94.910	137.587	193.447	212.576	216.017	226.369
Accounts Receivables	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000
Inventory	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000
Long-term Debt	6.868	1.691	0.460	0.068	0.000	0.000	0.000	39.140	237.982
Retained Earnings	−37.266	−158.439	−152.697	−131.920	−89.671	−40.589	27.974	108.536	199.090
Income Statement									
Total Revenues	75.912	152.806	272.243	506.228	682.213	996.660	1205.340	1371.161	1670.269
Cost of Goods Sold	20.110	51.659	97.369	188.254	358.773	469.849	561.206	668.023	821.737
Gross Margin	55.802	101.147	174.874	317.974	323.440	526.811	644.134	703.138	848.532
Income before Extraordinary items	−38.618	−21.947	6.512	21.595	42.027	49.082	66.952	83.026	115.860
Net income	−38.618	−21.947	6.512	21.595	42.027	49.082	66.952	83.026	115.860
Selected Income Statement items									
Interest Expense	1.852	11.972	0.417	0.170	0.407	0.000	0.000	2.458	6.475
Tax Expense	0.000	0.000	0.000	0.181	−33.692	31.236	44.549	48.474	76.332
Statement of Cash Flows									
Cash from Operations (CFO)	4.847	40.114	89.792	147.571	157.507	247.862	277.424	284.037	325.063
Cash interest paid	860.000	592.000	312.000	109.000	170.000	1.210	1.188	2.458	3.878
Cash taxes paid	0.000	0.000	0.000	0.000	0.977	2.324	15.775	40.494	58.770

EXERCISES

EXERCISE 10-1 **Multiple Choice** LO1 LO2 LO3 LO5

Select the best answer for each of the following:

1. Johnson joined other creditors of Alpha Company in a composition agreement seeking to avoid the necessity of a bankruptcy proceeding against Alpha. Which statement describes the composition agreement?
   (a) It provides that the creditors will receive less than the full amount of their claims.
   (b) It provides a temporary delay, not to exceed six months, insofar as the debtor's obligation to repay the debts included in the composition is concerned.
   (c) It must be approved by all creditors.
   (d) It provides for the appointment of a receiver to take over and operate the debtor's business.
2. Freeman Company ceased doing business and is in bankruptcy. Among the claimants are employees seeking unpaid wages. The following statements describe the possible status of such claims in a bankruptcy proceeding or legal limitations placed upon them. Which one is an *incorrect* statement?
   (a) The amounts of excess wages not entitled to a priority are mere unsecured claims.
   (b) Such claims include wages earned within 180 days before the filing of the bankruptcy petition, but not to exceed $4,650 in amount.
   (c) Such claims are entitled to priority.
   (d) If a priority is afforded such claims, it cannot exceed $4,650 per wage earner.
3. Which of the entities listed is not subject to an involuntary bankruptcy petition?
   (a) A municipality.
   (b) A partnership.
   (c) A wholesaler company.
   (d) A retailing corporation.
4. The highest priority for payment of unsecured claims in a bankruptcy proceeding is:
   (a) Wages up to $4,650 earned within three months before the petition.
   (b) Unpaid federal income taxes.
   (c) Administrative expenses of the bankruptcy.
   (d) Wages owed to an insolvent employee.
5. Which of the following situations that arise because of a debtor's financial difficulties and would not otherwise be acceptable to the creditor must be accounted for as a troubled debt restructuring?
   (a) As part of a negotiated settlement designed to maintain a relationship with a debtor, a creditor reduces the effective interest rate on debt outstanding to reflect the lower market interest rate currently applicable to debt of that risk class.
   (b) Because of a court order, a creditor reduces the stated interest rate for the remaining original life of the debt.
   (c) Because of a court order, a creditor accepts as full satisfaction of its receivable a building the fair value of which equals the creditor's recorded investment in the receivable.
   (d) As part of a negotiated settlement, a creditor accepts as full satisfaction of its receivable a building the fair value of which equals the debtor's carrying amount of the payable.

EXERCISE 10-2 **True or False** LO1 LO3 LO4

Indicate whether each of the following is true or false. If an answer is false, explain why.

______ 1. Insolvency means that a debtor has more current liabilities than current assets.

______ 2. Voluntary bankruptcy petitions may be filed under either Chapter 7 or Chapter 11 of the Reform Act.

______ 3. If an insolvent debtor has more than 12 creditors, an involuntary petition must be signed by at least three of those creditors.

______ 4. Unsecured creditors with priority will receive full satisfaction before secured creditors are paid.

______ 5. Either a debtor or its creditors may file a petition for reorganization under Chapter 11 of the Reform Act.

______ 6. In a reorganization involving a transfer of assets, the debtor will recognize a gain on restructuring measured by the excess of the carrying value of the payable settled over the book value of the assets transferred.

______ 7. Restructuring gains that arise from troubled debt restructurings are reported by the debtor as extraordinary gains.

______ 8. The statement of affairs is a report designed to estimate the amount expected to be earned by a debtor company during the time period needed to complete a reorganization.

EXERCISE 10-3 Transfer of Assets LO1

Bar Company, which is in financial difficulty and in the process of a voluntary reorganization, has agreed to transfer to a creditor a copyright it owns in full settlement of a $150,000 note payable and $15,000 in accrued interest. The copyright, which originally cost $100,000, has an accumulated amortization balance of $55,000 and a current fair value of $95,000.

Required:

A. Prepare the journal entries on Bar Company's books to record the transfer of the copyright.

B. Explain the proper treatment of any gain or loss recognized in (A).

C. Assuming the fair value of the copyright was $30,000, repeat the requirement in (A).

EXERCISE 10-4 Modification of Terms LO1

Lake Company, a major creditor of financially troubled Spain Company, has agreed to modify the terms of a debt owed to Lake Company. The debt consists of a $900,000, 12% note that is due currently along with accrued interest of $95,000. Lake Company agreed to extend the due date of the note and accrued interest for three years and to reduce the interest rate to 5% per annum (on both maturity value and accrued interest), with interest to be paid annually.

Required:

A. Should a gain on restructuring be recognized by Spain Company? Explain.

B. Prepare the entry that should be made on Spain Company's books on the date of restructure.

EXERCISE 10-5 Modification of Terms LO1

Assume the same situation described in Exercise 10-4 except that the terms of modification of the debt are

1. Accrued interest of $95,000 is to be canceled.

2. The face value of the note is reduced to $600,000, payable at the end of three years. Interest on the new face value at 8% is to be paid annually.

Required:

A. Should a gain on restructuring be recognized? Explain.

B. Prepare entries on the books of Spain Company to record the restructuring.

C. Prepare the entry on Spain Company's books to record the interest payment at the end of the first year after restructuring.

EXERCISE 10-6 Settlement of Priority Claims LO4

The following data are taken from the statement of affairs of the Monroe Company. (Assume that the realizable values of assets are accurate.)

Assets pledged with fully secured creditors (realizable value, $190,000)	$240,000
Assets pledged with partially secured creditors (realizable value, $90,000)	110,000
Free assets (realizable value, $102,000)	160,000
Fully secured creditor claims	91,000
Partially secured creditor claims	120,000
Unsecured creditor claims with priority	30,000
General unsecured creditor claims	350,000

Required:

Compute the amount that will be paid to each class of creditor.

EXERCISE 10-7 **Statement of Affairs** LO1

Ball Company is facing bankruptcy proceedings. A balance sheet dated June 30, 2012, and other information are presented below:

Ball Company Balance Sheet
June 30, 2012

Cash	$ 20,400
Accounts Receivable (net)	170,000
Inventory	180,000
Property and Equipment (net)	430,000
Total Assets	$800,400
Accounts Payable	$350,000
Accrued Wages	120,000
Notes Payable	200,000
Common Stock	400,000
Retained Earnings (deficit)	(269,600)
Total Equities	$800,400

Estimated realizable values of the company's assets are:

Accounts Receivable	$ 95,000
Inventory	110,000
Property and Equipment	320,000

Accounts receivable and inventory are each pledged as security on individual notes payable in the amount of $100,000 each.

Required:

Prepare a statement of affairs and determine the estimated settlement per dollar for general unsecured creditors. (Assume that all accrued wages are priority items.)

EXERCISE 10-8 **Reorganization Balance Sheet** LO1

The following balance sheet was prepared for Crane Company on December 31, 2012:

Crane Company Balance Sheet
December 31, 2012

Cash		$ 33,000
Accounts Receivable	$52,500	
Less: Allowance for Uncollectibles	3,800	48,700
Inventory		71,000
Property and Equipment (net)		142,000
Goodwill		20,000
Total Assets		$314,700
Accounts Payable		$ 66,000
10% Bonds Payable, due 6/30/15		130,000
Common Stock, $20 par, 10,000 Shares Outstanding		200,000
Retained Earnings (deficit)		(81,300)
Total Equities		$314,700

Crane Company has had operating difficulties, accumulating a deficit over several years before 2012. During 2012, however, Crane reported a significantly lower operating loss, and prospects for the future are relatively bright. Although management and stockholders are optimistic about the future, it is almost certain that the company will lack the necessary working capital to handle existing obligations and expected future growth. In light of these facts, Crane has filed for reorganization under Chapter 11 of the Bankruptcy Reform Act of 1978. The reorganization plan, the provisions of which are set out below, has received the approval of stockholders, creditors, and the court. Provisions of the reorganization plan are as follows:

1. Accounts receivable are to be written down to $40,000 to reflect their current expected realizable value.
2. Inventory is fairly valued, but goodwill is to be written off, and property and equipment is to be written down to its fair value of $118,000.
3. The $20 par value common stock is to be replaced with $4 par value common stock on a share-for-share basis in order to create some reorganization capital, which will be used to eliminate the deficit.
4. The bondholders agree to exchange their bonds for new 8% bonds in the same maturity amount, but with a due date of June 30, 2019, and 6,000 shares of $4 par value common stock. The stock will be divided ratably among the bondholders. The fair value of the common stock is equal to its par value.
5. Accounts payable are expected to be paid in full, although creditors have agreed to extend due dates by as much as six months.
6. Any accumulated deficit is to be eliminated.

Required:

A. Prepare journal entries to record the effects of the reorganization plan.
B. Prepare a balance sheet as it would appear immediately after the reorganization.

EXERCISE 10-9 Trustee Accounting LO1

TRX Company has been forced into receivership, and you have been appointed trustee. You decide to open your own set of books in order to distinguish more clearly between transactions occurring before and after your appointment. The following account balances were reported on September 1, 2012:

Cash	$ 26,700
Accounts Receivable	130,400
Inventory	191,900
Property and Equipment	590,400
Total	$939,400
Allowance for Uncollectibles	$ 16,000
Accumulated Depreciation	211,500
Accounts Payable	308,400
Capital Stock	800,000
Retained Earnings (deficit)	(396,500)
Total	$939,400

In the four months immediately after your appointment, the following transaction occurred:

1. Sales were made in the amount of $296,000, of which $31,500 were cash sales.
2. Receivables were collected in the following amounts:

Old receivables	$ 76,800
New receivables	242,200

3. Additional inventory was purchased on account in the amount of $127,500.

4. Cash payments were made as follows:

On old accounts payable	$206,500
On new accounts payable	61,600
For operating expenses	46,000
For trustee fees	13,000

5. Journal entries were made to record:
   (a) Bad debt expense of $21,600, of which $8,600 related to new accounts receivable.
   (b) Depreciation expense of $32,400.
   (c) Write-off of old accounts receivable of $21,000.

The inventory balance at the end of your first four months as trustee (the end of the fiscal year for TRX Company) was $149,700.

Required:

Prepare journal entries to record the foregoing on your set of books. Include appropriate closing entries.

EXERCISE 10-10 Combining Workpaper LO1

Use the data provided in Exercise 10-9.

Required:

Prepare a combining workpaper for TRX Company as of the end of the first four months of receivership (December 31, 2012).

ASC Exercises: For all ASC exercises indicate as part of your answer: the Codification topic, subtopic, section, and paragraph upon which your answer is based (unless otherwise specified). All ASC questions require access to the FASB Codification.

ASC10-1 **Presentation** A sometimes-confusing aspect of the definition of *current assets* is the inclusion of prepaid items. Prepaid expenses are not usually converted into cash in the current period. How do GAAP rationalize this classification issue?

ASC10-2 **Disclosure** Must a firm separately disclose the cash flow pertaining to extraordinary items or discontinued items in operating activities?

ASC10-3 **Scope** Must a defined pension plan that presents financial information in accordance with the provisions of topic 960 provide a statement of cash flows?

ASC 10-4 **General** List all the topics found in topic 400—Liabilities. (*Hint:* There are nine topics.) ASC 405-10 provides the overall guidance for liabilites. What is the overall objective of this section?

ASC 10-5 **Glossary** What is a *troubled debt restructuring*?

ASC 10-6 **Presentation** Describe fresh start accounting and the conditions under which it is acceptable under current GAAP.

PROBLEMS

PROBLEM 10-1 Journal Entries for Reorganization LO1

On February 1, 2012, Clover Company filed a petition for reorganization under the bankruptcy statutes. The court approved the plan on September 1, 2012, including the following provisions:

1. Unsecured creditors of open accounts amounting to $71,600 are paid 42 cents on the dollar in full settlement.
2. Clover Company is to exchange accounts receivable in the face amount of $92,000 and an allowance for uncollectible accounts of $19,450 for the full settlement of $132,400 owed

on open account to one of its major unsecured creditors. The estimated fair value of the receivables is $69,000.

3. Accrued expenses of $14,620, representing priority items, are to be paid in full.
4. Clover Company's only other major unsecured creditor agreed to a five-year extension of the $300,000 principal owed him on a 10% note payable. Accrued interest on the note on September 1, 2012, amounts to $27,000, one-third of which is to be paid in cash and the remainder canceled. In addition, no interest is to be charged during the remaining five years to maturity of the note.

Required:

Prepare journal entries on the books of Clover Company to give effect to the fore going provisions.

PROBLEM 10-2 Reorganization Entries and Balance Sheet LO1

On September 30, 2011, SRP Company filed a petition for reorganization with a bankruptcy court. The plan was approved by the court and all parties of interest on January 2, 2012, when SRP Company's balance sheet was as follows:

SRP Company Balance Sheet
January 2, 2012

Cash		$ 32,200
Accounts Receivable	$ 71,450	
Less: Allowance for Uncollectibles	16,750	54,700
Inventories		126,600
Plant and Equipment	322,000	
Less: Accumulated Depreciation	180,700	141,300
Land		20,800
Patents		92,000
Total Assets		$467,600
Current Liabilities		
Accounts Payable—Unsecured		$142,700
12% Notes Payable—Unsecured		57,000
Accrued Wages—with Priority		11,900
Accrued Interest Payable		38,400
Total Current Liabilities		250,000
10% Note Payable—Unsecured		54,400
9% Mortgage Note Payable—Secured by Equipment		80,000
Stockholders' Equity		
Common Stock, $.50 par value, 2,500,000 Shares Authorized, 480,000 shares issued and Outstanding		240,000
Retained Earnings (deficit)		(156,800)
Total Equities		$467,600

The terms of the reorganization plan are as follows:

1. Creditors represented by $69,000 of the unsecured accounts payable agree to accept the accounts receivable of SRP Company in full settlement of their claims. The fair value of the receivables is $51,000.
2. Creditors represented by $54,000 of the unsecured accounts payable agree to accept a patent with a book value of $42,000 and a fair value of $50,000 in full settlement of their claims.
3. Creditors of the remaining unsecured accounts payable agree to accept $.60 on the dollar. Cash is paid to these creditors and to the creditors with priority.
4. The creditor holding the 12%, $57,000 note (on which there is $6,000 accrued interest) agreed to extend the due date for two years from January 3, 2012, and to reduce the interest rate to 6% on the current carrying value of the debt ($63,000), payable annually.

5. The holder of the 10%, $54,400 unsecured note (on which there is $11,900 accrued interest) agreed to cancel the accrued interest and $14,400 of the principal; interest on the new note at 10% is due annually, with the principal due on January 3, 2015.
6. The holder of the 9%, $80,000 mortgage note (on which there is $20,500 accrued interest) agreed to accept 100,000 shares of common stock in exchange for full satisfaction of the debt. The common stock has a fair value of $.59 per share.
7. The par value of the common stock is reduced to $.10 per share and any remaining accumulated deficit is eliminated.

Required:

A. Prepare journal entries to give effect to the reorganization.

B. Prepare a post-reorganization balance sheet dated January 2, 2012.

C. Prepare journal entries to accrue interest on December 31, 2012, and to record the payment of interest on January 2, 2013.

PROBLEM 10-3 **Statement of Affairs and Deficiency Account** LO1

Prost Company has filed a bankruptcy petition. Its account balances at December 31, 2012, are presented here:

Cash	$ 2,500
Notes Receivable	60,000
Accounts Receivable (net)	76,000
Inventories	
Finished Goods	43,000
Work in Process	60,000
Raw Materials	51,000
Prepaid Expenses	4,000
Investment in Stock	12,000
Land	140,000
Property and Equipment (net)	400,000
Goodwill	10,000
Total	$858,500
Accounts Payable	$220,000
Accrued Wages (all with priority)	45,000
Bank Notes Payable	225,000
Mortgage Payable	350,000
Common Stock	380,000
Retained Earnings (deficit)	(361,500)
Total	$858,500

The following additional information is available:

1. All notes receivable with the exception of one for $2,500 are expected to be collected. The notes receivable are pledged as security on the bank notes payable.
2. Of the total accounts receivable, $55,000 is expected to be collected. The accounts receivable are also pledged as security on the bank notes payable.
3. Finished goods can be sold at 30% above cost. Selling expenses will be approximately 15% of selling price. Work in process is to be completed at an additional cost of $30,000, of which $19,000 represents the cost of raw materials. The expected selling price of the work in process (after completion) is 10% above cost, with selling expenses of 15% of selling price. Unused raw materials can be sold for $18,000.
4. Prepaid expenses are fully recoverable.
5. The investment in stock consists of 100 shares of MBI Company with a current market value of $19,000.

6. Land is appraised at $200,000, and plant and equipment is appraised at $205,000. The land and plant and equipment serve as collateral on the mortgage payable. Accrued but unrecorded interest on the mortgage payable amounts to $3,000.

Required

A. Prepare a statement of affairs, including a deficiency account.

B. Compute the estimated dividend to be paid general unsecured creditors.

PROBLEM 10-4 **Realization and Liquidation Account** LO1

A balance sheet for Bran Company on June 30, 2012, the date Jim Brown was appointed trustee, is presented here:

Bran Company Balance Sheet
June 30, 2012

Cash		$ 15,000
Accounts Receivable	$ 45,000	
Less: Allowance for Uncollectibles	6,000	39,000
Inventory		104,000
Plant and Equipment	215,000	
Less: Accumulated Depreciation	70,000	145,000
Total Assets		$303,000
Accounts Payable		$145,000
Common Stock		225,000
Retained Earnings (deficit)		(67,000)
Total Liabilities and Equities		$303,000

The following information concerning the period from June 30, 2012, to December 31, 2012, is also available:

1. All Bran Company's assets were transferred to the trustee.
2. Sales for the period were $130,000, of which $30,000 were cash sales.
3. Receivables collected by the trustee in cash were:

Old receivables	$38,000
New receivables	$85,000

4. Merchandise inventory was purchased on account by the trustee in the amount of $35,000.
5. Cash payments were made by the trustee for:
   (a) Accounts payable (old), $110,000
   (b) Accounts payable (new), $30,000
   (c) Operating expenses, $47,000
   (d) Trustee expense, $2,000
6. Adjusting entries recorded by the trustee on December 31, 2009, were:
   (a) Estimated uncollectibles

Accounts receivable (old)	$ 1,000
Accounts receivable (new)	2,000

   (b) Accounts receivable written off (old), $7,000
   (c) Depreciation expense, $10,000
7. The merchandise inventory balance on December 31 was $75,000.
8. The plant and equipment included a parcel of land and a piece of equipment, both of which were sold by the trustee for cash. The land cost $14,000 and was sold for $25,000. The equipment, which had a book value of $25,000 (cost, $50,000; accumulated depreciation, $25,000), was sold for $13,000.

Required:

Prepare a realization and liquidation account, including a copy of the cash account, for the period June 30, 2012, to December 31, 2012. Use the alternate approach for reporting the components of the net gain or loss on the sale of land and equipment.

PROBLEM 10-5 **Trustee Accounting and Combining Workpaper** LO1

Plum Company has been in receivership for the past five months. At the beginning of this period, the following trial balance was taken from Plum Company's books.

Cash	$ 4,500
Accounts Receivable	15,000
Inventory	142,650
Property and Equipment	90,600
	$252,750
Allowance for Uncollectibles	$ 3,750
Accumulated Depreciation	36,825
Accounts Payable	143,175
Capital Stock	135,000
Retained Earnings (deficit)	(66,000)
	$252,750

The trustee, P. Smith, who was appointed to manage the debtor's business during the period of liquidation, opened a new set of books and took title to Plum Company's assets on June 1, 2012. The activities of the trustee during the five-month period ended October 31, 2012, are as follows:

1. The trustee sold all Plum Company's inventory for $153,000, of which $75,000 represented credit sales.
2. Cash was collected on old receivables, $11,250, and on new receivables, $64,500.
3. Expenses paid during the period were

Operating expenses	$11,850
Trustee expenses	3,000

4. The trustee recorded depreciation expense of $5,250.
5. The trustee paid off all the accounts payable.
6. Estimated uncollectibles on the new accounts receivable were $2,250; the trustee wrote off all the remaining old accounts receivable.
7. The trustee sold all the property and equipment for $43,500.

Required:

A. Prepare journal entries to record the effects of these transactions on the books of both the trustee and Plum Company.
B. Prepare a combining workpaper at the end of the five-month period, October 31, 2012.

PROBLEM 10-6 **Realization and Liquidation Account** LO1

Use the data provided in Problem 10-5.

Required:

Prepare a realization and liquidation account for Plum Company to cover the five-month period of receivership (June 1, 2012, to October 31, 2012). Use the alternate approach to present the components of the net gain or net loss, and include a copy of the trustee's cash account for the period.

PROBLEM 10-7 **Statement of Affairs and Deficiency Account** LO1

Miner Company is being forced into bankruptcy. The company's creditors and stockholders have requested an estimate of the results of a liquidation of the company. Miner's trial balance follows:

Miner Company Trial Balance
May 31, 2012

	Debit	*Credit*
Cash	$ 6,000	
Accounts Receivable	63,000	
Allowance for Bad Debts		$ 2,000
Notes Receivable	50,000	
Accrued Interest on Notes Receivable	1,200	
Inventory	60,000	
Buildings	182,000	
Accumulated Depreciation—Buildings		63,000
Equipment	14,600	
Accumulated Depreciation—Equipment		1,400
Prepaid Insurance	1,100	
Goodwill	8,500	
Accrued Wages—with Priority		6,000
Taxes Payable—with Priority		2,400
Accounts Payable		170,000
Notes Payable		80,000
Accrued Interest Payable		1,600
Common Stock		110,000
Retained Earnings (deficit)	50,000	
	$436,400	$436,400

The assets are expected to bring cash on conversion in the following amounts:

Accounts receivable	$50,000
Notes receivable including $1,000 accrued interest	40,800
Inventory	30,000
Building	75,000
Equipment	4,200
Prepaid insurance	400

The notes receivable are pledged as security on a note payable of $40,000. A note payable of $20,000 is secured by a lien on the building, and the equipment is pledged as security on a note payable of $10,000. One-half of the interest payable relates to the $40,000 note payable; the other half of the interest payable relates to the $20,000 note payable. There is no accrued interest on the other notes payable.

Required:

Prepare a statement of affairs as of May 31, 2012. Include a deficiency account, and determine the estimated dividend rate to the general unsecured creditors.

PROBLEM 10-8 **Statement of Affairs and Deficiency Account** LO1

A receiver was appointed by the court to manage the affairs of Davis Manufacturing Company on March 31, 2012. On this date, the following balance sheet applied:

Davis Manufacturing Company Balance Sheet
March 31, 2012

Cash	$ 22,500
Accounts Receivable	115,500
Notes Receivable	60,000
Accrued Interest on Notes Receivable	1,375
Inventories	
Finished Goods	140,000
Work in Process	97,500
Raw Materials	60,000
Supplies	7,750
Prepaid Expenses	3,000
Investment in Stock	66,250
Land	105,000
Buildings (net)	495,000
Equipment (net)	232,500
Total	$1,406,375
Notes Payable	$ 196,000
Accounts Payable	587,500
Wages Payable (all with priority)	33,750
Payroll Taxes Payable (all with priority)	5,250
Accrued Interest Payable	
On Notes Payable	2,750
On Mortgage Note Payable	21,250
Mortgage Note Payable	440,000
Common Stock	469,000
Retained Earnings (deficit)	(349,125)
Total	$1,406,375

Additional Information:

1. The cash account includes a $500 travel advance that has been spent.
2. Of the total accounts receivable, $75,000 is believed to be collectible. The remaining accounts are doubtful, but it is believed that about one-third of these will be realized eventually. The accounts receivable are pledged as security on a $10,000 note payable.
3. Notes receivable of $50,000 have been pledged as security on a note payable of $45,000. This portion of the notes receivable has an estimated realizable value of $35,000. The remaining notes receivable, including the accrued interest, are expected to be fully collected. The $45,000 note payable has accrued interest due of $1,000.
4. The finished-goods inventory is expected to sell at 20% above its cost, with expenses involved in its disposition approximating 10% of selling price. The work in process inventory can be completed at an additional cost of $55,000, of which $40,000 represents materials used from the present raw materials inventory. The completed work in process should then sell for $145,000; the remaining raw materials should sell for one-half their cost. Supplies are expected to realize $1,300.
5. The investment in stock consists of 2,000 shares of Monelli Vineyards. The stock has a current market value of $50 per share and is pledged as security on a note payable of $41,000. Interest accrued on the note payable amounts to $1,750.
6. The land and buildings have been appraised at $165,000 and $260,000, respectively. They are pledged as collateral on the mortgage note payable.
7. The equipment is expected to realize $100,000.
8. Prepaid expenses are nonrealizable.

Required:

A. Prepare a statement of affairs.
B. Prepare a deficiency account detailing estimated gains and losses.
C. Calculate the dividend rate per dollar of unsecured liabilities.