

# Advisory Alert: Financial reporting during Chapter 11 reorganization

## Introduction

Tumultuous economic conditions and industry events can cause liquidity and other business challenges, forcing a company to seek protection under Chapter 11 of the Bankruptcy Code. As a means of reducing excessive debt, addressing major liabilities, and/or changing operational obligations, Chapter 11 provides a mechanism for a company to reorganize the business under a court-supervised process. This process, however, greatly increases the financial reporting requirements and, consequently, the resource demands on the debtor. Bankruptcy reporting entails three distinct areas of financial reporting and related work streams:

- (i) the initial bankruptcy reporting, which includes such items as the Statement of Financial Affairs (“SOFA”) and the Schedules of Assets and Liabilities (“Schedules”);
- (ii) ongoing bankruptcy reporting, in addition to the regular reporting obligations of the company, which includes items such as monthly operating reports (“MORs”) and other reporting that might be required/requested by the U.S. Trustee or other constituents; and
- (iii) reporting for the reorganized entity in the Plan of Reorganization (“Plan”) and Disclosure Statement, which may involve fresh start accounting principles. Financial reporting takes on new importance for an entity in Chapter 11 because it must provide all constituents and stakeholders with a clear view of past

and ongoing operations, as well as the entity’s potential future viability. In some cases, the initial filings and statements may provide the first indication of the extent of the company’s assets and obligations. While some of the required reporting may be similar to that which is prepared for entities that are not subject to bankruptcy proceedings, the audience for this reporting may be very different. For example, reports normally prepared for internal management or shareholders may now be disclosed to many interested parties, including creditors, customers, and potential acquirers.



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### Initial bankruptcy financial reporting

Certain financial reporting is required as part of the Chapter 11 petition. Some of this information is provided immediately, while other reporting (such as the SOFA and Schedules) can be filed within 15 days of filing the petition (or longer if an extension from the bankruptcy court is granted). The following is a summary of the financial reporting that is typically required in connection with a Chapter 11 filing:

- *Exhibit “A” to the Petition* – This is a brief outline of the financial condition of the business, listing total assets, total liabilities, information relating to the public trading of the debtor’s securities (including debt and equity), the nature of the entity’s debts (e.g., secured, unsecured, subordinated), a general description of the business, and a listing of insiders.
- *List of Creditors Holding 20 Largest Unsecured Claims* – This list contains the names of the debtor’s 20 largest unsecured creditors, excluding insiders. The list must also contain the creditors’ addresses; nature of the claim; whether the claim is contingent, unliquidated, disputed, or subject to setoff; and the amount of the claims.
- *List of Creditors* – This listing must include all of the debtor’s creditors by each class, including the amounts, character of each claim, securities and, if known, the name and address or place of business for each creditor. The list must also include whether a claim is contingent, unliquidated, disputed, or subject to setoff, when each claim was incurred, the consideration received, and other related data.

- *Corporate Ownership Statement and List of Equity Security Holders* – This list outlines all of the debtor’s equity security holders for each class and includes the number and kind of interests registered in the name of each holder, along with their last known address or place of business.
- *Schedules of Assets and Liabilities (“Schedules”)* – The Schedules are sworn statements of the debtor’s assets and liabilities as of the filing date. Organized in alphabetical order as Schedules A through J, they also include information about the debtor’s operations and obligations. It is critically important that these Schedules are as accurate as possible, as failure to provide accurate and thorough listings could cause a creditor’s claim to be exempted from a debt discharge when and if a Plan is later confirmed. Additionally, omission of material facts may be construed as a false statement or concealment. Further, the time and expense associated with addressing inaccurate or missing claims can be significant. See the table below for an overview of the Schedules of Assets and Liabilities.

Overview of the schedules of assets and liabilities	
<b>Schedule A</b>	Real property
<b>Schedule B</b>	Personal property
<b>Schedule C</b>	Property claimed as exempt
<b>Schedule D</b>	Creditors holding secured claims
<b>Schedule E</b>	Creditors holding unsecured priority claims
<b>Schedule F</b>	Creditors holding
<b>Schedule G</b>	Executory contracts and unexpired leases
<b>Schedule H</b>	Co-debtors
<b>Schedule I</b>	Current income of individual debtor(s)
<b>Schedule J</b>	Current expenditure of individual debtors(s)

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- *Statement of Financial Affairs (“SOFA”)* – The SOFA is a series of detailed questions about the debtor’s property and conduct. It primarily features questions that deal with financial information and, therefore, it is typically prepared by internal or independent accountants. The SOFA consists of 25 questions to be answered under oath. See the table below for an overview of the Schedules of Financial Affairs.

Overview of the statement of financial affairs	
1.	Income from employment or operation of business
2.	Income other than from employment or operation of business
3.	Payments to creditors
4.	Suits, executions, garnishments and attachments
5.	Repossessions, foreclosures and returns
6.	Assignments and receiverships
7.	Gifts
8.	Losses
9.	Payments related to debt counselling or bankruptcy
10.	Other transfers
11.	Closed financial accounts
12.	Safe deposit boxes
13.	Setoffs
14.	Property held for another person
15.	Prior address of debtor
16.	Spouses and former spouses
17.	Environmental information
18.	Nature, location and name of business
19.	Books, records and financial statements
20.	Inventories
21.	Current partners, officers, directors and shareholders
22.	Former partners, officers, directors and shareholders
23.	Withdrawals from a Partnership or distributions by a Corporation
24.	Tax consolidation group
25.	Pension funds

The debtor may also need to file additional reports or documents that may be required by local rules or by the U.S. Trustee.

### Ongoing reporting during reorganization

During the reorganization proceedings, financial reporting requirements are driven by the need to reflect the financial evolution of the bankrupt entity and to allow interested parties, including the U.S. Trustee, to monitor the debtor’s financial results. All financial statements must be detailed and must include thorough notes in order to provide interested parties with confidence in the underlying data. The debtor must continue to apply historical accounting methods but must clearly distinguish between items, events, and transactions directly associated with the reorganization and those associated with ongoing operations. The balance sheet must allow readers to determine pre- and post-petition debt, as well as the security positions among creditors.

A debtor must file several different reports while operating a business in Chapter 11. The nature of the reports and the timing of their issuance depend, to a certain extent, on local bankruptcy rules, the nature of the debtor’s reporting processes, and the extent to which ongoing losses are anticipated. However, all U.S. Trustee regional offices require that MORs be submitted to the bankruptcy court. These monthly operating reports are often prepared in accordance with generally accepted accounting principles and should clearly separate those activities related to normal business operations from those related to the Chapter 11 reorganization. This information allows interested parties to monitor both the business and the reorganization.

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The format and content of MORs may be dictated by the respective regional office of the U.S. Trustee, but generally, MORs will include an income statement, balance sheet, and some form of cash receipts and disbursements activity. MORs may also include select operating and financial data including, among others: accounts receivable detail and/or aging; accounts payable detail and/or aging; taxes paid and payable detail; copies of bank statements and/or bank reconciliations; status of payments to secured creditors, lessors, and other parties to executory contracts; insurance coverage details; and a schedule of amounts owed and paid to the U.S. Trustee. It is important to be aware that the local rules for many jurisdictions require information at a level of detail and/or timing that may be burdensome for the debtor to provide and, as such, negotiation with the U.S. Trustee for exceptions may be needed. See below for a sample statement of operations for a business in Chapter 11 reorganization.

Sample Statement of Operations for a business in Chapter 11 reorganization	
<b>Total revenue</b>	\$100,000
<b>COGS</b>	(40,000)
<b>Operating expenses</b>	(15,000)
<b>Interest</b>	(5,000)
<b>Earnings before reorganization</b>	40,000
<b>Reorganization items</b>	
<b>Loss on equipment disposal</b>	(30,000)
<b>Professional fees</b>	(20,000)
<b>Gain from debt forgiveness</b>	5,000
	(45,000)
<b>Loss before income tax and discontinued ops</b>	(\$5,000)

The debtor may also be required to provide additional regular reporting in accordance with a debtor-in-possession (“DIP”) financing agreement (e.g., rolling 13-week cash flow forecasts including variance analyses), or as requested by any of the official committees, such as the Official Committee of Unsecured Creditors.

### Accounting for the impact of the plan

As part of the reorganization process, a debtor must file a Plan and Disclosure Statement, which will be evaluated by the bankruptcy court and voted upon by creditors, before it can emerge from Chapter 11. A Plan is a debtor's detailed description of how the debtor proposes to pay creditors' claims over a fixed period of time. The Disclosure Statement includes financial and other information that must prove adequate for creditors and shareholders to make an informed judgment when voting to accept or reject the Plan. Key financial components of the Disclosure Statement include:

- Description of assets available and their value;
- Summary of the debtor's plan for the business going forward, including the business plan and, in many cases, projected financial results;
- Claim information, including an analysis that outlines what creditors would receive in the event of a conversion to chapter 7 liquidation (commonly referred to as the Best Interest of Creditors test);
- A discussion of the accounting and valuation methods used in the Disclosure Statement; and
- Financial information necessary to allow a creditor to decide whether to approve or reject the Plan.

### Post-reorganization financial reporting

In some instances, a reorganized entity will qualify for “fresh start accounting.” Fresh start accounting provides an emerging entity with a “clean” balance sheet that is more reflective of the company's financial position upon its emergence from bankruptcy by revaluing the entity's balance sheet based on the value of the reorganized business and the fair value of the entity's post-confirmation assets and liabilities.

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An entity must meet two conditions to be eligible for fresh start accounting:

1. The reorganized value of the emerging entity immediately before confirmation of the Plan must be less than the sum of its post-petition liabilities and allowed claims. This is referred to as “balance sheet insolvency”; and
2. Immediately before confirmation of the Plan, holders of existing voting shares must retain less than 50 percent of the voting shares of the emerging entity.

Fresh start accounting will update the financial reporting to: (i) record debt discharge, exchange, or issuance of new debt, equity securities, or cash for pre-petition claims; (ii) record the exchange of new stock, if any, for pre-petition stock; and (iii) record the adoption of fresh-start reporting which eliminates any existing deficit.

The financial reporting requirements of an entity in Chapter 11 reorganization can be quite burdensome but are critically important in helping interested parties understand the financial condition of the debtor, as well as pave the way for the debtor’s successful emergence.



#### Bibliography

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