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Educational Case

Johnson Manufacturing case study–bankruptcy [☆]

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ABSTRACT

The Johnson Manufacturing (Johnson) case demonstrates the steps a firm must take when exiting Chapter 11 bankruptcy, including the determination of the applicability of 'fresh-start' accounting. To complete the case, adjustments are required to the asset, liability, and equity accounts in accordance with the post-reorganization balance sheet date. The case also requires students to demonstrate an awareness and understanding of the authoritative guidance related to bankruptcy accounting under US GAAP and to recognize fresh-start accounting adjustments required under International Financial Reporting Standards (IFRS).

1. Case study

1.1. Background

Johnson Manufacturing (hereafter referred to as Johnson, or the Company) manufactures and distributes various plastic household products, such as wastebaskets, hangers, utensil trays, etc. throughout the United States. During 2014 and 2013, Johnson experienced a significant increase in the cost of resin, which is the primary raw material used to manufacture its products. These price increases were so quick and significant that Johnson was not able to pass on these cost increases to its customers. Johnson's gross margin decreased from 40% in 2009 to an average of 15% in 2014. This resulted in

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significant operating losses for Johnson, causing concern about its ability to pay its liabilities, including the senior notes. Therefore, in the second quarter of 2014, Johnson reached out to its senior note holders to restructure the debt before defaulting. After a month of negotiations, Johnson realized that the senior note holders were not open to restructuring. Johnson defaulted on its senior note September 30, 2014 required principal and interest payments and spent the next several months exploring bankruptcy options, including hiring a valuation firm to determine the reorganization value. On December 15, 2014, the Company voluntarily[1] petitioned to enter Chapter 11 bankruptcy reorganization. At that time, the firm expected to emerge from bankruptcy mid-March 2015 and submitted the following to the US bankruptcy court regarding the Company's reorganization plan:

- As previously mentioned, the Company engaged a valuation firm for the purpose of determining the value available for distribution to creditors and the relative recoveries to creditors pursuant to the plan. The details of the plan are as follows:
- For purposes of the plan, a valuation specialist estimated the reorganization value to range from approximately $85 million to $110 million as of an assumed effective date of March 15, 2015.[2]
- For purposes of the plan, the common equity value of the reorganized debtors is estimated to range from approximately $65 to $85 million.
- The senior note holders would receive approximately 7% of the face/nominal value of their notes through receiving common shares of the new Company. This would extinguish all debt owed to the senior note holders.
- All other creditors would receive 100% of their claims.
- The common shareholders of the company before entering Chapter 11 would own approximately 10% of the new company upon emergence from Chapter 11.
- Upon emergence from bankruptcy, the company would have 100,000 shares of common stock outstanding with a par value of $10.00 per share.
- The company's debtor-in-possession (DIP)[3] lending facility would be converted to an asset-based line of credit, and it would be funded at $25 million upon the emergence from Chapter 11.

The court granted the company's petition in April 2015 and the company successfully emerged from Chapter 11 as of the close of business April 30, 2015. At this time, the valuation firm estimated final reorganization and equity values as of the emergence date to be $100 million and $72.6 million, respectively.

Johnson's inventory as of April 30, 2015 was made up of raw materials in the amount of $4,000,000 (current value) with the remainder being finished goods. In addition, Johnson values its finished goods inventory utilizing the last in, first out (LIFO) method. The LIFO reserve on Johnson's April 30, 2015 balance sheet was $3,500,000.

Johnson has engaged an appraiser to determine the fair value of its assets at the time of the emergence of the Company from bankruptcy. The appraiser determined that Johnson's net account receivables were valued appropriately. Johnson's fixed assets were appraised at fair value as follows:

■ Land	$ 4,000,000
■ Buildings	$13,000,000
■ Transportation equipment	$ 1,000,000
■ Computer equipment	$ 375,000
■ Furniture and fixtures	$ 225,000
Total	$18,600,000

[1] In the real scenario, the senior note holders had no interest in forcing an involuntary bankruptcy and felt that the current management was in the best position to lead the company out of bankruptcy.

[2] This reorganization value range or the point estimate is included when submitting the bankruptcy plan and is derived by valuation specialists. A final value is estimated upon emergence from bankruptcy.

[3] When a firm files for Chapter 11 bankruptcy, it can continue to operate the business as the debtor-in-possession (DIP) until the firm emerges from bankruptcy.