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Fresh-Start Reporting

An Additional Challenge for Bankruptcy Counsel

By John M. Bonora

Emergence from bankruptcy presents a series of challenges for debtor companies, their creditors and counsel for all interested parties. One of the most significant challenges is financial reporting. How will the reorganized entity report? How and why does the entity's value change during the reorganization process? What is the process required to ensure that the emerging entity reports in a manner that is transparent, and that allows creditors and investors to understand the fiscal health of the "new" company?

For a select group of companies, the steps toward emergence and transparency are clearly laid out. 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."

But while the steps may be clear, fresh-start reporting can nevertheless be an intricate and demanding process for management of the emerging entity and debtor's counsel. The process needs to be better understood by all involved, so that they can manage it successfully.

Starting Over

Fresh-start reporting is just what the name implies. It is 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 a new company, 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 post-confirmation assets and liabilities. It enables management to wipe away the accumulated losses of the bankrupt company, and to illustrate to the marketplace the strengthened balance sheet of the emerging entity.

Complexity Is the Name of the Game

But the fresh-start requirements spelled out in SOP 90-7 are complex, and the process is demanding. The statement sets forth a strict set of rules for restatement and a timeline for implementing it.

Throughout, there is an obligation on the part of entities and counsel executing the restructuring to understand multiple factors, among them the intricacies of determining fair value for tangible and intangible assets, the 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.

These complexities are in addition to the already onerous demands of a Chapter 11 reorganization. Fresh-start reporting is not a stand-alone process. For companies that qualify, it is integral to the Chapter 11 reorganization. The process begins with the bankruptcy filing and the development of the reorganization plan. The additional question pertaining to fresh-start reporting is: "What is required to reset the balance sheet, over and above what was needed to get to that point?"

Qualification Criteria

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 post-petition liabilities; and
2. The holder of pre-confirmation voting shares will receive less than 50% of the voting shares upon emergence (AICPA SOP 90-7.12, Nov. 19, 1990).

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.

Getting Started: Reorganization Value and The Disclosure Statement

Among the most significant elements of the reorganization plan is the determination of reorganization value. Generally speaking, the reorganization value is the fair value of the entity — that is, what a willing buyer would pay for the assets immediately after restructuring — without taking into account the liabilities. This valuation is typically worked out in the pro forma balance sheet that in practice is usually part of the reorganization plan disclosure statement.

The First Test: Developing the Pro Forma Balance Sheet

While the Bankruptcy Code does not specifically require a valuation in order to approve a disclosure statement (SOP 90-7.37), a valuation is almost always prepared for companies that meet the criteria for fresh-start reporting, and the pro forma balance sheet is the vehicle for doing that.

The development of the pro forma balance sheet involves two main considerations:

- The pro forma recording of the effects of the plan, *e.g.*,
  1. Debt extinguishment;
  2. Cancellation of old common stock;

John M. Bonora, CPA/ABV, CFE, a director in the Litigation and Corporate Financial Advisory Services Group of accounting firm Marks Paneth & Shron, has more than 20 years of experience in litigation consulting and bankruptcy services. He has advised litigation counsel, the courts, Chapter 11 debtors and Chapter 11 and Chapter 7 trustees. Mr. Bonora can be contacted at Jbonora@markspaneth.com or at 212.201.2240.

3. Estimation of the settlement amount of allowed claims; and
4. Issuance of new stock and debt.

- Adjusting the balance sheet values to "fair value," *e.g.*,
  1. Valuing and writing up or down; receivables, inventory, fixed assets;
  2. Valuing the reorganized entity's intangible assets and adding them to the balance sheet; and
  3. Calculating the present value of all liabilities which will survive the reorganization and recording adjustments and/or additions, including:
- Pension and post-retirement benefits;
- Leases;
- Deferred taxes, including the impact of the newly identified, separable intangible assets:
  4. Eliminating prior retained earning/(deficit) and recording other direct charges to equity, including:
- Cancellation of debt; and
- Net operating loss carryforwards.

In practice, many steps are required after the *pro forma* recording of the plan effects to arrive at fair value. It's the combined effects of the two — the *pro forma* plan and the multiple fair value adjustments — that determine fair value.

Among those intricate steps is the valuation of intangible assets, which carries its own set of challenges. Regardless of whether an intangible asset was reported on the balance sheets of the original entity, it must 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. Then there is the matter of goodwill. Any portion of the reorganization value that cannot be attributed to tangible or intangible assets is to be treated as good will.

The new asset valuation presented in the pro forma balance sheet is the basis for determining whether the new entity meets the first of the two fresh start reporting criteria. This is the asset valuation that must be weighed against claims and post-petition liabilities.

The Second Test: Shareholder Participation

The second test for fresh-start reporting is to determine if the holders of pre-confirmation voting shares will receive less than 50% 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 have been debt for equity exchanges and where there are aggregated shareholdings which must be analyzed.

Determining the Reporting Date

Once the criteria for fresh-start reporting are clearly met, the real work begins. 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." (SOP 90-7.35)

"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 nothing to say about the date on which to begin fresh-start reporting. The usual practice 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.

Timing and Other Issues

While it's possible that the fresh-start reporting date will coincide with a fiscal year-end, in most real-world situations, that isn't going to be the case. Most emerging entities will need to establish cut-off procedures for closing their books in the middle of the year. 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's a difficult task to ensure that the adjustments appear on the correct underlying ledgers and subsystems, but one that's necessary for the fresh-start reporting requirements to be met.

Preparing the Initial Financial Statement

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 throughout. 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

The fresh-start financial statement is, by definition, a new beginning. Therefore, it is not comparable with the financial statements issued before the confirmation date. Entities and their counsel must not present comparative financial statements including pre- and post- confirmation reporting periods.

Conclusion: A Job for Professionals

Fresh-start reporting is inherently challenging, all the more so because it plays out amid the complexities of a bankruptcy.

The most important step management can take is to call on outside experts for support. 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 advisers, 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.