Floyd Advisory

Distressed Company Financial Reporting Considerations

Insights from a Forensic Accountant

Filing for bankruptcy protection doesn't just happen. It involves a process that takes weeks and in some cases several months of planning and preparation. Unfortunately, this process sometimes involves inappropriate actions for the benefit of those in control and to the detriment and harm of other stakeholders.

While the schemes may vary, investigating the wrongdoing and reporting the facts all involve forensic accounting and financial reporting expertise. As forensic accountants who have investigated numerous issues that occurred in the period before a bankruptcy filing, we have learned a tremendous amount from our experiences. We have followed the accounting trail to locate assets off the books, identified actions outside the ordinary course of business, and notably, reported on the misapplication of generally accepted accounting principles ("GAAP") and the presentation of misleading financial statements.

Based on these experiences, we prepared this report to highlight our expert accounting insights and considerations for legal counsel and others who may be investigating a debtor's financial reporting and accounting treatments.

Did the Debtor Keep Proper Books and Records?

Before discussing other matters, it's important to understand the quality of the company's recordkeeping. A common problem for distressed companies is the failure to maintain proper books and records. Sometimes this is due to high turnover in the accounting and finance group while other times it is attributable to budget pressures and other priorities.

Assessing the overall quality of the record keeping is critical to understanding the errors that may arise due to poorly kept books, as well as the obstacles for identifying accurate accounting information. For example, if the bank accounts have not been timely reconciled to the transactions in the general ledger, then cash receipts and disbursements may not all be recorded. Another example is if shipping and receiving "cut off" controls are not followed, the records may not reflect all events that occurred within an accounting reporting period (or improperly reflect activity that occurred outside the relevant period).

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As important, understanding the level of automation and connectivity for various accounting ledgers is a critical risk assessment procedure. It is much easier for mechanical and human errors, as well as intentional wrongdoing, to occur when dealing with more manual entry and spreadsheet-based reporting systems.

After vetting the quality of the debtor's books and records, there are several questions that counsel may ask to test the validity of historical financial reporting and accounting matters.

Below we will describe some of these questions, explain their importance in a bankruptcy investigation, and raise matters for counsel to consider.

In the audit industry, testing assets for existence and valuation are critical considerations. As you review the assets on the balance sheet, each line item should be vetted. Many of the subjects discussed below involve possible financial reporting misstatements, self-dealing, and the misappropriation of assets that rightfully belong to the bankruptcy estate.

When and How Much of the Accounts Receivable Will be Collected as Cash?

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Quite often, accounts receivable collections become more difficult once a company enters bankruptcy. While true that the disruption to the business plays a role, games played with sales terms and other accounting practices can also be contributing factors.

Similar to other pre-filing earnings management schemes, accelerating revenue recognition to improve results for earnings management reasons while under pressure for profits is a leading cause of poor receivable collections. Side letters for product rights of return, elongated payment terms, and channel stuffing with sell through agreements, all cause delayed and/or uncollected receivables.

While troubling to the bankruptcy estate's liquidity, manipulating revenue recognition can also equate to fraudulent financial reporting in the periods preceding the filing, opening up another possible avenue for recovery.

As problematic, accounts receivable write-offs and reserves taken in the periods preceding the filing raise questions about the proper timing for the loss, and the possibility of other related party relationships benefiting from customer accommodations.

What's the Inventory Worth?

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For a bankruptcy estate, fair market value and/or liquidation value for the inventory, less selling costs, will be critical inventory measures. These amounts will be determined in a different manner than the amounts on the balance sheet calculated under GAAP. Depending on the facts and circumstances, one may still want to investigate proper reporting for inventory.

Importantly, anything that overstates the inventory balance in the historical financial statements results in understated cost of goods sold, and thereby falsely increased profits. With that "motive" in mind, considerations to test for inventory overstatements commonly involve inquiries into product pricing, possible obsolescence, and physical counts.

The value of inventory on the balance sheet is not always a simple historical cost measure, especially for manufacturers. Pricing inventory can involve complex cost accounting systems that factor in raw materials, labor, and factory overhead employed in the production cycle. As part of this process, companies use estimates referred to as standard costs and periodically make adjustments when actual and standard costs differ. Playing games with standard costs can inflate balance sheet amounts and overstate historical profits.

Similarly, avoiding charges for product obsolescence is a common method to overstate inventory balances, and is very relevant to bankruptcy estates because overstated amounts on the balance sheet will not be realized into cash from a sale. Changing consumer preferences, new product versions, and technological advances are all examples of reasons that inventory should be written-off or down to the lower of cost or market, with the net realizable value from a sale being a critical consideration.

Finally, physical inventory counts, as simple as they may seem, should be a consideration. Lost, damaged, and stolen product, as well as even fabricated reports to overstate the balance sheet in a periodic inventory system are all problems to investigate, and will generally be surfaced by a physical inventory count following the filing.

Does the Debtor Possess and Really Own the Fixed Assets?

For tangible assets, like plant, property and equipment, does the debtor have title? Can you physically inspect the asset? As strange as it may sound, you should test to see if the debtor owns all the assets in its possession and whether all the debtor's assets are properly recorded on its fixed asset ledger.

If a company is part of a group of businesses, either through a common parent or management, then the sharing of equipment through related party transactions may cause unusual situations. For example, in the construction business, trucks and other equipment may be "borrowed." The examples are quite numerous once common control is established, making the forensic accountant's role very critical to identifying the facts.

Finally, leasehold improvements, which represent capitalized costs for rented space, can quickly be worthless for abandoned space. Bankruptcy highlights the accounting fiction of calling such expenditures an asset of the lessor. Some businesses invest heavily in their rented space and identifying which leasehold assets are fixtures versus salvageable assets is an important exercise to assist with identifying assets of value to the debtor.

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Will Future Cash Flow Support the Intangible Assets' Values?

As a basic premise, intangible assets, such as intellectual property and goodwill, are only as valuable as their ability to generate future cash flows. Combine this premise with the nature of a bankruptcy filing and it raises questions about the timing and extent of intangible asset write-offs and impairments. This issue is critical to the historical financial statements that were relied upon by stakeholders when making investment and business decisions.

Impairment testing is required annually or upon knowledge of a material event or change. If a company has determined that it must file for bankruptcy due to financial problems, then at what point prior to the filing did or should the company have known it needed to impair certain of its intangible assets? Did this time period cover a period when financial statements had been produced and shared with stakeholders? Were previous disclosures (if any) providing insights into management's assessment erroneous or misleading? Were the assets overstated, losses understated, and equity overstated? These are all factors that investors relying on the financial statements would want to know.

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What's in Other Assets?

Other common concerns with assets relate to misclassifications, especially whether an asset exists at all. There are two considerations in this category: fictitious assets and overstated assets that should be expenses.

Fictitious assets arise when a disbursement recipient and purpose doesn't match the accounting classification. For example, the use of monies to fund the purchase of assets for a different business could be recorded in the leasehold improvement account, rather than as a receivable from the entity receiving the benefit. Inappropriate transactions like this are not unique to bankruptcy but should be subject to increased scrutiny for a distressed company.

Overstated assets often include pre-paid accounts for items such as rent, insurance, or other categories where the potential exists for one disbursement to benefit multiple periods. This example highlights what may be prior period earnings management actions to avoid incurring expenses, that now create surprise losses to the bankruptcy estate.

You may be asking, "But aren't the financial statements audited!?" Even if the answer is "yes" - and this applies to other subjects discussed herein - an audit is an opinion that the statements are free from material misstatement, and is in part based on management representations and testing of transactions. The level of scrutiny needed when investigating and assessing the financial position and results of a distressed company is much different and more intense.

Surprised by the Newly Recorded Liabilities?

Generally, companies in financial distress are incurring losses or missing profit expectations. This puts incredible pressure on management to do whatever can be done to avoid recording additional liabilities and expenses. This occurs most frequently with contingent liabilities, such as litigation reserves, that require being "probable" and "reasonably estimable" before being accrued as an expense. Management may even be under such pressure that they avoid accruals for ordinary business expenses, such as accrued rent, professional fees, and other charges that should be recorded as incurred.

Users of the historical financial statements are often surprised to see the growth in liabilities as of the filing date. Some incremental liabilities do arise in the days and weeks preceding the filing, but others may have been known to management for a longer period of time and, regrettably, unknown to those relying on the financial statements.

Additional Considerations

As important as digging into the financial reporting policies and practices at a distressed company for indicia of wrongdoing is, there are a few other matters that are worthy of considering in a forensic accounting analysis.

First, the reporting for related parties receives special attention and disclosures under GAAP for a valid concern; by definition the transactions are not at arm's length and may not be representative of fair value. Importantly, because the transactions are disclosed in the footnotes doesn't mean they represent fair value. The disclosure is a "buyer beware" sign that you'll want to be informed about these and make your own judgments. Needless to say, related party transactions at a distressed company raise obvious concerns about whether funds have been improperly removed, and if so, can be recovered. As concerning, counsel may want to investigate if all related party transactions have been identified and properly disclosed. The most nefarious transactions may be hidden.

Other considerations in forensic accounting investigations with distressed companies include assisting counsel with assessing opportunities to pierce the corporate veil in pursuit of financial recoveries. The search for improper related party transactions is one element of a piercing the corporate veil investigation. Other elements include tests for adequate capitalization, adherence to proper corporate governance, and commingling of assets and activities, all to show a lack of respect for the corporation as an independent entity.

Finally, the sifting and sorting of disbursements to identify preferential vendor payments in the months preceding the filing is a common forensic accounting exercise and interestingly, another process often linked to the related party investigation discussed above. While more procedural in nature, the test for what parties received how much and when is critical to ensure fairness to all stakeholders in a bankruptcy situation. Of note, fairness is the key, and assessing whether there was a substantially contemporaneous exchange of value, whether the payments were made in the normal course, or whether new value was received are often essential considerations and can be subject to professional judgment by legal counsel working with forensic accountants.

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Whether a company is in a distressed situation or has filed for bankruptcy, we conduct investigations of transactions, analyze financial reporting treatments and prepare detailed forecasts. In addition to the investigative, valuation and complex accounting services we provide in bankruptcy or other distressed company settings, we act as trusted financial advisors to Bankruptcy Court-appointed examiners and trustees, which allows them to more effectively focus on their mandate to maximize the value of the entity and to investigate possible recoveries in any bankruptcy proceedings. Select practice leadership and their experiences are summarized below.

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JOSEPH FLOYD, CPA, JD, is a Partner and Co-Founder of Floyd Advisory. Mr. Floyd, for whom the company is named, has worked with a prestigious, varied list of clients including Global 1000 companies, major law offices, private equity firms and others in need of expert advice and solutions for complex financial reporting, accounting, and strategic business matters, including in the context of M&A-related disputes. Mr. Floyd has served as an expert witness and testified on accounting and financial issues in the United States District Court and the United States Bankruptcy Court in several states and in the trial courts of various states and appeared before the Securities and Exchange Commission to outline and analyze facts, practices and principles related to public company financial statement changes.

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ABOUT Floyd Advisory

Floyd Advisory is a consulting firm providing financial and accounting expertise in areas of Business Strategy, Valuation, SEC Reporting, Transaction Analysis, and Litigation Services.

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