

## Center for Plain English Accounting

AICPA's National A&A Resource Center

### Applying the Liquidation Basis of Accounting

By: Russ Madray

Most businesses are created and managed with the goal of operating as a going concern. However, a business can get to a point where the best option for its stakeholders is for the entity to cease operations, liquidate its assets, and settle its obligations. With the spread of the coronavirus pandemic (COVID-19), many entities will need to assess the financial and business repercussions of the pandemic on their operations.

The pandemic—with its lockdowns, which have started to ease—was enough on its own to put some businesses under. Robert J. Keach, a director of the American College of Bankruptcy, told the *New York Times* that, many companies have so far managed to put off bankruptcy by amassing cash and conserving it as best they can—drawing down existing credit lines, furloughing workers, delaying projects and taking advantage of federal and state pandemic-relief programs. But as those expire, he said, companies will use up the cash and bankruptcy filings are likely to skyrocket.<sup>1</sup>

In April 2013, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2013-07, *Presentation of Financial Statements (Topic 205): Liquidation Basis of Accounting*, which was codified in FASB Accounting Standards Codification (FASB ASC) 205-30, *Presentation of Financial Statements: Liquidation Basis of Accounting*. Before the issuance of ASU 2013-07, there was little guidance on when and how to apply liquidation accounting, which resulted in diversity in practice. In this report, we provide a roadmap to applying the liquidation basis of accounting. We will issue a subsequent report that addresses other aspects of this topic, including applying the liquidation basis accounting to employee benefit plan financial statements.

**Practice Note:** In some circumstances, a liquidating entity might choose to prepare financial statements on a modified-cash basis or other special purpose framework, if that basis would be more meaningful to users of the financial statements (and comply with the

---

<sup>1</sup> Walsh, Mary Williams. "A Tidal Wave of Bankruptcies Is Coming." *New York Times*, August 3, 2020.

needs of other parties). However, those financial statements would not be described as liquidation basis and would not comply with U.S. generally accepted accounting principles (U.S. GAAP).

Our preparation of this report was aided by content contained in the following two in-depth publications covering liquidations. Readers are encouraged to consult those publications for more detailed guidance.

- [PWC's Guide to Bankruptcies and Liquidations](#)
- [EY's Publication on Bankruptcies, liquidations and quasi-reorganizations](#)

### What is Liquidation?

As indicated in the FASB Master Glossary, liquidation is the process by which an entity converts its assets to cash or other assets and settles its obligations with creditors in anticipation of ceasing all activities. Upon cessation of the entity's activities, any remaining cash or other assets are distributed to the entity's investors or other claimants. Importantly, dissolution of an entity as a result of that entity being acquired by another entity or merged into another entity in its entirety and with the expectation of continuing its business does not qualify as liquidation.

**CPEA Observation:** Selling individual assets (or a group of assets) would not meet the definition of a liquidation. As noted above, liquidation is the process of converting all of an entity's assets to cash or other assets and settling its obligations with creditors in anticipation of ceasing all activities.

Clearly, the users of financial statements of a business in liquidation have very different needs than stakeholders in a going concern. As discussed in FASB Concepts Statement 1, *Objectives of Financial Reporting by Business Enterprises* (superseded), "...information about the past is usually less useful in assessing prospects for an enterprise's future if the enterprise is in liquidation or is expected to enter liquidation. At that point, emphasis shifts from performance to the liquidation of the enterprise's resources and obligations. The objectives of financial reporting do not necessarily change if an enterprise shifts from expected operation to expected liquidation, but the information that is relevant to those objectives, including measures of elements of financial statements, may change." Presentations of assets and liabilities at their historical bases are no longer relevant to liquidating entities and, therefore, financial statements of liquidating entities are adjusted to reflect amounts expected in liquidation.

**Practice Note:** As discussed further, below, when an entity adopts the liquidation basis of accounting, its financial statement presentations change from a balance sheet and

statements of income and cash flows to a statement of net assets in liquidation and a statement of changes in net assets in liquidation.

### Bankruptcy vs. Liquidation

Bankruptcy law in the United States is codified in federal law under Title 11 of the United States Code (Bankruptcy Code), which provides a uniform federal law governing all bankruptcy cases. There are two types of bankruptcy filings under the Bankruptcy Code available to business entities: Chapter 7 and Chapter 11.

Chapter 11 is the most common type of filing for businesses. A case filed under Chapter 11 is often referred to as a reorganization proceeding. In other words, a business that files for Chapter 11 protection is attempting to continue its business by restructuring the debt that existed prior to the proceeding. In a Chapter 11 proceeding, management usually continues to operate the business and prepares a "Plan of Reorganization." Nearly every type of business entity can file for protection under Chapter 11 provided they meet the criteria set forth by the Bankruptcy Code. For accounting purposes, bankruptcy proceedings under Chapter 11 are within the scope of FASB ASC 852-10, *Reorganizations -- Overall*.

However, in some cases, an entity may have financial issues so significant that it does not have any value beyond its identifiable net assets. In this case, a petition may be filed under Chapter 7. Upon filing, the Bankruptcy Court assigns an independent trustee to manage the business and the process of liquidation. The trustee will usually discontinue the entity's operations and sell its assets to the highest bidder using the proceeds of sale for the benefit of the creditors. Upon completion of the process, the debtor receives a discharge from its prepetition debts. Bankruptcy proceedings under Chapter 7 are within the scope of FASB ASC 205-30.

### When to Apply the Liquidation Basis of Accounting

Reporting entities are required to use the liquidation basis of accounting when liquidation is deemed to be imminent. Liquidation would be considered imminent when the likelihood is remote that the reporting entity would return from liquidation and either:

- A plan of liquidation is approved by the person or persons with the authority to make the plan effective and the likelihood is remote that execution of the plan will be blocked by other parties (e.g., those with shareholder rights), or
- A plan of liquidation is being imposed by other forces (e.g., through involuntary bankruptcy)

**CPEA Observation:** If the entity's governing documents indicated a plan for liquidation and the liquidation is carried out in accordance with that plan, the entity does not apply the liquidation basis of accounting. In these situations, the liquidation basis of accounting would be used only if the approved plan for liquidation differs from the plan for liquidation that was specified at the inception of the limited-life entity.

**Practice Note:** The application of liquidation-basis accounting is not a policy choice or election. FASB ASC 205-30 requires entities to use the liquidation basis when liquidation is imminent.

As noted above, a plan of liquidation must be approved by parties (e.g., shareholders, board of directors, etc.) with the authority to make the plan effective. After approving the liquidation plan, management would need to evaluate whether other parties could block the plan. Further, the liquidation basis of accounting should not be adopted prior to such approval because liquidation is not "imminent." If a plan of liquidation is imposed by others, the decision to liquidate is usually up to the Bankruptcy Court and would be beyond the control of the entity. In this case, it is remote that the entity would return from liquidation and, accordingly, should adopt the liquidation basis even if formal owner/shareholder approval is not obtained. It also may be wise to seek the guidance of legal counsel in determining when an involuntary liquidation is imminent.

When liquidation becomes imminent, the liquidation basis is applied prospectively from that day. Consequently, a reporting entity adopting the liquidation basis for the first time would not retrospectively adjust its historical financial statements.

Although not specifically addressed in FASB ASC 205-30, most believe that, for practical reasons, the liquidation basis may be adopted as of a date shortly before or after the date the criteria for adoption are met (e.g., the beginning or end of the month or quarter in which such criteria are met), as long as the impact is not material. However, the use of this practical expedient should be disclosed.

**CPEA Observation:** When the imminent threshold is met after the balance sheet date but prior to the release of the financial statements, prior period financial statements should continue to be prepared on a going-concern basis and an analysis should be conducted under FASB ASC 855, *Subsequent Events*, to determine the proper accounting and disclosure treatment. An auditor may choose to also add an emphasis of matter paragraph to the audit opinion describing the circumstances and referencing a subsequent event disclosure.

**Practice Note:** Although a convenience date may be used, the adoption date as presented on the financial statements and disclosed in the notes is usually the actual date the criteria were met.

The following examples illustrate several circumstances when it may or may not be appropriate to adopt the liquidation basis of accounting.

#### Example 1

Richards Corporation owns and operates a number of family restaurants across the southeast. Because of COVID-19 restrictions and economic difficulties, on August 18, 2020, the board of directors decided to close half of the company's restaurants until the economy improves. In the meantime, Richards Corporation will terminate all of the employees in those locations.

#### Analysis

Liquidation would not be imminent on August 18, 2020. If the economic picture improved, Richards Corporation could continue as a going concern and as such it's not a remote likelihood that the entity could resume business after liquidation. For liquidation to be imminent, board action to liquidate all assets and permanently cease operations would be necessary.

#### Example 2

Austin Corp owns a casino on the Louisiana-Texas state line. Because of the loss of a gaming license, the future prospects of the Austin Corp are in doubt. On July 16, 2020, the board of directors authorizes management to sell all of the assets and settle all of its obligations. But there is no plan to make a final distribution of its assets or to dissolve the company as the board investigates other alternatives.

#### Analysis

Although Austin Corp is disposing of its assets and settling its obligations, the entity is neither being dissolved nor are the proceeds from the liquidation being distributed. As such, Austin Corp should not adopt the liquidation basis of accounting because its liquidation is not considered imminent. As the board explores other alternatives, Austin Corp remains a going concern.

#### Example 3

On October 1, 2020, ABC Company's largest customer informed them that they were ceasing operations. From October through December 2020, ABC Company sought to secure new customers, but by the end of 2020, ABC Company had not been successful in this effort.

On February 1, 2021, the shareholders approved a plan of liquidation that is expected to be completed by June 2021. Under the plan, all employees will be

terminated, and the assets of ABC will be liquidated. ABC Company is preparing its December 31, 2020 financial statements.

### Analysis

In its December 31, 2020 financial statements, ABC Company is still a going concern and should not apply the liquidation basis of accounting as liquidation is not considered imminent at that date.

ABC Company's liquidation does not meet the imminent threshold until the shareholders approve the plan of liquidation. Further, although the December 31, 2020 financial statements are prepared on a going-concern basis, given the shareholder approval and the expected change to the liquidation basis, it may be appropriate to provide disclosure of the subsequent event, including pro forma financial data for the liquidation basis of accounting.

### Applying the Liquidation Basis of Accounting

Once a decision is made to apply the liquidation basis of accounting, the recognition and measurement of assets and liabilities will likely change. Under the liquidation basis of accounting, the emphasis shifts from a focus on the entity's economic performance and financial position to reporting on resources that will be available to creditors and investors. As a result, the financial statements differ significantly from those of an entity that expects to continue as a going concern.

### **Measuring Assets**

Under the liquidation basis of accounting, liquidating entities are required to measure assets to reflect the estimated amount of cash or other consideration expected to be collected in settling or disposing of those assets in carrying out the liquidation plan. That is, the entity stops applying the recognition and measurement provisions of other U.S. GAAP to its assets once it begins applying the liquidation basis of accounting. FASB ASC 205-30 does not specify how to measure the amount expected to be collected (e.g., whether to use a best estimate or probability-weighted approach), so judgment is required.

The above notwithstanding, in certain situations, fair value may approximate the amount expected to be collected. The definition of fair value under FASB ASC 820, *Fair Value Measurement*, is "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." Due to the inherent uncertainty in determining the cash to be received upon selling an asset, an entity's best estimate of the liquidation value may be equal to (or derived from) its current fair value. Therefore, a liquidating entity is not precluded from using fair value

to measure its assets in liquidation as long as such amount represents the best estimate of liquidation value (i.e., the cash that an entity expects to collect).

The actual sale or changes in a price of an asset after the reporting date but before the financial statements are issued (or are available to be issued) may provide evidence of the amount expected to be collected at the reporting date. However, judgment is required to determine whether the sale or changes in price that occur after the reporting date reflect conditions that existed as of the reporting date and are recognized or non-recognized subsequent events under FASB ASC 855.

**CPEA Observation:** Under the liquidation basis of accounting, an asset could be measured at an amount greater than its carrying amount under the going concern basis of accounting.

**Practice Note:** A liquidating entity would separately accrue the costs it expects to incur when selling assets. Accrued costs are separately presented from the related assets in the statement of net assets in liquidation; that is, the assets are presented on a gross basis. A liquidating entity should not discount accruals for estimated costs to be incurred in the process of disposing assets for the effects of the time value of money.

When using the liquidation basis of accounting, the liquidating entity should recognize other items that it previously had not recognized (e.g., trademarks, patents, licenses) but that it expects to either sell in liquidation or use to settle liabilities. Goodwill, on the other hand, cannot be sold, and would be written-off as an adjustment to adopt the liquidation basis. This also would be true of other charges that were deferred (e.g., prepaids), since they would not be expected to be sold.

**CPEA Observation:** Before adopting the liquidation basis of accounting, an entity should make any necessary adjustments (e.g., impairment) to its assets and liabilities. In other words, these are not liquidation adjustments.

#### Example 4

On October 15, 2020, Acme Company filed for Chapter 7 bankruptcy; liquidation is considered imminent as of that date. Management expects to sell its building for \$5 million, which had a book value of \$3 million (net of depreciation) as of October 15, 2020. After year-end, but before the 2020 financial statements were issued, Acme Company sold the building for \$5 million and incurred legal fees of \$10,000.

#### Analysis

The building would be measured and recognized in the opening statement of net assets in liquidation at the amount expected to be collected from disposal (\$5 million). The \$2 million increase would not be reflected in the statement of changes

in net assets in liquidation for 2020, but it would be disclosed with significant assumptions used in making the estimate). Also, no depreciation would be recorded on the building from October 15, 2020 to December 31, 2020. Acme Company also would accrue, separately from the building, a \$10,000 liability for the estimated costs to sell the building in the initial statement of assets in liquidation.

Several concepts applicable to going concern financial statements would not be relevant under the liquidation basis of accounting. Specifically—

- Assets are not depreciated and accumulated depreciation is not presented
- Impairment and other adjustments of asset values are not applicable under the liquidation basis
- Gains or losses on asset dispositions generally would not be expected since assets are measured at the amount of cash or other consideration expected to be collected in settling or disposing of those assets in carrying out the liquidation plan

### **Measuring Liabilities**

Liquidating entities need to recognize liabilities in accordance with the general recognition criteria otherwise spelled-out in U.S. GAAP (excluding the accrual of estimated disposal costs as described above and expected income and expenses as described below). With that said, liquidating entities may need to adjust amounts presented for non-contractual liabilities to reflect changes in assumptions that result from the decision to liquidate (e.g., timing of payments related to an asset retirement obligation). However, liquidating entities are precluded from anticipating that there will be a legal release from being the primary obligor under a liability, either judicially or by the creditor. This is true even if a liquidating entity does not have enough cash or other assets to satisfy its legal obligations.

### **Accruing Income and Expenses**

When the liquidation basis is adopted, estimated costs to dispose of assets or other items expected to be sold in liquidation should be accrued. In addition liquidating entities should accrue costs and income expected to be incurred or earned (e.g., payroll costs or income from preexisting orders expected to be fulfilled during liquidation, etc.) through the end of the liquidation process if and when there is a reasonable basis for estimation. Such costs are accrued even if the entity would have incurred the costs as a going concern (e.g., administrative costs, payroll costs, legal and professional fees, rent, insurance, etc.). Projected income and costs should be measured on an undiscounted basis. If the entity is not able to reasonably estimate the amount of future costs or income, it would expense costs as incurred and recognize income as earned until it has sufficient information to make such an estimate.



**Practice Note:** The financial statements should include disclosure of the assumptions used with regard to the accrual of fees (and all other significant income or expense) and the related estimation uncertainty, if any.

### **Subsequent Measurement**

At each reporting date, assets are remeasured at the amount expected to be collected, and accruals of income and expense are remeasured at the amount expected to be incurred or earned. However, liabilities would be remeasured only if required by other U.S. GAAP. Remeasurements are presented in the statement of changes in net assets in liquidation.

### Financial Statement Presentation

A liquidating entity must present, at a minimum:

- A statement of net assets in liquidation (a statement that presents a liquidating entity's net assets available for distribution as of the end of the reporting period)
- A statement of changes in net assets in liquidation (a statement that presents the changes in net assets during the period that they are available for distribution during liquidation)

Entities may provide other statements if desired or required by a stakeholder (e.g., court, lender, etc.).

**Practice Note:** Since FASB ASC 205-30 does not provide specific guidance, judgment is required to determine the level of detail to present in a statement of net assets in liquidation, and in a statement of changes in net assets in liquidation.

When financial statements are prepared using the liquidation basis of accounting, the titles and headings of the statements need to be modified to reflect the liquidation basis titles and headings, as appropriate.

When the liquidation basis of accounting is adopted at an interim date, there is no requirement to present going concern financial statements for the "stub period" (i.e., the period between its last balance sheet as a going concern and the date at which liquidation becomes imminent). However, a liquidating entity may separately present the stub period if it chooses or if another party (e.g., regulator, bank, etc.) requires it. With that said, since reporting entities are required to present a statement of changes in net assets in liquidation as of the first reporting period after liquidation becomes imminent, it would be necessary to determine the initial net asset balances at adoption.

**Practice Note:** The effects of adopting the liquidation basis of accounting are not recognized in the stub period going concern financial statements. In addition, FASB ASC

205-30 is clear that the effects also are not part of the initial statement of changes in net assets. However, it is generally appropriate for liquidating entities to disclose effects of adopting the liquidation basis of accounting.

### Disclosure Requirements

In addition to other disclosures that typically would be provided using U.S. GAAP requirements, certain incremental disclosures need to be provided in the statements, to include, at a minimum:

- Disclosure of the fact that the financial statements are prepared using the liquidation basis of accounting, including the facts and circumstances surrounding the adoption of that basis of accounting and the determination by the entity that liquidation is imminent
- A description of the plan for liquidation, including a description of each of the following:
  - The manner by which the liquidating entity expects to dispose of its assets and other items it expects to sell that previously had not been recognized as assets
  - The manner by which the liquidating entity expects to settle its liabilities
  - The expected date by which the liquidating entity expects to complete its liquidation
- The methods and significant assumptions used to measure assets and liabilities, including any subsequent changes to those measurements and assumptions
- The type and amount of costs and income accrued in the statement of net assets in liquidation and the period over which those costs are expected to be paid or over which the income will be earned

***Practice Note:*** We also think that, based on FASB ASC 205-30-50-1, a description of how the liquidation basis of accounting differs from the going concern basis of accounting would be helpful in understanding the entity's statement of net assets in liquidation and statement of changes in net assets in liquidation.

Also, keep in mind, disclosures required by other U.S. GAAP continue to be required. For example, if fair value is used as an estimate of the amount expected to be received for an asset upon disposal, the disclosures required by FASB ASC 820 should be included.

### Summary

Most businesses are created and managed with the goal of operating as a going concern. However, with the spread of COVID-19, many entities may get to a point where the best option for its stakeholders is for the entity to cease operations, liquidate its assets, and settle its obligations. With that in mind, we hope this report is helpful in understanding the

authoritative literature and requirements related to the liquidation basis of accounting. And, as always, the CPEA is available to answer our members' questions.

Center for Plain English Accounting | [aicpa.org/CPEA](https://aicpa.org/CPEA) | [cpea@aicpa.org](mailto:cpea@aicpa.org)

The CPEA provides non-authoritative guidance on accounting, auditing, attestation, and SSARS standards. Official AICPA positions are determined through certain specific committee procedures, due process and extensive deliberation. The views expressed by CPEA staff in this report are expressed for the purposes of providing member services and other purposes, but not for the purposes of providing accounting services or practicing public accounting. The CPEA makes no warranties or representations concerning the accuracy of any reports issued.

© 2020 Association of International Certified Professional Accountants. All rights reserved. For information about the procedure for requesting permission to make copies of any part of this work, please e-mail [cpea@aicpa.org](mailto:cpea@aicpa.org) with your request. Otherwise, requests should be written and mailed to the Center for Plain English Accounting, AICPA, 220 Leigh Farm Road, Durham, NC 27707-8110.