Business bankruptcies are surging. That fact is unsurprising given that we are in the midst of the worst economic crisis since the Great Depression, but the numbers are still startling. In 2008, there were 43,546 business bankruptcies—a 65 percent increase over 2007, and more than double the 2006 figure of 19,965. A total of 9,272 of those 2008 cases involved a chapter 11 filing—again, a dramatic increase over the 2007 and 2006 totals (there were 5,736 in 2007 and 5,163 in 2006).2

A chapter 11 filing is a dramatic event in the life of any business—as witnessed in the intensive, far-reaching media coverage of the Chrysler and General Motors bankruptcies. For business leaders, advisors, employees and interested parties, entry into chapter 11 is life-altering.

Fresh-start Reporting Is a Continuation of the Chapter 11 Process

For many companies, the chapter 11 process is the first, but not the last, step in a reorganization. Companies that successfully reorganize and meet a strict set of criteria qualify for fresh-start reporting—the reporting requirements for qualifying emerging entities as promulgated by the American Institute of Certified Public Accountants (AICPA) Statement of Position 90-7 (SOP 90-7), “Financial Reporting for Entities in Reorganization Under the Bankruptcy Code.”

How Companies Can Benefit

Fresh-start reporting is exactly what it sounds like—a financial statement by the new entity as it emerges from chapter 11, containing a “fresh” presentation of the newly-determined value of assets after liabilities have been cancelled or adjusted. Fresh-start reporting recognizes that, under certain conditions, the emerging entity is effectively new, and users of its financial statements are better served by revaluing the entity’s balance sheet based on the “fair value” of the entity’s postconfirmation assets and liabilities.

Fresh-start reporting can work in a company’s favor. It creates a clean balance sheet and can step up the value of the assets. It enables leadership to wipe away the accumulated losses of the bankrupt company, and to say accurately to the marketplace that the new company coming out of bankruptcy is stronger.

Requirements Are Complex

The fresh-start requirements spelled out in SOP 90-7 are complex. The statement sets forth a strict set of rules for restatement and a timeline for implementing fresh-start reporting. Those executing the restructuring must understand, among other factors, the intricacies of determining fair value for tangible and intangible assets, implications of timing issues, including the start date for fresh-start reporting, and best practices in “pushing down” fresh-start adjustments to subsidiary entities and underlying ledgers.

Added to this is the fact that fresh-start reporting is not a stand-alone process. For companies that qualify, it is integral to the chapter 11 reorganization. The first step in the chapter 11 process is to reorganize the company to create a solvent, operationally viable entity. A key component is the restructuring and discharge of certain debt, which is the essence of the reorganization plan. Then, if the entity qualifies, fresh-start accounting considerations come into play: the question at hand is, what do we need to do to reset the balance sheet, in addition to what we needed to get to that point?

Few Business Leaders and Advisors Have Experience in Fresh-start Reporting

Needless to say, many business leaders have never been exposed to the intricacies of either the chapter 11 process or fresh-start accounting, and even when it comes to their advisors, experience can be hard to come by. Many attorneys and accountants claim chapter 11 experience—but the demands
of fresh-start reporting are likely beyond most of them. Only practitioners and firms with extensive experience in fresh-start accounting are truly qualified to guide a company through the process. Keep in mind that the leadership of the new entity, together with its advisors, will need to support the reorganized entity’s individual asset valuations to the company’s auditors. The situation is demanding and the stakes are high, and penalties will apply for delayed reporting. A review of the specific demands will illustrate its complexities, and show why the process is best navigated with the help of an expert.

**Criteria: When Does a Company Qualify for Fresh-start Reporting?**

SOP 90-7 clearly states that companies emerging from chapter 11 qualify for fresh-start reporting if two conditions are met: (1) the reorganization value of the entity’s assets is less than the total of all claims and postpetition liabilities; and (2) the holder of preconfirmation voting shares will receive less than 50 percent of the voting shares upon emergence.3

The purpose of the first condition is to prevent the use of fresh-start reporting by solvent companies. The second condition, the change-in-ownership requirement, is, in concert with the first condition, intended to prevent companies from filing a chapter 11 petition solely for the purpose of adopting fresh start reporting and writing up the carrying value of assets.

**Determining Reorganization Value and Developing the Disclosure Statement**

Since fresh-start reporting is an integral element of the bankruptcy process for companies that meet the qualifying conditions, the process begins with the bankruptcy filing itself. The filing of the bankruptcy petition starts the reorganization proceeding. The goal of the proceeding (and of the whole bankruptcy process) is to maximize recovery by creditors and shareholders by preserving the company as a viable entity with a going-concern value. The plan specifies the treatment of all creditors and equityholders, and shapes the financial structure of the entity that emerges.

Among the most significant elements of the plan is the determination of reorganization value. Generally speaking, the reorganization value is the fair value of the entity—what a willing buyer would pay for the assets immediately after restructuring—without taking into account the liabilities. While that description is straightforward in concept, the determination of fair value is an intricate and time-consuming process that usually involves extensive arm’s-length negotiation—and sometimes litigation—among the interested parties.

At the conclusion of negotiations, the disclosure statement is prepared. This is required under the Bankruptcy Code in order to enable a hypothetical “reasonable investor” to make an informed judgment about the bankruptcy plan.4 The Code does not identify the elements of the disclosure statement, but in practice the statement usually includes a summary of the plan, historical and prospective information, and a pro forma balance sheet reporting the reorganization value and capital structure of the emerging entity.5

**Figure 1: Pro Forma Financial Statements**

### BEST PRODUCTS CO., INC.

#### PRO FORMA CONSOLIDATED BALANCE SHEET

January 29, 1994

(>Unaudited<)

<table>
<thead>
<tr>
<th></th>
<th>Pre-Confirmation Balance Sheet</th>
<th>Reorganization Adjustments</th>
<th>Fresh Start</th>
<th>Pro Forma Reorganized Best Balance Sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ASSETS:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current assets:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash and cash equivalents</td>
<td>$208,930</td>
<td>($70,180)</td>
<td>-</td>
<td>$138,750</td>
</tr>
<tr>
<td>Merchandise inventories</td>
<td>408,714</td>
<td></td>
<td>11,977</td>
<td>420,691</td>
</tr>
<tr>
<td>Other current assets</td>
<td>27,335</td>
<td></td>
<td>-</td>
<td>27,335</td>
</tr>
<tr>
<td>Total current assets</td>
<td>644,979</td>
<td></td>
<td>11,977</td>
<td>586,776</td>
</tr>
<tr>
<td>Land, property and equipment, net</td>
<td>272,873</td>
<td>(207,193)</td>
<td>-</td>
<td>65,680</td>
</tr>
<tr>
<td>Property under capital leases, net</td>
<td>129,836</td>
<td>(95,151)</td>
<td>-</td>
<td>34,685</td>
</tr>
<tr>
<td>Other assets, including favorably operating leases...</td>
<td>49,070</td>
<td>(39,011)</td>
<td>-</td>
<td>10,059</td>
</tr>
<tr>
<td>Deferred income taxes, net</td>
<td>-</td>
<td></td>
<td>-</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total Assets:</strong></td>
<td>$1,096,758</td>
<td>(70,180)</td>
<td>11,977</td>
<td>$597,200</td>
</tr>
</tbody>
</table>

| **LIABILITIES AND STOCKHOLDERS’ EQUITY:** |                               |                             |            |                                        |
| Current assets:          |                               |                             |            |                                        |
| Current portion long-term debt | $0                          | $230                        | -          | $230                                   |
| Current portion capital lease obligations | 4,158                      | 4,559                       | -          | 8,717                                  |
| Accounts payable          | 76,444                        |                             | -          | 76,444                                 |
| Accrued expenses and other | 70,330                       | (19,499)                    | 15,105     | 65,936                                 |
| **Total current liabilities:** | 150,932                     | (19,269)                    | 19,664     | 151,327                                |
| Liabilities subject to compromise | 1,201,443                  | (1,201,443)                 | -          | -                                      |
| Long-term debt           | 5,913                         | 124,106                     | -          | 130,019                                |
| Capital lease obligations | 60,348                       | 20,941                      | 10,594     | 91,885                                 |
| Deferred income taxes, net | -                            |                             | -          | 0                                      |
| **Total Liabilities:**   | 1,493,711                     | (1,075,665)                 | (44,817)   | 373,229                                |
| Common stock, warrants and additional paid-in capital | 85,750                     | 323,971                     | (85,750)   | 323,971                                |
| Retained earnings (accumulated deficit) | (482,705) | 681,514                     | (198,811)   | 0                                      |
| **Total Stockholders’ Equity:** | (395,953)                 | 1,005,485                   | (284,561)  | 321,971                                |
| **Total Liabilities and Stockholders’ Equity:** | 1,096,758                    | (70,180)                    | 11,977     | $697,200                               |

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3 AICPA SOP 90-7.12, Nov. 1990.
4 §1125(a)(1).
5 SOP 90-7.11.
6 SOP 90-7.37.

**The Pro Forma Balance Sheet: Basis for the Fresh-start Requirements Test**

While the Code does not specifically require a valuation in order to approve a disclosure statement, a valuation is almost always prepared for companies that meet the criteria for fresh-start reporting. The mechanism for presenting the valuation is the pro forma balance sheet. The development of the pro forma balance sheet involves two main considerations:

1. The **pro forma** recording of the effects of the plan, such as:
   - debt extinguishment;
   - cancellation of old common stock;
   - estimation of the settlement amount of allowed claims; and
   - issuance of new stock and debt;

2. Adjusting the balance-sheet values to “fair value,” such as:
   - valuing and writing up or down receivables, inventory and fixed assets;
• valuing the reorganized entity’s intangible assets and adding them to the balance sheet;
• calculating the present value of all liabilities that will survive the reorganization and recording adjustments and/or additions, including pension and post-retirement benefits, leases or deferred taxes, including the impact of the newly identified, separable intangible assets; and
• eliminating prior retained earnings (deficit) and recording other direct charges to equity, including cancellation of debt or net operating loss carryforwards.

In Figure 1 (taken from a real entity that went through the chapter 11 reorganization and fresh-start reporting processes), the first column shows the pro forma balance sheet at the point of filing the bankruptcy petition. The second column reflects the preconfirmation balance sheet at the point of confirmation of the chapter 11 plan and the third column reflects the pro forma balance sheet after the plan effects. The fourth column reflects the pro forma balance sheet as it would appear in the fourth column. The combined effects of the two produce the pro forma balance-sheet results, which appear in the fourth column.

Valuing intangible assets carries its own set of challenges. Regardless of whether an intangible asset was reported on the balance sheets of the original entity, it should be reported on the pro forma balance sheet if it results from contractual rights (legal or other), and if it can be easily separated from the entity and sold, transferred, exchanged, licensed or rented. As for goodwill—any portion of the reorganization value that cannot be attributed to tangible or intangible assets is to be treated as goodwill.

The extensive work involved in the balance-sheet adjustments is, of course, just one example of a broader movement toward “fair value” as a standard for valuing assets. Although fair value accounting has received significant attention in the wake of the global financial crisis, the truth is that for many nonfinancial assets, and in the absence of a merger or acquisition, the accounting standard remains historic cost-based, and this is reflected on the balance sheets of thousands of companies. The application of fair value standards in the development of the reorganized entity’s pro forma balance sheet is part of a trend toward greater transparency and fuller disclosure. In this context it represents a way to clear accumulated distortions from the balance sheet and establish that the new entity is, in fact, a healthier company.

The new asset valuation presented in the pro forma balance sheet is the basis for determining whether the new entity meets fresh-start reporting criteria—this is the asset valuation that must be weighed against claims and postpetition liabilities. If the asset value is less than claims and liabilities, then according to SOP 90-7, one of the two conditions for fresh-start reporting has been met.

**Determining the Preconfirmation Shareholders’ Participation in the New Entity**

The second test for fresh-start reporting is to determine whether the holders of preconfirmation voting shares will receive less than 50 percent of the voting shares in the new entity. Like other steps in bankruptcy and re-emergence, this can be a complex and lengthy process, especially when there are debt-for-equity exchanges and aggregated shareholders whose holdings must be analyzed. A particularly challenging situation is one in which there has been a change in the parent company ownership structure. Consider, for example, the case of a U.S. company—a subsidiary of a Korean company—coming out of bankruptcy. The Korean company had been restructured in complex ways that made it hard to determine whether the U.S. entity had or had not been subject to a change in ownership. The debtor’s financial advisors usually lead the analysis, with help from the debtor’s counsel and the debtor’s treasury department.

**Challenges in Fresh-start Reporting: Establishing the Reporting Date**

Once the criteria are clearly met, the real work begins and a central challenge is determining the reporting date. According to SOP 90-7, fresh start reporting should be applied “as of the confirmation date or as of a later date when all material conditions precedent to the plan’s becoming binding are resolved.” “Material conditions precedent” are conditions that could delay or impede the debtor’s ability to emerge from bankruptcy. These might include:

• Exit financing for which a lender has not yet been established;
• Pending appeals;
• An SEC settlement; and
• Other external factors—regulatory, for example—not under the debtor’s control.

Beyond that, SOP 90-7 has absolutely nothing to say about the date on which to begin fresh-start reporting. The usual practice—in order to minimize disruption to the organization—is to choose a fiscal month-end, usually close to the confirmation date or the emergence date, depending on when the “material conditions precedent,” if any, are resolved.

**Issues in Fresh-start Implementation**

While it is possible that the fresh-start reporting date will coincide with a fiscal year end, in 99-plus percent of situations, that is not going to be the case. Most emerging entities will need to establish cut-off procedures for closing their books.

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**Figure 2: Fresh-start Reporting Timeline**

- Petition Filed
- Plan Filed
- Plan Confirmation
- Fresh Start Reporting Date
- Emergence (“Effective Date”)
- Chapter 11 Process
- Fresh Start Reporting Process

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7 SOP 90-7.35.
in the middle of the year, and there are many accounting steps involved. “Stub period” income statements must be generated for the period leading up to the fresh-start date and for the first year of the emerged entity’s operations.

In addition, it will be necessary to “push down” the balance-sheet valuation and cancellation of debt adjustments to the level of the legal entities that actually housed the assets and debts in the first place. It is an intricate, but necessary, task to ensure that the adjustments appear on the correct underlying ledgers and subsystems.

**Initial Financial Statement: Making Sure Transparency Wins Out**

The initial financial statement issued under fresh-start reporting rules carries a special burden: It must fulfill the obligation of transparency that has been the goal of the entire reorganization process. Specifically, the initial financial statement must disclose:

- the adjustments made to the historical amounts of individual assets and liabilities;
- the amount of debt forgiveness;
- the amount of prior retained earnings or deficit eliminated; and
- how reorganization value was determined—that is, the valuation methods, including key assumptions.

Since the fresh-start financial statement is, by definition, a new beginning, it is not comparable with the financial statements issued before the confirmation date, and comparative financial statements including pre- and postconfirmation reporting periods should not be presented.

**Timeline: Step by Step Through the Fresh-start Accounting Process**

A review of the steps involved in fresh start-reporting (see Figure 2) clearly shows that the process falls into two distinct phases: (1) steps undertaken during the chapter 11 reorganization, up to and including the plan confirmation; and (2) the steps undertaken to implement fresh-start reporting if the entity qualifies. Fresh-start requirements testing sits between the two phases: It takes place in the late stages of plan development, as the pro forma balance sheet is created. Then, if fresh-start reporting criteria are met, it drives the considerations undertaken during the fresh-start reporting process itself.

**Conclusion: A Job for Professionals**

As these examples illustrate, fresh-start reporting is an intricate process—one made even more challenging because it plays out in the context of a bankruptcy, which is already challenging. Simply put, fresh-start reporting is not an obligation that C-level executives should meet on their own. However gifted they are in business and finance, they likely will not have enough exposure to the process to carry it off effectively. The same may be true of professional advisors (attorneys and accountants) who are not specialists with extensive experience in the specific demands of fresh-start reporting.

A leadership team or professional counsel managing a bankruptcy reorganization should secure an experienced advisor—one with a strong background in fresh-start accounting and in the practical challenges of similar cases. Without a qualified guide, fresh-start reporting can be a hazardous—or even disastrous—process, but with a qualified professional on hand to manage the steps, fresh start-reporting can be exactly what the name implies: a representation of the scorekeeper’s role in the entity’s renewal.

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