

# **CHARACTERISTICS AND SUBSEQUENT OPERATING PERFORMANCE OF FIRMS ELECTING QUASI-REORGANIZATIONS**

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## **ABSTRACT**

A quasi-reorganization is an accounting transaction that permits a firm with a retained earnings deficit to transfer that deficit to paid-in capital in conjunction with a restatement of its assets and liabilities to current market values. In this paper, we provide empirical evidence on the characteristics and subsequent operating performance of a sample of firms that elected quasi-reorganizations in the 1978-1991 time period. We find that, on average, the quasi-reorganization firms were larger than a sample of firms that were eligible, but chose not to, elect a quasi-reorganization. After controlling for size differences, we demonstrate that the quasi-reorganization sample firms had a higher debt-to-assets ratio, a larger retained earnings deficit, and were more likely to declare bankruptcy or liquidate in the three years subsequent to the quasi-reorganization than the control sample.

In addition, we are unable to support the hypotheses that firms elect quasi-reorganizations to

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allow them to pay dividends or to issue new debt or equity securities. Finally, we demonstrate extremely limited subsequent operating performance differences in the quasi-reorganization firms and a group of negative retained earnings firms that elected not to undertake a quasi-reorganization. Therefore, our results do not lend support to the alleged usefulness of the quasi-reorganization procedure as a way to allow “fresh start” accounting for firms that have indeed “turned the corner” in terms of profitability. Based on our results, we recommend that the Financial Accounting Standards Board reconsider whether the quasi-reorganization procedure should remain a component of generally accepted accounting procedures.

### INTRODUCTION

Quasi-reorganizations have been referred to as “an infrequently used but a frequently abused accounting procedure.”<sup>1</sup> In fact, the same authors conclude that the “quasi reorganization concept has little theoretical validity, and we urge the Financial Accounting Standards Board to delete it from GAAP.”<sup>2</sup> In this paper, we extend the public policy debate on the appropriateness of quasi-reorganizations by providing empirical evidence on the characteristics and subsequent operating performance of a sample of firms that elected to undertake a quasi-reorganization. We document only isolated significant differences between the subsequent performance of our sample firms and those of a sample of similar firms that elected not to reorganize in this fashion. In addition, the results reveal that the quasi-reorganization firms have a higher average level of debt, a greater mean deficit in retained

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<sup>1</sup> M. Davis and J. Largay, “Quasi Reorganization: Fresh or False Start,” *Journal of Accountancy* (July 1995), 79-84, at 83.

<sup>2</sup> Davis and Largay at 79.

earnings, and are more likely to declare bankruptcy and/or liquidate within three years after the quasi-reorganization than the control group. We are therefore unable to empirically validate the alleged positive consequences of quasi-reorganizations. Thus, our results support the previously mentioned arguments that the FASB should consider dropping quasi-reorganizations from GAAP. At a minimum, we urge the FASB to reexamine the requirements for election of the quasi-reorganization procedure.

## **BACKGROUND**

### **What is a Quasi-Reorganization?**

A quasi-reorganization, pursuant to Accounting Research Bulletin 43, is an accounting transaction that permits a firm to transfer a deficit balance in retained earnings to paid-in capital accounts. It also requires the restatement of assets and liabilities to reflect current market value. Even though a quasi-reorganization is not an arms-length transaction and does not involve any cash flows of the firm, this accounting procedure allows a firm to restate its financial condition and to set up its accounts so that the financial statements reflect a "fresh start."

The Securities and Exchange Commission (SEC) has strict requirements that must be met in order for a firm to undertake a quasi-reorganization. The following are required:

1. Retained earnings must be negative prior to the quasi-reorganization.
2. Consent must be obtained from the stockholders.
3. The accounting transaction should accomplish substantially what would result from a reorganization by legal proceedings (including restating assets to fair value).
4. After the transaction, no capital account may have a deficit balance.
5. The retained earnings account must be dated from the date of the quasi-reorganization forward.

In addition, a quasi-reorganization is only allowed under circumstances which would justify an actual reorganization or

formation of a new corporation. In other words, the procedure is only permitted when an enterprise has engaged in a "fresh start" in substance rather than form. A fresh start in substance is indicated when a firm develops a modified operating strategy or when its present form of operations has improved from a depressed economic state. In addition, a firm is entitled to present "fresh start" financial statements in the event of a significant change in the management of the firm, such as replacement of the board of directors or the chief executive officer.

In the early 1990s, the American Institute of Certified Public Accountants (AICPA) issued Statement of Position 90-7 (SOP 90-7) that limited the utilization of the quasi-reorganization technique by firms as they emerge from Chapter 11 bankruptcy proceedings. In particular, SOP 90-7 mandates that only firms that meet the following criteria may employ "fresh start" accounting after legal reorganization through the bankruptcy process.<sup>3</sup>

1. The reorganization value of the entity's assets immediately before it emerges from reorganization is less than the total of all its liabilities incurred after entering reorganization plus the claims existing on entering reorganization and allowed by the court.
2. Holders of existing voting shares immediately before emerging from the reorganization retain less than 50% of the voting shares of the emerging entity.

In the empirical analyses that follow, we separately analyze the characteristics and subsequent operating performance of two subsamples of firms that employed the accounting reorganization. The first subsample elected a quasi-reorganization in conjunction with Chapter 11 bankruptcy proceedings and the second consists of firms that were not involved in the bankruptcy process at the time of the quasi-reorganization. This separation of the sample firms into Chapter 11 and non-Chapter 11 subsamples is necessary since

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<sup>3</sup> J. Robbins, A. Goll, and P. Rosenfield, "Accounting for Companies in Chapter 11 Reorganization," *Journal of Accountancy* (January 1991), 74-80, at 78.

the requirements for election of a quasi-reorganization currently differ between the two groups.

### **Potential Motivations for Quasi-Reorganizations**

There are three motivations offered in support of quasi-reorganizations. First, a commonly cited benefit of quasi-reorganizations is that the elimination of the retained earnings deficit enhances the ability of the firm to distribute cash dividends to shareholders. Many states prohibit dividend payments if retained earnings are negative. A quasi-reorganization wipes out the deficit in retained earnings and will thus allow dividend payments to the extent of a firm's future net income. A quasi-reorganization will therefore allow a firm to immediately begin paying dividends if in fact its profitability has significantly improved.

A second potential motivation for undertaking a quasi-reorganization is that a deficit in retained earnings may hinder the firm's ability to raise debt or equity financing. One possible reason for the accounting reorganization is to present a better financial picture of the firm immediately prior to issuing new securities, particularly if restrictive covenants in loan indentures would otherwise prevent the firm from issuing new securities.

Finally, a quasi-reorganization is often seen as a way to signal that the firm's operating performance and financial condition has improved. In conjunction with this benefit, it is also a means for the firm to "clean house" in an accounting sense. By restating overvalued assets to current market values, the firm can reduce future depreciation, amortization, and depletion expenses, resulting in increased future operating profits. A quasi-reorganization therefore may provide many of the same benefits that corporate restructuring charges, asset write-downs, and troubled debt restructurings provide for companies that do not have a retained earnings deficit. Also, by revaluing assets and liabilities, performance measures such as return on investment and capital structure ratios are improved. In addition, proponents argue that these performance measures are more reliable

representations of current operating performance following a quasi-reorganization.

### **Purpose of the Study and Relation to Other Research**

The purpose of this study is to examine the characteristics and subsequent operating performance of firms that elect a quasi-reorganization. Characteristics of those firms that adopt this accounting restatement are examined in comparison to other firms with deficits in retained earnings that could have, but chose not to, undertake a quasi-reorganization.

Even though the quasi-reorganization procedure is a part of GAAP, there has been scant empirical evidence concerning the appropriateness of the technique. In 1989, the AICPA published a comprehensive survey of financial statement disclosures of quasi-reorganizations through that date.<sup>4</sup> A contemporaneous article examined in detail the financial statement disclosures of 22 quasi-reorganizations over the 1981-1986 period.<sup>5</sup> These studies provide useful evidence on issues such as managers' stated rationales for electing quasi-reorganizations and the level of detail provided in the financial statements in the year of the accounting reorganization.

As stated earlier, a recent study questions the theoretical soundness of the concept and urges the Financial Accounting Standards Board to delete it from GAAP.<sup>6</sup> To our knowledge only one other study<sup>7</sup> has examined the characteristics and performance of quasi-reorganization firms in an attempt to provide evidence to standard setters on the appropriateness of the technique. That study examined a sample of pre-1989 quasi-reorganizations (QR)

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<sup>4</sup> H. Clark and L. Lorenzen, *Quasi-Reorganizations: A Survey of Quasi-Reorganizations Disclosed in Corporate Annual Reports to Shareholders* (American Institute of Certified Public Accountants, 1989).

<sup>5</sup> C. Gibson, "Quasi-reorganizations in Practice." *Accounting Horizons* (September 1988), 83-89.

<sup>6</sup> Davis and Largay at 79.

<sup>7</sup> D. Kennedy and W. Shaw, "The Timing and Effects of Quasi-reorganizations." Unpublished working paper (August 1994).

and found that “firms appear to adopt a QR when there is a significant improvement in firm profitability.”<sup>8</sup> However, the authors caution that the improved profitability appears to be a short-term phenomenon.

In comparison, our results demonstrate that, on average, it is the weakest performing eligible firms that elect quasi-reorganizations. In addition, these quasi-reorganization firms are more likely to declare bankruptcy and/or liquidate in the three years subsequent to the reorganization than other eligible firms. Our evidence thus does not support the hypothesis that firms that elect quasi-reorganizations have “turned the corner” in terms of profitability and are reflecting this “fresh start” through the use of the quasi-reorganization. In fact, we find that the only firms that demonstrate any significant improvement in performance subsequent to electing a quasi-reorganization are those firms that elected the accounting reorganization in conjunction with Chapter 11 bankruptcy proceedings. As stated earlier, SOP 90-7 now restricts the election of the quasi-reorganization technique by such firms. We therefore urge the FASB to reexamine the issue of whether quasi-reorganizations should continue to be part of GAAP.

## **DATA AND DESCRIPTIVE STATISTICS**

### **Sample Selection Criteria and Descriptive Statistics**

An initial sample of 159 firms that elected to undergo a quasi-reorganization between 1978 and 1991 was identified from the National Automated Accounting and Retrieval Services (NAARS) and from Disclosure Inc.'s CD-ROM database. Although these data sources provided sufficient information to identify the sample firms, additional information on the financial statement effects of the quasi-reorganizations required an examination of the firms' 10-K filings with the SEC. Of the 159 firms in the initial sample, 33 firms were deleted because the

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<sup>8</sup> Kennedy and Shaw at 15.

required 10-K report was not available in the University of Chicago library.

A final selection sample criterion was the requirement that sufficient data were available on the Compustat database to calculate measures of operating performance for the period ranging from one year prior to one year subsequent to the quasi-reorganization. This criterion ensured that we could compare the performance of the firm in the pre- and post-quasi-reorganization periods. This final criterion resulted in the loss of an additional 57 firms. The final sample thus consists of 69 firms that chose to undergo a quasi-reorganization during the 1978-1991 time period.

Table 1 provides some descriptive statistics on the 69 sample firms. The table demonstrates that the number of quasi-reorganization firms is fairly evenly distributed over the 13-year time period. The table also provides the mean and median level of total assets of the firms over the sample period. It is evident that the size of the sample firms varies considerably from year to year.

### **Control Sample**

In order to make meaningful inferences about the characteristics and operating performance of our sample firms, we also collected data for a potential control sample of firms that could have, but chose not to, undertake a quasi-reorganization.<sup>9</sup> The potential control firms were identified as those that met all of the Compustat data availability requirements of the sample selection process. Hence, both the sample and potential control firms were drawn from the same population. In particular, the potential control firms consisted of all firms on the Compustat database that had both negative retained earnings and positive stockholders' equity in a particular year. As stated earlier, in order for a firm to elect a quasi-reorganization, it must have negative retained earnings prior to the accounting reorganization; in addition, total owners' equity subsequent to the accounting

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<sup>9</sup> We identified 7,711 Compustat firms that reported negative retained earnings at least once during the period from 1977 through 1991.

transaction must be positive. Since a quasi-reorganization transfers the negative retained earnings balance to paid-in capital, a positive stockholders' equity balance prior to the accounting transaction is a necessity.

Table 1 also lists descriptive statistics on the population of potential control firms. It is evident that the number of such firms varies widely by year. The number of possible control firms varies from 266 in 1978 to 1,331 in 1991. It is also readily apparent that, on average, the quasi-reorganization firms are larger in terms of total assets than these potential comparison firms. Therefore, our data suggests that firms that elect to undergo a quasi-reorganization are typically larger than eligible firms that choose not to reorganize in this fashion.<sup>10</sup>

Based on the size differences documented in Table 1, we chose to select a size-matched control sample rather than employ the entire population of potential control firms described in the table. In particular, we matched each of the 69 sample firms with the ten potential control firms that were nearest to the same level of total assets in the corresponding year. As expected, this matching was effective in eliminating the size differences between the two samples that was documented in Table 1. From this point forward, all references to the control sample are to this reduced 690 firm size-matched sample.

## **EMPIRICAL RESULTS**

### **General characteristics of firms electing quasi-reorganizations**

Table 2 provides some additional descriptive statistics on the quasi-reorganization sample firms. In particular, Panel A details the magnitude of the adjustments that were made to total assets, net assets, and retained earnings as a result of the quasi-

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<sup>10</sup> To some extent, this size difference is due to the large number of small, start-up firms that report negative retained earnings in the early years of operations. As a consequence, the observed differences in size may reflect differences in firm age. That is, younger, start-up firms appear to be less likely to elect a quasi-reorganization than mature established firms.

reorganization itself. On average, the quasi-reorganization firms wrote down over \$13.5 million in overvalued assets. The panel also provides the results after we separated the 18 firms that went through a Chapter 11 bankruptcy in conjunction with the quasi-reorganization from the 51 firms that elected a quasi-reorganization without concurrent bankruptcy proceedings. Hereafter we will refer to these two groups as the Chapter 11 and the non-Chapter 11 samples, respectively. It is interesting to note that the Chapter 11 sample wrote down over six times the amount of assets as the non-Chapter 11 sample. This result is not unexpected since a write-off of overvalued assets is a common component of bankruptcy proceedings. The Chapter 11 firms also had a larger write-down of net assets than the non-Chapter 11 companies.

The final lines of Panel A reveal that the quasi-reorganization sample transferred an average retained earnings deficit of approximately \$88 million to paid-in capital as a result of the accounting reorganization. The quasi-reorganization firms thus had a large average retained earnings deficit prior to the reorganization. This contrasts with the control sample in that the comparison firms only had an average retained earnings deficit of approximately \$30 million. Panel B provides additional detail on the retained earnings differences of the two samples prior to the reorganization. For example, the panel demonstrates that 30.4% of the quasi-reorganization sample had a retained earnings deficit that was larger than their level of total assets, whereas only 12.3% of the control firms exhibited the same characteristic.<sup>11</sup> Thus, our data demonstrate that another characteristic of firms that elect to undergo a quasi-reorganization is that, on average, they have a

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<sup>11</sup> In addition, our results (not reported in the table) demonstrate that 8.7% of the quasi-reorganization firms generated enough net income in the year of the quasi-reorganization so that they would have reported positive retained earnings in that year without the accounting restatement. This contrasts with 11.6% of the control firms that reported positive retained earnings in the corresponding year.

larger retained earnings deficit than other firms that have negative retained earnings but choose not to elect a quasi-reorganization.

Table 3 provides details on the survivorship characteristics of our sample firms in relation to the control sample firms. Both the quasi-reorganization sample firms and the control firms display about the same rate of survivorship. The interesting finding in both Panels A and B is that the reasons for attrition differed between the two groups. The quasi-reorganization firms were much more likely to fail due to bankruptcy and/or liquidation than the control sample in the years subsequent to the quasi-reorganization. By contrast, the control sample firms were more frequently the subject of a merger, acquisition, or a leveraged buyout. Taken together, these results imply that firms that elect quasi-reorganizations appear to be in a weaker financial condition than the comparison firms and also appear to be less attractive as potential takeover targets than other eligible firms in the years subsequent to the accounting restatement.

This inference is supported by Table 4. The table compares the debt-to-assets ratio of the quasi-reorganization firms and the control firms.<sup>12</sup> It is evident that the quasi-reorganization firms have a higher debt-to-assets ratio prior to the quasi-reorganization than the comparison firms. This result that the firms electing quasi-reorganizations had a higher level of debt also holds for the year of the quasi-reorganization for the full sample and in the reorganization year and first subsequent year for the non-Chapter 11 sample firms. These results provide additional evidence that firms that elect to undertake quasi-reorganizations are in a weaker financial condition than other eligible firms. It is interesting to note that the subset of firms that were in Chapter 11 bankruptcy proceedings concurrent with the quasi-reorganization no longer

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<sup>12</sup> The test statistic that we employ in Table 4 (and in subsequent tests) compares the debt to total assets ratio of a sample firm to the mean ratio for the ten control firms matched on size (total assets). This resulted in 69 differences, one for each sample firm. The mean difference is reported in Table 4 and the significance level was determined by a t-test.

had a higher debt-to-assets ratio following the reorganization while the non-Chapter 11 sample did. A likely explanation for this result is that the Chapter 11 sample had their debt restructured as a component of the bankruptcy proceedings.

### **Test of the dividend explanation for election of a quasi-reorganization**

Table 5 provides the results of a test of the hypothesis that firms elect quasi-reorganizations in order to be able to pay dividends. In particular, we provide data on whether dividend payments increase after quasi-reorganizations. As stated earlier, most states prohibit dividend payments unless retained earnings is greater than zero. A quasi-reorganization therefore would allow firms with a retained earnings deficit to begin paying a dividend as soon as a profit is earned, rather than requiring sufficient earnings to eliminate the deficit in retained earnings.

The Table 5 results cast doubt on the dividend motivation for quasi-reorganizations. The table shows that 11.6% of the sample firms paid cash dividends prior to the quasi-reorganization, and that the percentage slightly increases in the four subsequent years. However, a similar marginal increase in the number of firms paying dividends is documented for the control firms. Therefore, the post-reorganization dividend paying behavior of the sample firms is comparable to a random sample of firms that had negative retained earnings but chose not to undertake a quasi-reorganization. In addition, the table demonstrates that the number of sample firms that paid dividends increased by only three firms over this five-year period.<sup>13</sup> Taken together, these results do not support the hypothesis that the ability to pay dividends drives the decision to elect a quasi-reorganization.

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<sup>13</sup> In fact, four of the sample firms began paying dividends subsequent to the quasi-reorganization, while one firm ceased dividend payments.

### **Test of the new financing explanation for election of a quasi-reorganization**

As stated earlier, another possible motivation for electing a quasi-reorganization is that a retained earnings deficit may restrict a firm's ability to raise debt or equity financing. Therefore, a firm might elect a quasi-reorganization in order to present a better financial picture immediately prior to a debt or equity offering. This would be particularly relevant if loan indentures would otherwise prevent the firm from issuing new securities.

We test this hypothesis and present the results in Table 6. The table compares the level of new financing of the quasi-reorganization firms and the control firms for the years surrounding the quasi-reorganization. We define new financing as the total amount of new equity and debt issued deflated by total assets. The table illustrates few significant differences in the level of new financing activity for the two groups. It is only when we examine the subsample of firms that went through a Chapter 11 bankruptcy in conjunction with the quasi-reorganization that significant differences are documented in any of the three years immediately surrounding the quasi-reorganization. However, the results are mixed in that the Chapter 11 sample firms had a significantly higher level of new financing activity in the year of the reorganization and a significantly lower level in the preceding and subsequent year. As mentioned earlier, a possible explanation for these results is that the restructuring of debt is a common component of bankruptcy proceedings. In particular, many of our Chapter 11 sample firms issued new equity securities in exchange for outstanding debt as a condition of emerging from bankruptcy. Such court ordered equity for debt swaps would likely explain the higher level of new financing activity of the Chapter 11 sample in the quasi-reorganization year.

When we restrict our attention to the non-Chapter 11 sample, we notice no significant differences until two years after the reorganization. However, that difference is in the direction opposite of that hypothesized. It is evident from the table that there is not a higher level of new financing activities for the non-

Chapter 11 quasi-reorganization firms following the accounting reorganization. In addition, any increased new financing activity of the Chapter 11 sample firms is likely due to court ordered equity for debt swaps and are therefore not voluntary new security offerings. Therefore, the Table 6 results do not provide strong support for the hypothesis that firms elect quasi-reorganizations prior to new financing activities.

### **Test of the “fresh start” explanation for election of a quasi-reorganization**

A third explanation for the election of a quasi-reorganization is that it serves as a signal that the firm has “turned the corner” in terms of operational performance. Proponents argue that the resulting restated financial statements reflect this operational “fresh start.” We employ two variables to proxy for this fresh start concept. We examine the quasi-reorganization firms’ subsequent capital expenditures and return on assets to ascertain whether the fresh start accounting allowed under the quasi-reorganization reflects an operational fresh start for these firms.

Table 7 addresses the question of whether there is a difference between quasi-reorganization firms and the control firms in their level of capital expenditures. A higher level of discretionary capital expenditures would be consistent with better future prospects (i.e., higher net present value projects) and would be a signal that the firm had “turned the corner.” The table provides the mean of the differences between the quasi-reorganization sample and the control sample for the period ranging from one year prior through three years after the quasi-reorganization. It is evident that the quasi-reorganization sample does not differ from the control sample in the level of capital expenditures. The only significant difference occurs in the Chapter 11 sample and is in the opposite direction than would be predicted if quasi-reorganizations were undertaken to reflect that the firm had engaged in a “fresh start.” These results suggest that quasi-reorganization firms do not have profitable investment

opportunities above and beyond those available to the control firms.

Table 8 provides additional evidence on whether the quasi-reorganization firms had actually begun an operational “fresh start.” The table compares the return on assets (ROA) of the sample firms and the control firms over the five years surrounding the quasi-reorganization. It is apparent that the quasi-reorganization firms had a lower ROA than the control firms prior to the quasi-reorganization. However, there are no significant differences following the accounting reorganization. Therefore, the sample firms demonstrated an improvement in operating performance in the year of the quasi-reorganization. However, this performance improvement merely brought the quasi-reorganization firms in line with the control firms in that year and in subsequent years.

When we separate the sample firms into the Chapter 11 and non-Chapter 11 subsamples, we discover that the results for the Chapter 11 firms mirror those for the full sample. In contrast, the ROA of the non-Chapter 11 sample firms do not significantly differ from the control firms either before or after the quasi-reorganization. Taken together, these results indicate that only the Chapter 11 firms demonstrated any improvement in ROA surrounding the quasi-reorganization and that improvement merely brought them in line with the ROA of the control sample. These results therefore do not provide compelling evidence that the quasi-reorganization firms had turned the corner in terms of financial performance and had indeed engaged in a fresh start. Figure 1 provides graphical evidence of this one year improvement in ROA experienced by the Chapter 11 sample firms and the lack of significant ROA improvement by the non-Chapter 11 firms.

## **CONCLUSIONS AND PUBLIC POLICY IMPLICATIONS**

In this paper, we provide empirical evidence on the characteristics and subsequent operating performance of a sample of firms that elected quasi-reorganizations in the 1978-1991 time period. We find that, on average, the quasi-reorganization firms

were larger than a sample of firms that were eligible, but chose not to, elect a quasi-reorganization. After controlling for firm size differences, we demonstrate that the quasi-reorganization sample firms had a higher debt-to-assets ratio, a larger retained earnings deficit, and were more likely to fail due to bankruptcy or liquidation in the three years subsequent to the quasi-reorganization than the control sample. Therefore, it appears that it is the weaker performing eligible firms that elect the quasi-reorganization accounting procedure.

In addition, we are unable to support the hypotheses that firms elect quasi-reorganizations to allow them to pay dividends or to issue new debt or equity securities. In particular, we find a slight increase in the number of firms paying dividends subsequent to the quasi-reorganization. However, the post-quasi-reorganization dividend paying activity of the sample firms parallels that documented for the control sample of firms that elected not to undertake a quasi-reorganization. In addition, the only significant increase in new financing that we find is restricted to the firms that elected the quasi-reorganization in conjunction with a Chapter 11 bankruptcy. We surmise that most of this documented increase is due to court ordered debt restructurings in which new equity securities are issued in exchange for outstanding debt.

Finally, we do not document significant improvements in profitability for the non-Chapter 11 quasi-reorganization firms following the accounting reorganization. The only significant profitability improvement that we find is a one-year improvement in ROA for the Chapter 11 sample firms. However, this ROA improvement merely brought these firms in line with the control firms and no subsequent improvements were documented. Our data therefore do not support the hypothesis that quasi-reorganizations serve to signal that the firm's future prospects are improved to the extent that they have undergone an operational "fresh start."

In summary, we demonstrate extremely limited subsequent operating performance differences in a group of quasi-

reorganization firms and a group of negative retained earnings firms that elected not to undertake a quasi-reorganization. Therefore, our results do not lend support to the alleged usefulness of the quasi-reorganization procedure as a way to allow “fresh start” accounting for firms that have indeed “turned the corner” in terms of profitability.

There are two related public policy implications of our empirical results. First, since our results do not support the hypothesis that quasi-reorganizations are utilized by firms that have undergone an operational “fresh start,” we urge the Financial Accounting Standards Board to reconsider whether the quasi-reorganization technique should remain a component of generally accepted accounting procedures. Secondly, at a minimum we believe that our results indicate that the requirements for the election of a quasi-reorganization should be reexamined. Just as SOP 90-7 served to restrict the utilization of fresh start accounting by firms emerging from Chapter 11 bankruptcy, the FASB should consider placing more restrictive requirements on the use of quasi-reorganizations by non-Chapter 11 firms.

**Table 1**  
**Comparison of Mean and Median Total Assets of Sample  
 Firms and Potential Control Firms**

Year	<u>Sample Firms</u>			<u>Potential Control Firms</u>		
	# of firms	Mean*	Median*	# of Firms	Mean*	Median*
78	4	4.158	4.011	266	64.95	22.63
79	4	81.530	43.977	327	46.71	16.17
81	5	468.322	57.315	499	38.85	9.72
82	6	218.614	53.408	690	36.08	6.26
83	5	93.914	52.831	728	53.88	7.66
84	4	219.822	29.839	862	68.68	8.25
85	6	49.995	23.519	887	135.52	8.10
86	4	56.610	50.262	1008	189.90	9.30
87	8	548.252	378.096	1174	96.63	10.36
88	12	1140.110	38.466	1273	111.60	11.12
89	3	814.163	29.076	1304	144.36	11.79
90	1	51.374	51.374	1295	213.65	11.56
91	7	277.200	62.535	1331	217.96	

\*in millions of dollars

**Table 2**  
**Descriptive Statistics**  
**Panel A: Mean Financial Statement Adjustments Related to**  
**Quasi-Reorganizations (in millions)**

	Full 69- Firm Sample	Chapter 11 Sample	Non- Chapter 11 Sample	Control
Total assets	-13.663	-36.697	-5.533	
	2.6%	2.0%	2.7%	
Net assets	-8.475	-14.633	-6.301	
	4.5%	11.6%	2.0%	
Retained earnings	87.998	87.731	88.093	29.840
	103.2%	167.9%	80.4%	33.6%

**Panel B: Distribution of Pre-Quasi-Reorganization Retained  
 Earnings**

RE/TA	Sample Firms		Control Firms	
	# of Firms	Percent *	# of Firms	Percent *
<-1.00	21	30.4%	85	12.3%
-0.50 — - 0.99	19	27.5%	81	11.7%
-0.25 — - 0.49	12	17.4%	104	15.1%
-0.10 — - 0.24	5	7.2%	129	18.7%
> -0.5	<u>12</u>	17.4%	<u>291</u>	42.2%
	69		690	

**Table 3**  
**Compustat Survivorship and Attrition among Sample and Control Firms**

<b>Panel A</b>	<u>Sample Firms</u>		<u>Control Firms</u>	
	# of Firms	Percent	# of Firms	Percent
Survived through 1996	37	53.6	369	53.5
Dropped due to:				
Bankruptcy and liquidation	14	20.3	47	6.8
Merger, acquisition and LBO	9	13.0	166	24.1
Other reasons	<u>9</u>	<u>13.0</u>	<u>108</u>	<u>15.7</u>
Total	69	100.0	690	100.0

<b>Panel B</b>	<u>Sample Firms</u>		<u>Control Firms</u>	
	# of Firms	Percent	# of Firms	Percent
Survived through:				
Year 0	69	100.0	690	100.0
Year +1	68	98.6	689	99.9
Year +2	64	92.8	645	93.5
Year +3	58	84.1	596	86.4
Dropped due to:				
Bankruptcy and liquidation	5	7.2	11	1.6
Merger, acquisition and LBO	2	2.9	52	7.5
Other reasons	<u>4</u>	<u>5.8</u>	<u>31</u>	<u>4.5</u>
Total	11	15.9	94	13.6

**Table 4**  
**Comparison of Capital Structure**  
**(Total Debt divided by Total Assets)**

Year relative to quasi-reorganization	-1	0	+1	+2	+3
Full sample	0.443	0.103	0.065	0.039	0.040
	(4.538)*	(3.465)*	(1.761)	(0.961)	(0.669)
Chapter 11 sample	0.918	0.044	-0.052	0.008	-0.029
	(3.820)*	(0.685)	(0.674)	(0.103)	(0.227)
Non-chapter 11 sample	0.275	0.123	0.104	0.049	0.060
	(2.996)*	(3.735)*	(2.515)*	(1.022)	(0.880)

Mean of the differences between sample firms' and control firms' total liabilities divided by total assets (t-statistics in parentheses).

\* Significant at the 5% level, two-tailed test.

**Table 5**  
**Number of Firms Paying Dividends**

Year	Sample Firms		Control Firms	
	# of Firms	Percent*	# of Firms	Percent*
-1	8	11.6	106	15.4
0	7	10.7	107	15.5
+1	7	10.3	126	18.3
+2	9	14.0	126	19.5
+3	11	19.0	120	20.1

\*Percentages are calculated by dividing the number of firms paying dividends by the number of firms remaining in the sample or control group in each year. Refer to Table 3 for rates of survivorship.

**Table 6**  
**Comparison of New Financing**  
**(Total New Financing divided by Total Assets)**

Year relative to quasi-reorganization	-1	0	+1	+2	+3
Full sample	-0.058	0.052	-0.038	-0.076	-0.059
	(1.070)	(1.759)	(1.226)	(2.258)*	(1.533)
Chapter 11 sample	-0.147	0.137	-0.120	-0.066	-0.024
	(2.555)*	(2.043)*	(2.148)*	(1.466)	(0.353)
Non-chapter 11 sample	-0.028	0.021	-0.014	-0.079	-0.069
	(0.394)	(0.671)	(0.357)	(2.883)*	(1.516)

Mean of the differences between sample firms' and control firms' new equity and debt financing divided by total assets (t-statistics in parentheses).

\* Significant at the 5% level, two-tailed test.

**Table 7**  
**Comparison of Capital Expenditures**  
**(Capital Expenditures divided by Total Assets)**

Year relative to quasi-reorganization	-1	0	+1	+2	+3
Full sample	0.004	-0.015	-0.018	-0.005	0.003
	(0.216)	(1.442)	(1.547)	(0.346)	(0.237)
Chapter 11 sample	-0.035	-0.036	-0.044	-0.019	-0.011
	(1.644)	(1.478)	(2.203)*	(0.900)	(0.406)
Non-chapter 11 sample	0.019	-0.008	-0.010	0.000	0.007
	(0.722)	(0.687)	(0.717)	(0.007)	(0.434)

Mean of the differences between sample firms' and control firms' capital expenditures divided by total assets (t-statistics in parentheses).

\* Significant at the 5% level, two-tailed test.

**Table 8**  
**Comparison of Return on Assets**  
**(Net Income divided by Beginning Total Assets)**

Year relative to quasi-reorganization	-1	0	+1	+2	+3
Full sample	-0.065	-0.114	0.004	0.039	-0.024
	(2.583)*	(1.433)	(0.246)	(1.010)	(1.269)
Chapter 11 sample	-0.159	-0.346	0.045	-0.015	0.017
	(3.013)*	(1.179)	(1.034)	(0.656)	(0.361)
Non-chapter 11 sample	-0.031	-0.030	-0.009	0.055	-0.036
	(1.159)	(1.466)	(0.484)	(1.113)	(1.781)

Mean of the differences between sample firms' and control firms' net income divided by beginning total assets (t-statistics in parentheses).

\* Significant at the 5% level, two-tailed test.

**Figure 1**  
**Return on Assets**  
**Chapter 11 Sample and Non-Chapter 11 Sample versus**  
**Control Sample**

