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Financial reporting on reorganizations under the United States Code

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Financial reporting on reorganizations under the United States Code.

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I. Introduction

In recent years bankruptcy laws of the United States of America have served as a model for many countries around the world. The latest example is the upcoming German procedure that will take effect on January 1, 1999. Contrary to the existing German law, the new procedure will also allow rehabilitations of struggling enterprises. The coming process of court-supervised rehabilitations follows in most parts Chapter 11 of the United States Code, which codifies the American reorganization procedure. Since the late 1930s, reorganization proceedings have been part of the bankruptcy laws in the U.S.[1] The latest significant reform act dates from 1978. At least since then, Chapter 11 of the United States Code, has become famous around the world of bankruptcy professionals. Due to the long time period court-supervised business reorganizations have been in place in the U.S., it may be assumed that not only the legal steps of the bankruptcy law are well known, but also experience in the field of financial reporting on reorganization exists that may be applicable to the German proceedings.

Although it is not very controversial to assert that financial reporting plays a valuable role in obtaining information on the process of rehabilitation and satisfaction of the creditors,[2] reorganizations under the Bankruptcy Code have long been known as one of the few untouched areas of financial reporting.[3] Eventually, the *American Institute of Certified Public Accountants (AICPA)* formulated guidelines on financial reporting by entities in reorganization under the Bankruptcy Code.[4] Besides this statement of position (SOP) 90-7 most of the literature on reorganization is law-oriented.[5]

This paper first closely examines the major elements of a reorganization procedure in the United States. After such a basis of understanding the process of reorganization under Chapter 11 U.S.C. has been established, the following sections will illustrate the practices of entities reorganizing as going concerns in a time-oriented way. This will lead to an analytical approach that differentiates financial reporting on filing a petition, on filing a plan of reorganization, on confirmation a plan, and on supervising a plan.

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[1] The first Bankruptcy Act ever took place origins from 1898. For a closer look on the history of the development of the different American Bankruptcy Acts, comp. Baird/Jackson (1990), p. 959.

[2] Comp. Newton (1995a), p. 443, and Alix/Heupel (1991), p. 3.

[3] Comp. Robbins et al. (1991), p. 74.

[4] See Statement of position 90-7 issued by the AICPA on November 19, 1990.

[5] Jensen-Conklin (1992), pp. 28, observes that bankruptcy seems to be an extremely unpopular topic in accounting and that "the SOP represents the first formalized attempt to bridge the dichotomy between accounting and bankruptcy".

II. Major elements of the reorganization procedure

The United States Code, more commonly known as the Bankruptcy Code or simply the Code, consists of eight chapters, containing the requirements in odd numbers with the exception of Chapter 12.[6] Besides Chapter 1, 3, and 5, which hold general rules for all kinds of bankruptcy procedures, the requirements for business reorganizations are mostly codified in Chapter 11 of the Code.[7]

Court-supervised reorganization starts by filing the petition of opening. The court will open the proceedings by granting an order for relief, which provides the debtor with an automatic stay. Within this time period the debtor has an exclusive right to file a plan of reorganization. Once such a plan that determines creditor's satisfaction has been confirmed, the procedure ends officially. But within the period of supervising the implementation of a plan, a dismissal or conversion is still possible. Further explanation will focus on the mentioned elements and indicate thereby the necessity of financial reporting on reorganizations.

a. Filing a petition

Either the debtor or the creditor has the right to file a petition to open the proceedings. Regardless of who the petitioner is, he or she has to decide at that very moment whether to pursue a liquidition or a reorganization. If the latter is chosen, it does not mean that a liquidation is out of reach. But the parties-in-interest do have to focus for the time being on making adequate efforts to satisfy the creditors by restructuring the company.

Conversely to the procedure before the Bankruptcy Reform Act of 1978,[8] the Bankruptcy Code nowadays lacks an insolvency requirement. The absence of such a requirement, however, only holds true for those petitions that are filed by the debtor. 11 U.S.C. § 109 (a) provides, that in a case of a so called voluntary petition,[9] the debtor has to have his place of business in the United States and has to pay a filing fee of currently US $ 800.[10] Under 11 U.S.C. § 301 the capacity to file a petition is

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[6] Chapter 12 U.S.C. was added in 1986 and deals with Family Farm Reorganization and may therefore be seen as an amendment to a Chapter 11 reorganization.

[7] Chapter 9, 12 and 13 U.S.C. deal with various types of non-business reorganizations, whereas Chapter 11 has been primarily designed for business reorganizations. Comp. Gerber (1986), pp. 110. See Salerno et al. (1996), pp. 7, for an overview of the contents of the single chapters of the Code.

[8] See §§ 530, 723, 823 former U.S.C. that constituted two reasons of insolvency. First, a debtor was eligible to file a petition if the assets were insufficient to pay its debts (overindebtness) and second, insolvency existed if the debtor was unable to pay its debts as they matured (inability to pay).

[9] This will be the focus of attention since it can be seen as a rule whereas an involuntary petition is an exception.

[10] The amount of filing fees differ, depending on the kind of bankruptcy procedure. See 28 U.S.C. § 1930 (a).

open to every entity. In this sense, *Salerno et al.* state that "of course a debtor need not be insolvent to file a voluntary petition under Chapter 11".[11] *Bienenstock* makes clear that, on the one hand the proof of insolvency would be too complicated and somehow arbitrary and that, on the other hand, uncertainties of a Chapter 11 proceeding, including the possibility that a debtor will be liquidated or at least partially dismembered make it too costly for a company to invoke a filing just to obtain protection of the bankruptcy law. [12] Sometimes, however, the danger of abusing the bankruptcy procedure to get rid of debts or delay payments has been realized. To prevent such a misuse, courts have developed the prerequisite of good faith[13] of the petitioner by case law.[14] A lack of good faith may be recognized if delay and harassment of the creditors seems to be obvious.[15]

According to 11 U.S.C. § 303 (a) the use of an involuntary petition is possible if three unsecured creditors claiming at least US-$ 10,000 in aggregation prove that the debtor is generally not paying its debts as they come due.[16] Obviously, there has been considerable uncertainty concerning the meaning of "generally not paying".[17] In spite of being a flexible standard, courts have developed some qualitative criterias such as, number of debts, amount of debts, and length of time the debtor has been unable to pay which they apply to individual cases.[18] Since most of the petitions are filed by debtors, the discussion about the appropriate steps to measure "generally not paying" has not become the focus of attention. The burden of proof however lies on the petitioner. Once the court believes that the debtor matches the standard of "generally not paying", the debtor has twenty days to prove the contrary.[19]

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[11] Salerno et al. (1996a), p. 188. In the same manner Bienenstock (1987), p. 16: "The solvency of a debtor does not preclude its prosecution of a Chapter 11 case."

[12] See Bienenstock (1987), pp. 16.

[13] Gerber (1986), pp. 125, explains the origins of the term good faith and its application with regard to filing a petition.

[14] Good faith was also a requirement of the former 11 U.S.C. § 541, but the current Code does not contain such a rule.

[15] Comp. Gerber (1986), p. 133, as well as Bienenstock (1987), pp. 28. The line between good faith and bad faith is of course hard to draw. A widely known example is the case of Continental Airlines that filed a petition that according to the unions, was primarily aimed at rejecting the unions contracts. Comp. in re Continental Airlines, printed in: Gerber (1986), pp. 163.

[16] For a listing of all formal requirements, comp. Bienenstock (1987), pp. 52, as well as Salerno et al. (1996), p. 198, and see 11 U.S.C. § 303 (a).

[17] Bienenstock (1987), p. 56, writes for example: "Whether a debtor is generally paying its debt as they become due has been difficult to determine."

[18] This is exactly the scope of arbitrariness and lack of comparability and transperancy that has motivated the legislator to waive a proof of insolvency in case of a voluntary petition.

[19] Comp. Salerno et al. (1996a), pp. 199, and see 11 U.S.C. §§ 303 (i) and (h). The time period between filing an involuntary petition and the final decision of the court is called gap period. 11 U.S.C. § 303 (f) provides, that normally the debtor is free to continue its operations unless the court orders otherwise.

No matter who has filed the petition, the court grants an order for relief, which marks the official opening of the reorganization procedure.[20] At the same time an automatic stay comes into effect[21] that frees the debtor to concentrate on its business and allows him to develop a plan of reorganization. Thereby, adequate protection is given to both the debtor and the creditor. The debtor enjoys a temporary relief from having his property collected, and the creditors do not have to fear a decrease in the value of their collateral securities.[22] The objective of the automatic stay is clearly to preserve the possibility of rehabilitation. As *Newton* points out "the debtor ... must be able to use a secured party's collateral, or in most situations there would be no alternative but to liquidate the business"[23].

Under Chapter 11 the debtor normally remains in posession and is therefore known as the debtor-in-posession (DIP). 11 U.S.C. § 1108 provides, that the DIP - in the case of a corporation the management - continues to operate the business without an affirmative authorization by the court.[24] The presumption in favor of allowing the debtor to keep the business running may only be abolished if fraud, dishonesty, incompetence or gross mismanagement can be shown by a party-in-interest. But the party requesting the replacement of the DIP must provide clear and convincing evidence, i.e. simple mismanagement or disagreement with the DIP's business judgement will not be sufficient to prove the failure of the DIP.[25] Once the court favors the replacement of the DIP relying on 11 U.S.C. § 1104 (a) (1) and (2), a trustee will be appointed.[26] In such a case the trustee performs two functions: Running the business and investigating the debtor's affairs. Instead of taking such a harsh and costly step, the court may also consider appointing an examiner according to 11 U.S.C. § 1104 (b). An examiner is not allowed to interfere in the debtor's business. His function is solely

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[20] Comp. Newton (1994a), p. 178.

[21] See 11 U.S.C. § 362 (a) for details. An overview of the scope of acts automatically stayed is given by Bienenstock (1987), pp. 98. The exclusions of categories listed in 11 U.S.C. § 362 (b) are summerized by Bienenstock (1987), pp. 115.

[22] In order to obtain relief from the automatic stay under 11 U.S.C. § 362 (d) (1) the creditor must show cause for lack of adequate protection or prove, that in accordance with 11 U.S.C. § 362 (d) (2), the debtor lacks equity, and that the collateralized asset is not necessary to an effective reorganization. For details, comp. Bienenstock (1987), pp. 132.

[23] Newton (1994a), p. 192.

[24] Comp. Newton (1994a), p. 178.

[25] Obviously the proof is somehow problematic, because, as Salerno et al. (1996a), p. 298, point out, it must be recognized that mismanagement has occured in nearly every Chapter 11 business. The easy grounds for appointing a trustee are fraud and dishonesty. Harder are cases of gross mismanagement. Salerno et al. (1996a), pp. 298, provide a list of situations in which a court appointed a trustee.

[26] Comp. Salerno et al. (1996a), p. 297, who consider the appointment of a trustee a remedy to be used only in extraordinary circumstances. See also Newton (1994a), p. 186, and Gerber (1986), pp. 251. Note that 11 U.S.C. § 1104 (a) (1) authorizes the appointment of a trustee for the mentioned cause whereas 11 U.S.C. § 1104 (a) (2) allows the appointment in the interest of the creditors. The latter just hints that running the business by a trustee is a costly alternative that should not be considered too rushly. Concerning the cost factor, comp. Gerber (1986), p. 263.

investigative.[27] But note that in several situations the court has even refused to appoint an examiner, even though the prerequisites of 11 U.S.C. § 1104 (b) have been met.[28] This underlines once again the norm of leaving the debtor in posession in a Chapter 11 case.

b. Filing a plan

When the debtor still runs the business, 11 U.S.C. § 1121 (b) offers the debtor an exclusive time period of 120 days after the order for relief has been granted to file a plan of reorganization. Another 60 days will be provided to obtain acceptance in accordance with 11 U.S.C. § 1121 (c) (3). Taking into account that relying on 11 U.S.C. § 1121 (d) the mentioned 180 days can even be extended upon the request of the debtor,[29] a severe burden is put on the shoulder of the creditors. After the exclusive time period has expired or if a trustee has been appointed, any party-in-interest may file a plan. An important part of the plan of reorganization is the disclosure statement that has to provide sufficient information to enable the creditors and the court to make an informed judgement about the plan. It is argued that the necessity of delivering financial information on the debtor's situation is the major motivation to concede an exclusive time period for the debtor to file a plan. In this sense, *Bienenstock* confirms that "the debtor's knowledge of its assets, business opportunities, and liabilities is typically far superior to the knowledge of any other party-in-interest"[30].

Generally speaking, "a plan is an agreement between a debtor and its creditors and interest holders, which says how and how much the debtor will pay them in satisfaction of their claims"[31]. A plan might suggest extending the terms of loans, a reduction in interest charges, or exchanging debt for equity. Other typical measures are the reduction of claims by some percentage (e.g. ten cents on the dollar) or the complete elimination of some claims altogether. In a nutshell, a plan provides adequate measures to satisfy the debtor's creditors and shapes the financial structure of the entity that emerges.[32] The problem, however, consists in allocating not only current earnings and assets of the

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[27] An examiner and not a trustee is therefore the model for the new German trustee, who will not be eligible to run the debtor's business. His main duty will be the supervision of the debtor and the reporting to creditors.

[28] This emphazises the rigid burden of proof necessary to have the court replaced the debtor-in-posession although the reasons for appointing an examiner are not as tough as in the case of requesting a trustee. Examples of when an examiner has been appointed are unexplained loss of assets, poor financial reports and sales of assets to a related corporation. Comp. Salerno et al. (1996a), p. 308, and Newton (1994a), pp. 187.

[29] Newton (1994a), p. 211, observes that courts have been fairly lenient in extending the time period in which the debtor has the exclusive right to develop a plan. Bienenstock (1987), p. 577, states that the 120 to 180 days serve only as a starting point which may be reduced or more often extended in a case to case analysis.

[30] Bienenstock (1987), p. 580.

[31] Gerber (1986), p. 771.

[32] Comp. AICPA (1990), rem. 3.

restructuring entity but future earnings as well. In addition, it has to be taken into account that not every slice of the reorganization pie can be distributed to the creditors, but a substantial amount has to be retained by the debtor to form the core of the reorganizing entity.[33] Although specifying the turnaround measures to be taken by the entity are the basis of future earnings,[34] the typical plan of reorganization in the U.S. focuses on the treatment of the creditors.[35]

The Code provides some guidance in drawing up a plan. To shape a plan 11 U.S.C. § 1123 (a) requires some mandatory items whereas 11 U.S.C. § 1123 (b) suggests several permissive measures. Mandatory is the distinction of creditors and stockholders affected.[36] In this sense 11 U.S.C. §§ 1123 (1), (2), (3), and (4) require every plan to designate classes of creditors and interests.[37] It has to be specified how each single class - impaired or not - will be treated under the plan.[38] On the above 11 U.S.C. § 1123 (a) (5) sets forth a non-exclusive list of different ways the stated treatment of the classes may be reached. Steps of implementation may be the previously noted measures of transfering or selling of property, cancellation or modification of any lien, and issuance of equity for debt. Under the permissive provisions, 11 U.S.C. § 1123 (b) (5) seems to be the most important, since it allows the establishment of any appropriate measure that is consistent with the Code. As *Gerber* notes, that "the Code does not - apart from the mentioned requirements and options - dictate what shape a plan must take"[39]. This leads to an intensive discussion and negotiation between the parties-in-interest about financial valuation and prognostication of the future business of the debtor.[40]

c. Confirming the plan

Prior to confirmation, the proponent of the plan must turn in a written disclosure statement containing adequate information to make an informed judgement on the plan. Precisely what constitutes adequate information in any particular instance is not explicitly given in 11 U.S.C. § 1125

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[33] Comp. Salerno et al. (1996b), p. 121.

[34] Confirming: Scarberry et al. (1996), p. 242.

[35] See an example of a reorganization plan on "United Merchants and Manufactures Inc.", printed in: Newton (1994b), pp. 84.

[36] Comp. Salerno et al. (1996b), pp. 139.

[37] Bienenstock (1987), pp. 582, sees the following distinction of classes as a minimum: Administrative claims, priority claims for certain wages and benefits, priority claims for certain taxes and duties, secured claims, unsecured claims and interests of stockholders.

[38] The creation of classes as impaired or unimpaired is thereby up to the proponent of the plan as far as 11 U.S.C. § 1124 is obeyed.

[39] Gerber (1986), p. 774.

[40] Comp. Bienenstock (1987), p. 662.

(a), but as a minimum standard, different historical and projected financial statements will be part of it.[41] The statement, however, has to be approved by the court as a matter of adequate information. After the plan and the disclosure statement have been distributed, the proponent seeks acceptance from the related classes of creditors and interest holders as well as the court. To receive that acceptance, all impaired classes have to vote in favor of the plan.[42] According to 11 U.S.C. 1126 (c) the plan is accepted, when one-half in number and two-thirds in amount of each class has approved the plan.

To set forth, 11 U.S.C. § 1129 (a) lists the requirements that need be obeyed in order to be confirmed by the court.[43] The heart of the requirements are rules that demand some sort of economic understanding.[44] In this sense, the court has to decide if the plan has been proposed in good faith[45] and if the plan is feasible. The latter is given when the confirmed plan is not likely to be followed by liquidation or the need for any further financial reorganization.[46] Moreover, the court has to judge if the plan is in the best interest of the creditors, i.e. that each holder of a claim or interest either accepts the plan or receives at least the amount of value that would have been distributed to him in case of liquidation.

11 U.S.C. § 1129 (b) provides the rules for the famous cram-down procedure. This procedure comes into play when all requirements of 11 U.S.C. § 1129 (a) have been fullfilled except 11 U.S.C. § 1129 (a) (8) which requires the acceptance of all impaired classes. According to 11 U.S.C. § 1129 (b) the court has to confirm a plan, on request of the proponent, even if it has been rejected. But the law requires the compliance with several conditions. First, at least one class has to have accepted the plan and second, the plan must not discriminate unfairly[47] and has to be found to be fair and equitable with respect to each class of creditors and stockholders that have rejected the plan. The latter is the application of the absolute priority rule: All members of a senior class must have been satisfied in full

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[41] Comp. Newton (1994a), p. 221. A bright discussion on the financial statements will be delivered further on.

[42] It should be clear, that those creditors who are expecting to be paid the full amount of their secured claim are not eligible to vote on the plan because they are unimpaired.

[43] See also AICPA (1990), rem. 7. According to 11 U.S.C. § 1129 (c) only one plan can be confirmed. In case of competing plans the court has to decide on the behalf of creditors and stockholders which plan should be preferred.

[44] A detailed - quantitative - analysis will be taken later on.

[45] Since it is very problematic to apply the good faith requirement uniformily, courts have been judging plans in good faith whenever full disclosure has been made. Comp. Bienenstock (1987), pp. 682, and Salerno et al. (1996b), p. 185.

[46] In several cases the feasibility requirements have been interpreted. See, for example, Salerno et al. (1996b), p. 188: "The proponent need not show that the plan is foolproof but only that a failure of the plan is not likely." and "The plan need not guarantee success but must present a workable scheme that shows a reasonable likelihood of success."

[47] Unfair discrimination is given if similar claimants receive different treatments. Comp. Salerno et al. (1996b), p. 194, and much more detailed Bienenstock/Isom (1992), pp. 684.

before classes junior to it receive anything.The law differentiates classes of secured claims, unsecured claims and stockholders. 11 U.S.C. § 1129 (b) (2) formulates the condition for those tests. The holder of a secured claim has to receive at least the present value in payments of the claim. The requirements for the classes of unsecured claims and stockholders are lower. The holder of any claim or interest that is junior to the claims or interest of such class will not receive any payments or property as far as the class senior to it is not fully satisfied.[48] Once the proponent does comply with 11 U.S.C. § 1129, confirmation of the plan by the court is binding on all parties-in-interest, even though some of them may have rejected the plan.[49] Assets and earnings not supposed to be distributed to creditors and stockholders in accordance with the confirmed plan, will be reverted to the debtor.[50]

d. Supervising a plan

Assuming the debtor remains in posession, there may be two different time periods requiring immediate attention by the creditor's committee. First, it seems to be highly advisable for the creditors to supervise the debtor's activities during the time of the automatic stay, especially when no examiner has been appointed. The second crucial time period during which control must be exercised is the period after agreement to and confirmation of the plan.[51]

Within the first time period after filing the petition but before confirmation of a plan that may last more than the 180 days the debtor keeps running the ordinary business. It has to be expected that the business continues to generate losses since mismanagement is the main cause for the adverse situation. In this instance the creditor's committee may keep an eye on the preservation of assets and review all disbursements in order to avoid preferential payments, concealments of assets, and conversion of assets into cash that is exempt from distribution.[52] Once a plan has been confirmed, control is necessary to ensure proper flow of installment payments to the creditors and stockholders. The financial statements that the debtor has to issue are the major source of the creditor committee's

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[48] Comp. Bienenstock/Isom (1992), pp. 688, as well as Munitz/Gabbia (1992), pp. 615.

[49] This is in accordance to 11 U.S.C. § 1141 (a). Comp. AICPA (1990), rem. 5. For a discussion on that topic see Bienenstock (1987), pp. 673, or Salerno et al. (1996b), pp. 219.

[50] 11 U.S.C. § 1141 (c) states: After confirmation of a plan, the property dealt with by the plan is free and clear of all claims and interests of creditors, equity security holders, and of general partners in the debtor. See also Salerno et al. (1996b), p. 181.

[51] Comp. Newton (1994a), p. 352.

[52] Comp. Newton (1994a), p. 357.

information. On that basis the creditors have to value the likelihood of rehabilitation and the probability of future payments.

11 U.S.C. § 1112 provides that every party-in-interest may request the dismissal or conversion of the reorganization proceedings at any time. Firstly, 11 U.S.C. § 1112 (a) allows the debtor to convert voluntarily to a Chapter 7 case, i.e. the liquidation of his business.[53] Secondly, 11 U.S.C. § 1112 (b) provides the possibility to convert or dismiss a case for cause.[54] The law gives a non-exclusive listing of ten reasons that have to be proven by any requesting party-in-interest[55] to convert or dismiss the reorganization.[56] Especially after a plan is confirmed, the most important reasons to have the case dismissed or converted are stated in 11 U.S.C. §§ 1112 (b) (1), (2), (3), (7) and (8). Accordingly, the requesting party has to prove alternatively[57]

(1) continuing loss to or diminuition and the absense of a reasonable likelihood of rehabilitation
(2) inability to effectuate a plan
(3) unreasonable delay by the debtor that is prejudicial to creditors
(7) inability to effectuate substantial consummation of a confirmed plan
(8) material default by the debtor with respect to a confirmed plan

Regardless of the type of cause that a party-in-interest may rely on, courts have shown some reluctance to accept such requests thoughtlessly. In that sense *Salerno et al.* point out that involuntary conversion or dismissal is an extreme step and should be exercised only when a court is convinced that no fruitful avenue remains.[58] Persuasive financial information has to be brought up by the requesting party to prove one of the causes stated above.

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[53] But the debtor has to fulfill some formal prerequisites, as no trustee has been appointed, the case was a voluntary filing, and the case was not converted to a Chapter 11 on the request of a party other than the debtor. Comp. Salerno et al. (1996a), p. 376.

[54] Note that dismissals are fairly rare because they lead to a race to courthouse among creditors on a first come first serve basis. Conversions to Chapter 7 occur more often, but they have the disadvantage of being expensive since the law requires a mandatory appointment of a trustee. Because of that practice has developed a liquidation plan under Chapter 11 as a cheap alternative. Comp. Bienenstock (1987), pp. 573.

[55] Controversial is the question if the court may act sua ponte power, i.e. without a request by the debtor or creditor. For a broad discussion in that point, see Kemper (1996), pp. 139.

[56] It remains highly controversial, if lack of good faith is an additional cause, to get the case dismissed or converted. Comp. Kemper (1996), pp. 143.

[57] It does not have to be emphasized that also the other five reasons not listed above are causes for dismissal or conversion.

[58] Comp. Salerno et al. (1996a), p. 377.

III. Financial reporting with regard to filing a petition

In case of a voluntary petition, the Code requires several documents be submitted. Among them are the statement of affairs, recent financial statements, schedules about assets and liabilities, and a statement of executory contracts of the debtor.[59] The following remarks will focus on the competence and sequence of the drawing, and will certainly evaluate the contents as well as the character and disclosure of financial reporting at this stage.

a. Competence and sequence

Since the debtor files the petition, he has the responsibility to assemble the financial information that is required. *Newton*, however, points out that the debtor-in-posession has the right to retain an accountant for the necessary accounting functions.[60] But the court has to approve the retention of an accountant because the cost will surely lower the debtor's assets to be contributed.[61]

The question referring to the sequence of reporting seems easy to answer. The debtor or the retained accountant are forced to submit the necessary documents at the time of the petition or shortly thereafter. Most often the material to be prepared is unique and not of continuing nature. Conversely, the survey of the proceedings has shown that there is a considerable length of time between the filing of a petition and the filing of a plan by the debtor. That necessitates not only the issuance of financial information on the day of filing the petition, but also the preparation of financial statements that illustrate the ongoing business. How often these financial statements have to be drawn up depends on the wishes of the court. *Newton* observes that the accounting duties between the commencement of the case and confirmation of a plan normally occur monthly, and sometimes weekly.[62]

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[59] Comp. Newton (1994a), p. 442.

[60] Comp. Newton (1994a), p. 256.

[61] The Administrative Office of the United States Courts has requested the official authorizing of accountants. An example of an affidavit of an accountant for the debtor in a Chapter 11 filing is provided by Newton (1994b), pp. 188.

[62] Comp. Newton (1994a), pp. 264.

b. Form and substance

According to rule 1007 the debtor, or the retained accountant, has to supply the court with the following items:

- List of creditors. The list shall contain the names and addresses of the creditors and additionally the amount of claims of the twenty largest creditors.
- List of stockholders. The number and kinds of interests registered in the name of each holder ought to be listed.
- Statement of financial affairs. This is not to be confused with an accountant's usual term although it is a series of detailed questions the debtor or the accountant must answer that deal with accounting information. The questions refer to the following areas:[63]
  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 counseling 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. Nature, location, and name of business.
  17. Books, records, and financial statements.
  18. Inventories.
  19. Current partners, officers, directors, and shareholders.
  20. Former partners, officers, directors, and shareholders.
  21. Withdrawals from a partnership or distributions by a corporation.

[63] An example of a company answering that questions are provided by Newton (1994b), pp. 319.

- Supporting schedules. These schedules that must accompany the petition are statements of the debtor's assets and liabilities as of the date the petition is filed. Often the single schedules are summarized in a control sheet that gives the court an overview of the debtor's financial situation.[64] This emphasizes the importance of the schedules showing the property on the one side and the liability on the other side. The following figures show the most important forms that the debtor or the accountant has to hand in. Schedules A and B list the assets of the debtor,[65] whereas schedules D, E and F show the different types of claims the debtor is confronted with. Schedule G - not shown here - records the contracts and leases of the debtor. In the first column, name and address of the party to lease or contract has to be listed, while in the second column the contract or lease has to be described. Also because of its simplicity, schedule H is not listed here. It illustrates the codebtors, i.e. parties like guarantors and cosigners. The name and address of the codebtor in regard to each creditor has to be given.[66] All the forms have to be arranged in accordance with the revised official bankruptcy form number six effective August 1, 1991. These forms are used to comply with 11 U.S.C. § 521 (1) and Rule 1007 (b).

[64] Comp. Alix/Heupel (1991), p. 578.

[65] Form C is not listed here because it applies only to individuals.

[66] Comp. Alix/Heupel (1991), p. 591.

Figure 1: Summary of schedules.

United States Bankruptcy Court

_____District of_____

In re _____. Case No. _____.

Name of schedules	Attached (yes/no)	No. of sheets	Assets	Liabilities
A. Real property			$	
B. Personal property			$	
C. Property claimed as exempt				
D. Creditors holding secured claims				$
E. Creditors holding unsecured priority claims				$
F. Creditors holding unsecured nonproperty claims				$
G. Executory Contracts and Unexpired leases				
H. Codebtors				
	Total no. of sheets →			
		Total assets →	$	
			Total liabilities →	$

Source: Following Alix/Heupel (1991), p. 578, and Newton (1994b), p. 286.

Looking at the listed assets of the debtor it seems to be remarkable that the valuation of the assets sometimes differs. Although the forms indicate that the property has to be shown at market values, *Newton* observes that in practice the assets are often reported at book value.[67] This applies especially to large bankruptcy cases due to the administrative efforts that would have to be undergone otherwise.[68]

[67] Comp. Newton (1994a), p. 304.

[68] Comp. Newton (1994b), p. 285.

Figure 2: Schedule A - Real Property.

Schedule A - Real Property

In re _____. Case No. _____.

Description and Location of Property	Nature of Debtor's Interest in Property	Current Market Value of Debtor's Interest in Property without Deducting any Secured Claim or Exemption	Amount of Secured Claim
	Total →	$	

Source: Following Alix/Heupel (1991), p. 579, and Newton (1994b), pp. 287.

The most important parts of schedule B itimizing goods are machinery, equipment, patents copyrights and so on. As stated before, the major problem consists of valuing the listed property. This holds especially true for the actual inventory, because the valuation method used does not necessarily have to present the real value. In contrast, a continuation of the business is intended and therefore a valuation method that is consistent with the previous recordings is recommended. But if the method used differs significantly from the real going-concern value the listed amount should be explained.[69]

[69] This might very well be in case of using LIFO instead of average costs.

Figure 3: Schedule B - Personal property.

Schedule B - Personal Property

In re _____. Case No. _____.

Type of Property	None	Description and Location of Property	Current Market Value of Debtor's Interest in Property without Deducting any Secured Claim or Exemption
1. Cash on hand. 2. Checking, savings or other financial accounts, certificates of deposit, or shares in banks, savings and loan, thrift, building and loan, and homestead associations, or credit unions, brokerage houses, or cooperatives. 3. Security deposits with public utilities, telephone companies, landlords, and others. 4. Household goods and furnishings, including audio, video, and computer equipment. 5. Books, pictures and other art objects, antiques, stamp, coin, record, tape, compact disc and other collections or collectibles. 6. Wearing apparel. 7. Furs and jewelry. 8. Firearms and sports photographic, and other hobby equipment. 9. Interests in insurance policies. Name insurance company of each policy and itemize surrender or refund value of each. 10. Annuities. Itemize and name each issuer. 11. Interests in IRA, ERISA, Keogh, or other pension or profit sharing plans. Itemize. 12. Stock and interests in incorporated and unincorporated businesses. Itemize. 13. Interests in partnerships or joint ventures. Itemize. 14. Government and corporate bonds and other negotiable and nonnegotiable instruments. 15. Accounts Receivable. 16. Alimony, maintenance, support, and property settlements to which the debtor is or may be entitled. Give particulars.			

Source: Alix/Heupel (1991), pp. 580, and Newton (1994b), pp. 290.

Figure 3 (continued): Schedule B - Personal Property.

Schedule B - Personal Property
(Continuation Sheet)

In re _____. Case No. _____.

Type of Property	None	Description and Location of Property	Current Market Value of Debtor's Interest in Property without Deducting any Secured Claim or Exemption
17. Other liquidated debts owing debtor include tax refunds. Give particulars.			
18. Equitable or future interests, life estates, and rights or powers exercisable for the benefit of the debtor other than those listed in Schedule of Real Property.			
19. Contingent and non-contingent interests in estate of a decedent death benefit plan, life insurance policy, or trust.			
20. Other contingent and unliquidated claim of every nature, including tax refund, counterclaims of the debtor, and rights to setoff claims. Give estimated value of each.			
21. Patents, copyrights, an other intellectual property. Give particulars.			
22. Licenses, franchises, and other general intangibles. Give particulars.			
23. Automobiles, trucks, trailers, and other vehicles.			
24. Boats, motors, and accessories.			
25. Aircraft and accessories.			
26. Office equipment, furnishings, and supplies.			
27. Machinery, fixtures, equipment and supplies used in business.			
28. Inventory.			
29. Animals.			
30. Crops - growing or harvested. Give particulars.			
31. Framing equipment and implements.			
32. Farm supplies, chemicals, and feed.			
33. Other personal property of any kind not already listed. Itemize.			

Source: Alix/Heupel (1991), pp. 580, and Newton (1994b), pp. 290.

Figure 4: Schedule D - Creditors Holding Secured Claims.

Schedule D - Creditors Holding Secured Claims

In re_____. Case No. _____.

Creditor's Name and Address	Codebtor	Date Claim was Incurred, Nature of Lien, and Description and Market Value of Property Subject to Lien	Contingent	Unliquidated	Disputed	Amount of Claim Without Deducting Value of Collateral	Unsecured Portion, if any
Account No.		Value $					
Account No.		Value $					
Account No.		Value $					
Account No.		Value $					
		Total →					

Source: Following Alix/Heupel (1991), pp. 584, and Newton (1994b), pp. 299.

The figure above shows schedule D listing the holders of claims secured by a deposit or property of the debtor. In the next figure, schedule E, the creditors holding unsecured priority claims are listed. The debtor or the accountant has to mark the type of priority that is adequate to the specific claims. For those creditors who are not entitled to hold a priority claim against the debtor only the amount of the claim has to be given. It should be noted that each creditor's claim will only be listed once. For example, the unsecured portion of a partially secured claim shown in schedule E will not be repeated in schedule F.[70]

[70] Comp. Alix/Heupel (1991), p. 577.

Figure 5: Schedule E - Creditors Holding Unsecured Priority Claims.

Schedule E - Creditors Holding Unsecured Priority Claims

In re_____. Case No. _____.

Types of Priority

Extension of credit in an involuntary case
Wages, salaries, and commissions
Contributions to employee benefit plans
Certain farmers and fishermen
Deposits by individuals
Taxes and other debts owed to governmental

Creditor's Name and Address	Codebtor	Date Claim was Incurred and Consideration for Claim	Contingent	Unliquidated	Disputed	Amount of Claim	Amount Entiteled to Priority
Account No.		Value $					
Account No.		Value $					
Account No.		Value $					
Account No.		Value $					
		Total →					

Source: Following Alix/Heupel (1991), pp. 586, and Newton (1994b), pp. 303.

Figure 6: Schedule F - Creditors Holding Unsecured Nonpriority Claims.

Schedule F - Creditors Holding Unsecured Nonpriority Claims

In re_____. Case No. _____.

Creditor's Name and Address	Codebtor	Date Claim was Incurred and Consideration for Claim, if Claim is Subject to Setoff, so State	Contingent	Unliquidated	Disputed	Amount of Claim
Account No.		Value $				
Account No.		Value $				
Account No.		Value $				
Account No.		Value $				
		Total →				

Source: Following Alix/Heupel (1991), pp. 588, and Newton (1994b), pp. 309.

c. Character and disclosure

The list of creditors, the statement of financial affairs, and especially the supportive schedules are requirements by law that are highly developed. Federal Rule 1007 of the Bankruptcy Procedure, and forms number 6 and 7 of the Official Bankruptcy Forms demand reporting in the way already

shown.[71] The official forms are available at bankcruptcy courts and have to accompany the filing of the petition.[72]

The competence of filing the petition lies in the hand of the debtor. He or his accountant is the one who is using the official forms to receive the court's order for relief. Therefore, the main addressee is the court. But normally also the creditors receive the information provided by the debtor. To ensure that the data is accurate and complete, an incorrect listing might result in a failure to continue with the proceedings even after a plan has been confirmed. Creditors are advised to file a proof of claim to the court, although it is not required by law.[73]

IV. Financial reporting with regard to filing a plan

The plan is the heart of every Chapter 11 reorganization. But not only the specification on how to satisfy the creditors and to reemerge as a healthy entity is of special interest when filing a plan. As stated previously 11 U.S.C. § 1125 (b) requires that a disclosure statement must be provided containing adequate information at the time of solicitation. In this sense *Anzivino* remarks: "The primary purpose of the disclosure statement is to give the creditors information they need in order to decide whether to accept or reject a plan."[74] Although the content of the disclosure statement is not governed by any bankruptcy law, but is to be decided solely by the court, it has not remained a controversial issue that the appropriate form of disclosure can only be some sort of financial statements.[75]

a. Competence and sequence

In order to answer the question of competence it seems advisable to distinguish the plan itself from the financial information to be provided to make an informed judgement on the narrative regulations of the plan. As noted, the debtor has an exclusive right to file a plan for the first 120 days after an

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[71] The rules shall be constructed to secure the just, speedy, and inexpensive determination of every case and proceeding.

[72] A form is also for the petition itself required (Official Form 1). See Newton (1994b), pp. 19.

[73] Comp. Newton (1994a), p. 199.

[74] Anzivino (1987), p. 150. See also Quittner (1992), p. 465.

[75] Comp. AICPA (1990), rem. 11, as well as Alix/Heupel (1991), pp. 592, Newton (1994a), p. 221, and Gianelli/Crapo (1992b), pp. 410. Quittner (1992), p. 460, remarks that the "court denied confirmation of the plan of reorganization because of the lack of information ... concerning the debtor's financial progress since the commencement of the Chapter 11 proceedings".

order for relief has been granted unless a trustee has been appointed.[76] Within this period of time the only one who can draw up a plan of reorganization and the accompanying disclosure statement is the debtor or his accountant. After the exclusive period, any party-in-interest is entitled to file a plan. But note, that for any other than the debtor, it is diffcult to assemble the needed financial information.[77] Nonetheless, it has to be said that the proponent of the plan also has the competence of drawing up the disclosure statement that gives quantitative information on the consequences of the plan to be implemented.

The financial information provided by the proponent of the plan has to accompany the plan at the time of solicitation or shortly thereafter. Before it is transmitted to the related creditors and stockholders, it must be approved in a hearing by the court. Without providing financial information to make a judgement on the filed plan, possible acceptance and confirmation cannot be achieved.[78] This means that all the quantitative information has to be given at once unless a confirmed plan gets modified thereafter.[79] This result can also be deduced from the objective of the disclosure statement. Since the plan seeks approval only once, the disclosure statement has to contain all the needed information at that particular time.

b. Form and substance

The plan has to meet the requirements of 11 U.S.C. § 1123 (a) and may follow the options provided in 11 U.S.C. § 1123 (b). Typically, the plan starts by classifying the claims and interests, followed by the different treatment the classes ought to undergo. Normally, the method, amount, and timing of the payments to the creditors and the stockholders are explained. In addition, some sort of restructuring methods to revitalize the struggling company may be given.[80] The plan ends suggesting the date of effectiveness and general provisions that, of course, vary.[81]

Although the exact type and amount of information to be submitted in a disclosure statement is not given by law, some sort of understanding about a minimum standard exists among the literature. In this way, *Newton* believes that the minimum contents a description of the business unless it is already

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[76] Comp. AICPA (1990), rem. 4.

[77] Comp. Bienenstock (1987), p. 580.

[78] Comp. AICPA (1990), rem. 13.

[79] Comp. Newton (1994a), p. 227.

[80] Comp. Daniels et al. (1995), p. 30.

[81] Comp. the different contents of plans that are provided by Freiermuth (1989), pp. 119, and Newton (1994a), pp. 84.

provided in the plan, financial information about the debtor's prepetition history, liquidation analysis, projection of operations, and the estimated reorganization value of the entity reemerging.[82] The *AICPA* suggests that every disclosure statement "include a summary of the reorganization plan, historical and prospective financial information and a pro forma balance sheet reporting the reorganization value and the capital structure of the emerging entity"[83]. Besides the fact that nearly every Chapter 11 case has its unique circumstances, and certainly these have to be considered in evaluating what constitutes adequate information,[84] the focus will be on historical and prospective financial information on the one hand and on a liquidation, and reorganization analysis on the other hand.

aa. Historical and prospective financial information

First of all, creditors and stockholders need some quantitative data to assess the current financial situation as of the date of filing the petition. Therefore, *Alix/Heupel* conclude that the initial filing typically includes the most recent annual and interim financial statements.[85] But note that the latest balance sheet, income statement, and statement of cash flow may not have been already audited. This holds especially true for the interim statements.[86] However, disclosing only the very last financial statements may not be sufficient to match the creditor's information needs since the company's business has undergone a dramatic change in the past period that eventually had led to bankcruptcy. Because of that, not only the most recently audited and unaudited statements should be provided, but also the historical statements for the past two to five years should be made accessible.[87] The past financial statements should be in accordance with the reasons of the financial difficulties that are explained in the narrative part of the plan.

More interesting are the financial projections the proponent of the plan has to draw up. The projected statements consist of a balance sheet, a statement of operation, and a statement of cash

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[82] Comp. Newton (1994a), p. 223.

[83] AICPA (1990), rem. 11.

[84] Anzivino (1987), p. 150, writes: "Precisely what constitutes adequate information in any particular instance will develop on a case by case basis. Courts should take a practical approach as to what is necessary under the circumstances of each case ..."

[85] Comp. Alix/Heupel (1991), p. 592.

[86] See the disclosure statement of Zefco Container Mfg. Co., Inc., found in Freiermuth (1989), p. 138: Certain of the financial data contained herein is unaudited and may not have been prepared in conformity with Generally Accepted Accounting Principles. However, the management of the debtor has made great effort to ensure that all such information is accurate and fairly presented.

[87] Sometimes even more historical statements will be necessary as Newton (1994a), p. 223, observes.

flow. This exercise has a dual purpose. First, the projections provide a quantitative understanding of the company's future in order to seek acceptance of the plan. In so far, the projections describe the expected financial future of the company as a result of implementing the plan of reorganization.[88] The parties-in-interest need that information to judge the probability of getting the debtor restructured and the creditors satisfied as in the plan proposed.[89] The second purpose of financial projections, once the plan has been accepted and confirmed, is to serve as a basis to which the financial results during the reorganization proceedings can be compared to evaluate the actual success of the plan. Only if the structure of the projections match the requirements the *AICPA* holds for financial reporting during the proceedings, an intended comparision between the projections and the actual results seems to be feasible.

Projections are normally done on a monthly basis although the court may require a different sequence.[90] To match the purpose of comparability it seems highly advisable to structure the projected statements similar to the reports that will occur during the reorganization proceedings. The *AICPA* requires to distinguish transactions and events that are directly associated with the reorganization from those attributed to the ongoing operation of business.[91] Applied to the structure of the balance sheet, the *AICPA* suggests the following: "The balance sheet of an entity in Chapter 11 should distinguish prepetition liabilities subject to compromise from those that are not and postpetition liabilities."[92] The SOP goes on that "the principal categories of the claims subject to compromise should be disclosed ..." and that "liabilities not subject to compromise should be further segregated into current and noncurrent classifications..."[93] Liabilities not subject to compromise are those claims that are fully secured, and liabilities that occured after the entity entered the proceedings.[94] More difficult than the structure of the balance sheet is to find the value of the assets and liabilities to be projected. When drawing up the disclosure statement the assets are generally forecasted by their bookvalue whereas the liabilities are valued by the amounts expected to be

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[88] See Newton (1994a), p. 309, who writes: "The forcasts of the results of operation and financial position should be prepared on the assumption that the proposed plan will be accepted ..."

[89] In this sense Newton (1994a), p. 309, states: "The creditors must be assured by the projected income statement and cash flow statement that the debtor will be in a position to make the payments as they become due." Comp. also Freiermuth (1989), p. 57.

[90] Comp. Newton (1994a), p. 303, and Alix/Heupel (1991), p. 595.

[91] Comp. AICPA (1990), rem. 22. See also Schultz (1995), p. 24, Ratcliffe /Munter (1991), p. 52, Robbins et al. (1991), p. 76, and Lorensen (1994), p. 7.

[92] AICPA (1990), rem. 23.

[93] AICPA (1990), rem. 26. Further explanation are provided by Robbins et al. (1991), p. 76, and Ratcliffe/Munter (1991), p. 52.

[94] Comp. Ratcliffe/Munter (1991), p. 52, and Schultz (1995), p. 24.

allowed. This means nothing else than transferring the proposed steps of the plan of reorganization to a quantitative level.[95] Taking this into account, a projected balance sheet may look as follows:[96]

[95] For example the plan might suggest the sale of some kinds of fixed or current assets as well as some sort of debtforgiveness.

[96] The figures in the following financial statement are arbitrary. It is just intended to give a better understanding of the structure of the financial statements.

Figure 7: Layout of projected balance sheet.

Projected Balance Sheet

In re _____. Case No._____.

Assets and Liabilities	Filing date	Month 1	Month 2	Month 3	Month ...
Assets					
Current assets					
Cash	330				
Accounts receivable, net	900				
Inventory	750				
Other current assets	90				
Total current assets	2,070				
Property, plant and equipment, net	1,290				
Goodwill	630				
Total Assets	3,990				
Liabilities and Shareholders' Deficit					
Liabilities not subject to compromise					
Current liabilities:					
Short-term borrowings	75				
Accounts payable-trade	600				
Other liabilities	450				
Total current liabilities	1,125				
Liabilities subject to compromise[1]	3,300				
Total liabilities	4,425				
Shareholders' deficit:					
Preferred stock	975				
Common stock	225				
Retained earnings (deficit)	(1,635)				
Total liabilities & Shareholders' deficit	3,990				
[1] Liabilities subject to compromise consists of:					
...					

Source: Own table in accordance with AICPA (1990), pp. 26, Alix/Heupel (1991), p. 596, and Lorensen (1994), p. 42.

The following two tables illustrate the structure of the income statement and the statement of cash-flow. Both statements put the segregation of transactions and events associated with the reorganization and those which are not into effect. With regard to the statement of operations the *AICPA* requires that "revenues, expenses, realized gains and losses, and provisions for losses should be reported separately as reorganization items"[97]. *Kearns et al.* explain the background of these requirements, saying that "the segregation of ongoing operations from reorganization activities will help the financial statement user to evaluate the quality of earnings"[98]. In this sense it may be argued that earnings generated from the ongoing business consist of a higher quality than earnings from reorganization items since there are more predictable. Conversely, earnings that come from typical reorganzation efforts, like sale of assets, issuance of new stocks or forgiveness of debt occur only once, whereas regular revenues tend to represent a stable and steady flow of income. Prior to SOP 90-7 some diversity existed in accounting for professional fees and similar types of expenditures related to the plan.[99] To ensure a standardized proceeding the *AICPA* concluded that professional fees and related expenditures do not result in deferrals but ought to be reported as reorganization items.[100] The SOP continues to suggest that interest income and interest expenses should be dealt with differently. Interest income arises mostly due to the fact that the entity is not paying its debt during the procedure of reorganization, i.e. would have been earned if the entity was not bankrupt.[101] Because of that, interest income should be reported as a reorganization item whereas interest expense is not a reorganization amount since it would have occured anyway.[102]

Referring to the statement of cash flow the *AICPA* recommends the use of the direct method since the cash flow items that are directly related to reorganization can be better segregated from those resulting from regular operations.[103] Further improvement is given to the statement of cash flow because reorganization items ought to be disclosed separately within the operating, investing, and financing categories.[104] However, if the indirect approach is used, details of receipts and disbursements should be reported in a supplementary schedule.[105]

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[97] AICPA (1990), rem. 27.

[98] Kearns et al. (1993), p. 38.

[99] Comp. AICPA (1990), rem. 28, as well as Ratcliffe/Munter (1991), p. 53.

[100] AICPA (1990), rem. 28. Comp. also Robbins et al. (1991), p. 76, and Ratcliffe/Munter (1991), p. 53.

[101] Schultz (1995), p. 25, writes: "Because a firm in reorganization is not paying its obligations currently, it typically accumulates cash during the proceedings."

[102] Comp. AICPA (1990), rem. 29, 30. Note, that the reported amount of interest expense which differs from the original contractual interest should be disclosed.

[103] Comp. AICPA (1990), rem. 31, and Ratcliffe/Munter (1991), pp. 53.

[104] Comp. Schultz (1995), p. 25, and Robbins et al. (1991), p. 78.

[105] Comp. Ratcliffe/Munter (1991), p. 54.

In all financial statements the proponent faces the problem that the future is certainly not obvious. Normally, a solid data base is provided by the past experiences. But in case of a beginning reorganization, reliance on historical data or patterns are not recommended since it is intended to turn around the business. Therefore, as noted before, the projections should never be a simple extrapolation but ought to be made on the assumptions of the plan. In so far, it is necessary that all assumptions are clearly mentioned such as the elimination of a division or a product line.[106] *Newton* recommends to draw up notes on the financial projections to explain the quantitative results the proponent assumes for the future.[107] To provide such a catalog of assumptions seems to be essential in order to serve both purposes of financial projections. Firstly, the parties-in-interest are eager to know the circumstances of satisfying the creditors and reorganizing the business. For example, the court may approve the forecasted data, but creditors may disapprove the assumptions the financial projection rely on.[108] Secondly, drawing up a comparison of estimates with results, i.e. interpreting a gap between the projected data and the actual data at the stage of supervision is only meaningful if the actual data is based on the anticipated assumptions that are made at the time of handing in the disclosure statement.

[106] Comp. Newton (1994a), p. 309.

[107] See the example at Newton (1994b), pp. 343.

[108] An example would be drawing a picture in which restructuring of the company is fairly easy because the debtor proposes a large debtforgiveness.

Figure 8: Layout of projected statement of operations.

Projected Statement of Operations

In re _____. Case No._____.

Revenues and Expenses	Filing date	Month 1	Month 2	Month 3	Month ...
Revenues:					
Sales	7,200				
Cost and Expenses:					
Cost of goods sold	5,400				
Selling, operating and administrative	1,650				
Interest (contractual 15)	9				
	7,059				
Earnings before reorganization items and income tax benefit	141				
Reorganization items:					
Loss on disposal of facility	(180)				
Professional fees	(150)				
Provision for rejected executory contracts	(30)				
Interest earned on accumulated cash resulting from Chapter 11 proceeding	3				
	(357)				
Loss before income tax benefit and discontinued operations	(216)				
Income tax benefit	30				
Loss before discontinued operations	(186)				
Discontinued operations:					
Loss from operations of discounted products segment	(168)				
Net loss	(354)				
Loss per common share:					
Loss before discontinued operations	(1.86)				
Discontinued operations	(1.68)				
Net loss	3.54				

Source: Own table in accordance with AICPA (1990), p. 28, Alix/Heupel (1991), p. 595, and Lorensen (1994), p. 41.

Figure 9: Layout of projected statement of cash-flow.

Projected Statement of Cash-Flow

In re _____. Case No._____.

Cash and Cash Equivalents	Filing date	Month 1	Month 2	Month 3	Month ...
Cash flows from operating activities:					
Cash received from customers	6,600				
Cash paid to suppliers and employees	(6,210)				
Interest paid	(9)				
Net cash provided by operating activities before reorganization items	441				
Operating cash flows from reorganization items:					
Interests received on cash accumulated because of the Chapter 11 proceeding	3				
Professional fees paid for services rendered in connection with th Chapter 11 proceeding	(150)				
Net cash used by reorganization items	(147)				
Net cash provided by operating activities	294				
Cash flows from investing activities:					
Capital expenditures	(15)				
Proceeds from sale of facility due to Chapter 11 proceedings	120				
Net cash provided by investing activities	105				
Cash flows used by financing activities:					
Net borrowings under short-term credit facility	75				
Repayment of cash overdraft	(135)				
Principal payments on prepetition debt authorized by court	(9)				
Net cash provided by financing activities	(69)				
Net increase in cash and cash equivalents	330				
Cash and cash equivalents at beginning of period	-				
Cash and cash equivalents at end of period	330				
Reconciliation of net loss to net cash provided by operating activities					
Net loss	(354)				
Adjustments to reconcile net loss to net cash provided by operating activities					
Depreciation	60				
Loss on disposal of facility	180				
Provision for rejected executory contracts	30				
Loss on discontinued operations	168				
Increase in postpetition payables and other liabilities	750				
Increase in accounts receivable	(540)				
Net cash provided by operating activities	294				

Source: Own table in accordance with AICPA (1990), pp. 29, Alix/Heupel (1991), pp. 597, and Lorensen (1994), p. 43.

bb. Reorganization and liquidation analysis

Somewhat related to the issue of the projection of financial data is the disclosure of a pro forma balance sheet that typically includes an estimate of the reorganization value.[109] The purpose of the pro forma balance sheet is to illustrate how the company will end up if the plan is accepted and all provisions based on the anticipated assumptions are carried out.[110] This far reaching projection seems to be helpful because it provides relevant information about the final success of the plan of reorganization and must therefore be seen as a part of adequate information that is needed to make an informed judgement for creditors and stockholders about how to vote on the plan. The problems of projecting assets and liabilities remain as illustrated above, or may even be aggravated because drawing up a pro forma sheet that reflects the final results of implementing the plan means forecasting over a longer period of time that includes, of course, a higher degree of uncertainties.

The main issue of the pro forma sheet, however, is the estimation of the reorganization value which is required to be included in the disclosure statement.[111] The purpose of the reorganization value is dual: First, it might serve as a basis of comparison to the estimated liquidation value. Second, the reorganization value is needed to determine if the reorganizing entity qualifies for a so-called fresh start reporting after it reemerges from the proceedings.[112] The *AICPA* defines: "Reorganization value generally approximates fair value of the entity before considering liabilities and approximates the amount a willing buyer would pay for the assets of the entity immediately after the restructuring."[113] In other words, the "reorganization value represents the fair value of the reconstituted business"[114]. Note, that the SOP definition does not consider liabilities. It is a debt-off valuation. To measure this value "representing the amount of current and future resources"[115] several approaches have been used. The *AICPA*, however, wants the proponent "to discount future cash flows for the reconstituted business that will emerge from Chapter 11 and from expected proceeds or collections from assets not required in the reconstituted business, at rates reflecting the business and financial risks involved"[116]. Hence, the reorganization value consists of three components: First, the present value of forecasted

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[109] Comp. AICPA (1990), rem. 11.

[110] Comp. Alix/Heupel (1991), p. 592.

[111] Comp. Newton (1994a), p. 310. The AICPA (1990), rem. 9, writes: "An important part of developing a plan is the determination of the reorganization value of the entity that emerges from bankruptcy." In rem. 37 the AICPA continues: "the most likely place to report the reorganization value is in the pro forma balance sheet that is commonly part of the disclosure statement."

[112] Comp. AICPA (1990), rem. 12.

[113] AICPA (1990), rem. 9.

[114] Patterson/Newton (1993), p. 50.

[115] Schultz (1995), p. 25.

[116] AICPA (1990), rem. 9.

cash flow, secondly, the residual value the entity will generate beyond the projection period, and thirdly, the liquidation value of unnecessary assets.[117] In this paper it is clearly not intended to discuss all the problems that arise in dealing with estimating the different components that assemble the reorganization value.[118] It, however, remains obvious that because of the degree of uncertainties and unsecure assumptions, the estimate of the reorganization value cannot be interpreted as mathematical truth.[119] In the end the proponent of the plan who estimates the reorganization value has to persuade the parties-in-interest on a case-by-case approach that the assumptions that have been made are reasonable and feasible.The *AICPA* even admits that despite the availability of statistical methods, the "reorganization value and the terms of the plan are determined only after extensive arms-length negotiations or litigation between the interested parties"[120].

As noted before, the company may qualify for fresh start reporting. Although fresh start reporting will not come into effect until the binding conditions of the plan have been carried out, the results of the negotiations and estimations on the reorganization value play an important role in drawing up the pro forma balance sheet. The purpose of the pro forma balance sheet is to demonstrate what the financial data of the debtor will look like if the plan is going to be accepted and implemented. To be able to evaluate and vote on the plan more effectively, the pro forma statement is supposed to contain not only historical value but rather reorganization value.[121] But the *AICPA* limits the use of the negotiated reorganization value, i.e. fresh start reporting, to insolvent companies: "If the reorganization value of the assets of the emerging entity immediately before the date of confirmation is less than the total of all postpetition liabilities and allowed claims, and if holders of existing voting shares immediately before confirmation receive less than 50 percent of the voting shares of the emerging entity, the entity should adopt fresh-start reporting upon its emergence from Chapter 11."[122] In other words, the first condition is the existence of overindebtness, and the second

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[117] Comp. Newton (1994a), p. 382, and Jensen-Conklin (1992), pp. 25.

[118] See the example given by Newton (1994b), pp. 473. Newton chooses a forecasting period of eleven years and capitalizes the yearly cash flow by a cost of capital at 15 per cent.

[119] Also the recommandations of the AICPA (1990), p. 31, are not of great help in order to specify the reorganization value. One may take for granted to consider the impact of corporate restructuring and other operating program changes in order to estimate the cash flow results. The residual value at the end of the forecast period based on capitalized cash flow for the least year of that period, the AICPA (1990), p. 32, continues relys on market share and position, competition and general economic considerations, projected sales growth, potential profitability, and seasonality and working capital requirements.

[120] AICPA (1990), rem. 9, as well as Lorensen (1994), p. 71. See also Jensen-Conklin (1992), p. 24: "[The reorganization value] can never be objectively ascertained or verified, but always remains in the realm of opinion or belief."

[121] Comp. Newton (1994a), pp. 362.

[122] AICPA (1990), rem. 36.

condition requires a substansive loss of control[123] by the old stockholders.[124] Once the conditions are expected to be fullfilled, the entity is enabled to allocate the reorganization value to individual assets in the pro forma statement.[125] A basis for allocating the reorganization value to the single assets is set by the *Accounting Principles Board (APB)* Opinion No. 16 for transactions reported based on the purchase method. Normally, the reorganization value will exceed the asset value estimated on the purchase method. If so, such amounts should be reported as an intangible asset identified as "reorganization value in excess of amounts allocable to identifiable assets".[126] In conformity with *APB* Opinion No. 17 that rules on intangible assets, the amortization period of the "reorganization value in excess of amounts allocable to identiable assets" should be substantially less than fourty years.[127] The SOP goes on to state that "the same considerations used in determining the reorganization value should be applied in determining the period of amortization"[128]. The requirements for fresh-start reporting are also supposed to be taken into consideration on the valuation of liabilities. Liabilities should be shown at their present value of amounts to be paid determined by appropriate current interest rates.[129] The following simplified example may illustrate the application of the rules the *AICPA* requires: Referring to the figures of the balance sheet shown in figure 7 the total liabilities add to $ 4,425. The reorganization value has been negotiated to $ 4,200.[130] The plan of reorganization determines the issuance of 345 common stock in exchange for $ 1,000 of unsecured liabilities. Moreover $ 230 liabilities ought to be paid back in cash, and $ 770 liabilities will be discharged. Both conditions of fresh-start reporting are fullfilled[131] and will lead to the following pro forma balance sheet in which the assets valued by their reorganization value and the position "reorganization value in excess of amounts allocable to indentfiable assets" come into existence.[132] It should be emphasized that at the time of drawing up the pro forma statement, allocation of the reorganization value to the single assets may be problematic. In this case the *AICPA*

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[123] The AICPA (1990), rem. 36, adds that "the loss of control contemplated by the plan must be substansive and not temporary". Such a loss of control happens, for example, due to the exchange of equity for debt.

[124] Comp. Newton (1994a), pp. 476, Schultz (1995), p. 26, Ratcliffe/Munter (1991), p. 54, Robbins et al. (1991), p. 78, and Kearns et al. (1993), p. 31.

[125] Comp. AICPA (1990), rem. 37, and Newton (1994a), p. 478.

[126] See the original rem. 38 of the AICPA (1990): "If any portion of the reorganization value cannot be attributed to specific tangible or identified intangible assets of the emerging entity, such amounts should be reported as the intangible asset identified as reorganization value in excess of amounts allocable to identifiable assets."

[127] Fourty years is the accepted maximum convention of amortization for goodwill.

[128] Comp. AICPA (1990), rem. 38. Applying this to reality can only mean that the forecasting period and the amortizing period should be identical.

[129] Comp. AICPA (1990), rem. 38.

[130] Here it is just an assumed figure that may consist of $ 3,400 of present value in cash flow, $ 500 in residual value and $ 300 in liquidation value of assets at disposal.

[131] The liabilities are higher than the reorganization value (4,425 > 4,200) and there is a substansive loss of control (345 voting stocks have been issued).

[132] Numerous examlpes are provided by Lorensen (1994), pp. 63.

suggests segregating the reorganization value at least into major categories.[133] A complete adoption of fresh-start reporting does not occur until the plan has been applied in its full extent.[134] Fresh-start reporting will never be used if the conditions of overindebtness and loss of control are not met. In such a case the pro forma sheet simply reports the present value of assets and liabilities.[135]

On top of the reorganization value, the accounting literature also favors the inclusion of the liquidation value.[136] In this sense *Newton* remarks: "Included in the disclosure statement should be an analysis of the amount that creditors and equity holders would receive if the debtor was liquidated under Chapter 7.[137] An estimation of the liquidation value helps the parties-in-interest to evaluate the reorganization alternative more effectively. The plan of reorganization has to provide at least as much as would be received in a liquidation. Although in most cases the liquidation value will be far lower than the going-concern value, it is normally not sufficient to state only that.[138] Instead, a quantitative analysis should be made which may measure the liquidation value on a forced[139] and an orderly approach. In this analysis, each asset may be estimated at its liquidation value. Thereafter, a table of distribution by each class may be drawn up to provide an overview of the liquidation alternative to each claimant.

[133] Comp. AICPA (1990), rem. 37.

[134] The AICPA (1990) , rem. 39, specifies that the effects of the plan should be reflected in the predecessor entity's final statement of operations. After the plan has been applied "adopting fresh-start reporting results in a new reporting entity with no beginning retained earnings or deficits".

[135] Comp. Ratcliffe/Munter (1991), p. 58, and very detailed Lorensen (1994), pp. 95.

[136] Comp. Freiermuth (1989), p. 148.

[137] Newton (1994a), p, 363

[138] Alix/Heupel (1991), p. 621, present an example of liquidation balance sheet.

[139] Newton (1994a), p. 380, calls this a "fire sale approach".

Figure 10: Layout of pro forma balance sheet.

Pro Forma Balance Sheet

In re _____. Case No._____.

Assets and Liabilities	Precon-firmation	Debt Dis-charge	Exchange of Stock	Fresh Start	Reorgani-zed Sheet
Assets					
Current assets					
Cash	330	(230)			100
Accounts receivable, net	900				900
Inventory	750			140	890
Other current assets	90				90
Total current assets	2,070				1,980
Property, plant and equipment, net	1,290			600	1,890
Goodwill	630			(630)	
Reorganization value in excess of amounts allocable to identfiable assets				100	100
Total assets	3,990	(230)		210	3,970
Liabilities and Shareholders' Deficit					
Liabilities not subject to compromise					
Current Liabilities:					
Short-term borrowings	75				75
Accounts payable-trade	600				600
Other liabilities	450				450
Total current liabilities	1,125				1,125
Liabilities subject to compromise[1]	3,300	(2,000)			1,300
Total liabilities	4,425				2,425
Shareholders' deficit:					
Preferred stock	975				975
Common stock	225		345		570
Retained earnings (deficit)	(1,635)				0
Total Liabilities & Shareholders'deficit	3,990				3,970
[1] Liabilities subject to compromise consist of:					
...					

Source: Own table in accordance with AICPA (1990), p. 34.

c. Character and disclosure

11 U.S.C. § 1125 (b) provides that "an acceptance or rejection of a plan may not be solicited ... unless ... a written disclosure statement [has been] approved ... by the court as containing adequate information". Therefore, handing in a disclosure statement is mandatory. Problematic, however, is to determine the contents of such a disclosure statement. Generally, the disclosure has to provide information that enables the parties-in-interest to make an informed judgement about the plan.[140] Although it seems clear that an informed judgement can only be made by providing quantitative information that is supplementary to the narrative part of the plan, only the court determines what kind of items have to be included in the disclosure statement.[141] Even the *AICPA* concedes that the content of adequate information depends "on the circumstances of the entity in Chapter 11, the nature of the plan, and the sophistication of the various classes whose acceptance is required"[142]. As pointed out, the statements of the *AICPA* are not binding either to the proponent or to the court. But in practice it can be observed that some sort of minimum standard has been set by the *AICPA* and the accounting literature. Most courts require at least the stated historic and prospective financial information as well as an estimation of the reorganization and liquidation value. But remarkably, it seems that although a tendency towards standardization of the content of the disclosure statement may be observed, the requirements of the Bankruptcy Code remain flexible.[143]

The main addressee of the disclosure statement is - from the perspective of the law - the court. If the proponent of a plan fails to provide adequate information in terms of a disclosure statement the court cannot approve such a plan. Apart from the court, the creditors and stockholders are the related parties-in-interest receiving adequate information.[144] On the basis of the disclosure statement they have to vote on the plan. A further disclosure of the given financial information to the public, media, or competetors is clearly not intended, either by law or on pupose. This is preliminary due to the confidential information that is contained by the disclosure statement.

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[140] Comp. AICPA (1990), rem. 10.

[141] Comp. Anzivino (1987), p. 150.

[142] AICPA (1990), rem. 12.

[143] Comp. Anzivino (1987), p. 150. See also Gianelli/Crapo (1992b), p. 403.

[144] Comp. Gianelli/Crapo (1992b), p. 400.

V. Financial reporting with regard to confirming a plan

Before a proposed plan can be implemented it has to seek acceptance by certain parties-in-interest. The creditors' committee and the court have to approve the suggestions made by the proponent. Further explanation will, again, be divided into competence and sequence of reporting, form and structure, as well as character and disclosure of reporting. But in contrast to the previous stages of reporting, the following remarks will focus on the problematic issues of quantifying the court's decision, accomplishing transparancy, and comparability. Whereas competence and sequence ought to be fairly clear, form and structure of the approval decision - especially by the court - are an unexplored area since it is mostly a confidential and closed decision.[145]

a. Competence and sequence

Both, the creditors' committee and the court play a vital role in getting the plan confirmed. The affected creditors' committee votes on the plan on the basis of the information provided in the disclosure statement. As already stated, it is necessary to receive the approval of each impaired class by two-thirds in amount and one-half in number. If any class denies its approval, the plan has been rejected by the creditors, and will not be pursued anyfuther unless the proponent of the plan seeks confirmation in accordance with the cram-down procedure. With regard to the competence of the proceedings one has to state: The holder of a claim or interest that is permitted to vote on the plan does so. Once the plan has been accepted by all classes, the court has to decide if the requirements set in 11 U.S.C. § 1129 (a) are fullfilled by the plan. On the above, the court has the competence to rule on the plan in case the proponent seeks confirmation of the court requesting cram-down. That means the plan has to pass two hurdles: Approval of the affected creditors and shareholders as well as confirmation by the court.

Note, however, that the competence of the court will not come into play when a proposed plan has been rejected by the voting parties and the proponent is not requesting a cram-down procedure. Referring to the sequence of reporting, it means that first the affected creditors and shareholders decide on the plan before the court may rule on it.

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[145] Courts do not have to take evidence on the requirements of the law. Declaring the plan has been proposed in accordance with 11 U.S.C. § 1129 is sufficient. See Scarberry et al. (1996), p. 844.

b. Form and substance

The approval by the creditors committee is highly subjective, although every single creditor might follow the results of the financial information that is provided by the disclosure statement. Conversely, the confirmation requirements are codified by the American legislator. The requirements should be applied evenly in all cases, i.e. the decision of the court should somehow be objective. To ensure this objectivity, the main economic requirements - good faith, feasibility, and the best interest test - will be analyzed in futher detail.

11 U.S.C. § 1129 (a) (3) requires that the plan has been proposed in good faith. Unfortunately, it has not been stated what constitutes good faith.[146] The law literature, however, tries to narrow the provision of good faith by paraphrasing good faith in general terms. *Bienenstock*, for example, observes, "that courts dismiss cases for lack of good faith when it appears that a debtor may not effectuate any of its plan proposals"[147]. *Scarberry et al.* take a positive approach, writing: "Where a plan is proposed with a legitimate and honest purpose to reorganize and has a reasonable chance of success, the good faith standard is satisfied."[148] In the same manner, *Gerber* as well as *Gianelli/Crapo* state that "a reorganization plan is proposed in good faith when there is a reasonable likelihood that the plan will achieve a result consistent with the objectives and purposes of the Bankruptcy Code"[149]. The problem that still exists, is to define terms like "reasonable likelihood" and "honest purpose" more objectively. To cope with this problematic issue[150] courts have shown some tendency to reject the confirmation of the plan in accordance with 11 U.S.C. § 1129 (a) (3) only in obvious cases. When it appears clear that the proponent's intention is solely tax avoidance or creditor harrassment, confirmation is denied for lack of good faith.[151] This holds true also when there seems to be undoubtable evidence that false disclosure has been made.[152] *Bienenstock* points out that sometimes courts see the good faith standard matched when full disclosure has been made by the proponent of the plan. [153] Admittedly, the hurdles set by the courts are fairly low and one may question the purpose of such a requirement.

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[146] Comp. Gianelli/Crapo (1992a), p. 655.

[147] Bienenstock (1987), pp. 38.

[148] Scarberry et al. (1996), p. 844.

[149] Gerber (1986), p. 894, as well as Gianelli/Crapo (1992a), p. 657.

[150] Bienenstock (1987), p. 682, writes: "The meaning of good faith is cameleon-like and cannot uniformily applied." Same opinion: Kemper (1996), p. 168.

[151] Factors recognized as indica of bad faith are listed by Gianelli/Crapo (1992a), pp. 669.

[152] In so far the court carries the burden of proof on the issue of avoidance.

[153] Comp. Bienenstock (1987), p. 683.

11 U.S.C. § 1129 (a) (11) requires that the plan is feasible, i.e. that the confirmation of the plan is not likely to be followed by a liquidation or the need for further reorganization. Among others, *Baird/Jackson* see the purpose of feasibility "to ensure that the plan offers a reasonable workable prospect of success and is not a visionary scheme"[154], which promises more under a proposed plan than the debtor can possibly attain after confirmation. So, once again, the court has to fullfill an economic task as to ascertain that the debtor has a reasonable chance of surviving once the plan is confirmed.[155] *Alix/Heupel, Bienenstock,* as well as *Gerber* suggest that in order to judge feasibility, factors like capital structure, earning power, management competence, credit availability, and working capital available to the reorganized debtor should be taken into consideration.[156] Obviously, a listing of qualitative data makes the problem more clear but does not solve it. To overcome this, *Alix/Heupel* and *Newton* suggest to focus on the projected statement of cash flow:[157] "If the projected cash flows contained in the disclosure statement indicate that the debtor will not have enough cash to make the debt payments, as required in the terms of the plan, the plan would not meet the feasibility requirement."[158] Note, that it is also absolutely necessary to analyze the underlying assumptions of the forecast of future operations.[159] Although the court cannot guarantee the success of a plan,[160] a surplus of cash flow over the debt payments seems to be a strong indicator of feasibility.

Also, the best interest test that has to be carried out by the court in accordance to 11 U.S.C. § 1129 (a) (7) (A) (ii) refers to the financial information of the disclosure statement.[161] *Jensen-Conklin* outlines the procedure: "The liquidation analysis projects what creditors and shareholders would receive if the debtor's estate were liquidated in Chapter 7. The result is then compared with the present value of what they are to be given under the plan. If they are to receive at least as much under the plan, then it is deemed to be in their interests."[162] In so far the amount available for every

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[154] Baird/Jackson (1990), p. 1058.

[155] Comp. Kemper (1996), p. 172.

[156] Comp. Alix/Heupel (1991), p. 253, Bienenstock (1987), p. 687, and Gerber (1986), p. 879.

[157] Comp. Alix/Heupel (1991), p. 253, and Newton (1994), p. 232.

[158] Newton (1994), p. 232. Alix/Heupel (1991), p. 287, provide a quantitative example of comparing the projected cash flow with the financial need in order to service the debt.

[159] In the same manner, Baird/Jackson (1990), p. 1058: "Income projections indicating financial progress must be based on concrete evidence ... and must not be speculative, conjectural or unrelistic."

[160] Jensen-Conklin (1992), p. 22, for example, admits that often the debtor experiences traumatic changes during the case.

[161] The best interest test has to made only for this creditors and shareholders who rejected the plan. In so far no test has to be implemented in case of a unanimous acceptance of the plan by each member of each voting class.

[162] Jensen-Conklin (1992), p. 20. Munitz/Gabbia (1992), p. 605, simplify: "In other words, all impaired creditors and interest holders must be at least as well off in the reorganization as in a Chapter 7 liquidation."

dollar of unsecured claim in case of liquidation has to be compared with the proposals of the plan.[163] Problematic remains the issue of the estimated values.[164] This holds true for both: The liquidation value and the forcasted debt payments suggested by the proposed plan. Again, the court has to judge the feasiblity of the assumptions that provide the basis for valuation.

c. Character and disclosure

The term reporting with regard to confirming a plan may be misleading, since the main issue in this context is the quantification of the court's decision. U.S. courts have to fullfill a considerable amount of economic tasks even in case of acceptance of a plan by all impaired classes. The reflections stated above represent the opinion of the law and business literature. The purpose of such consideration is to prevent arbitrariness in the court's decisionmaking. Nevertheless, one has to concede that mistakes in measuring good faith, feasibility, or the best interest cannot be excluded. Although the problems of valuation will be discussed in a confirmation hearing, the court is not obliged to prove its decision in much detail. In this regard, the character of the possible considerations and statements must be seen as not mandatory. But the judge will serve his own purpose of comparable and consistent decisionmaking in different cases if the stated criteria are followed.

In addition, the disclosure of any consideration and quantification of the court is permissive. But in case of a non-confirmation, the judge may announce the legal cause why the plan has not been confirmed. An oral reasoning shall normally occur during the confirmation hearing. Supportive data that underlines the decision will only be provided to the affected parties-in-interest. Any further disclosure does not seem to be considerable since the debtor has some interest in keeping his financial data secretly.

VI. Financial reporting with regard to supervising a plan

After confirmation the proposals of the plan have to be implemented.[165] The actual application of the contents of the plan will be carried out by the debtor.[166] It seems obvious that the debtor's activities have to be monitored to ensure proper control. In this sense, *Newton* notes that "supervision of the

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[163] Comp. an actual quantitative comparision, drawn up by Baird/Jackson (1990), pp. 1057.

[164] See the detailed discussion by Munitz/Gabbia (1992), pp. 605.

[165] Bienenstock (1987), p. 702, writes: "A confirmed plan is a court approved contract."

[166] This holds true unless a trustee has been appointed, which is the exception.

debtor and its activities is essential throughout the proceedings ... ending only when the plan has been consummated"[167]. The following remarks will focus in accordance to the previous systematic on competence and sequence of reporting on supervision, the form and substance, as well as the character and disclosure of the statements are to be drawn up.

a. Competence and sequence

Amazingly, the Bankruptcy Code is silent on the issue of supervision. This also applies, certainly, to the competence of the establishment of proper measures to monitor the debtor. Because of that, the competence of implementing controls has to be deducted by purpose. The affected parties-in-interest are mainly the creditors and shareholders who will be satisfied in accordance to the contents of the plan. But also the debtor himself will be affected since a successfull implementation of the plan will result in reemergence. The reorganized business enjoys the opportunity of having a second chance or a fresh start leaving the past behind. In so far, both parties are generally interested in pursuing the given path of the plan successfully. The competence is therefore divided. The *AICPA* recommends that financial statements should be drawn up by the entity, i.e. the debtor, during the proceedings.[168] Measuring the progress of the reorganization and, of course, ensuring the creditor's satisfaction may be up to the creditor's committee,[169] that is the watchdog over the activities of the debtor.[170]

The sequence of providing actual financial information is crucial to control the debtors' activities properly. On the one hand, the debtor should not be overburdened with administrative tasks but, on the other hand, the information needs have to be fullfilled. Although the solution of such a conflict of aims may vary from case to case, the issuance of financial statements on a monthly basis is suggested by literature nearly unanimously.[171] Moreover, the guidelines for the Districts of New York, Conneticut, and Vermont require monthly financial statements as well as an annual statement. *Newton* views this guidelines as a model for other judical districts and generalizes the local requirements for the U. S. as a whole.[172]

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[167] Newton (1994a), p. 351.

[168] Comp. AICPA (1990), rem. 22.

[169] Newton (1994a), p. 351, states: "Control is normally aimed at conservation of the assets, and the creditors' committee holds an excellent position to perform such a function".

[170] Note that not all members of the creditors'committee are experienced in serving this task. Therefore an accountant may be hired to provide some guidance.

[171] Comp., for example, Baird/Jackson (1990), p. 951.

[172] Comp. Newton (1994a), pp. 328.

b. Form and substance

To serve the purpose of reflecting the debtors' financial evolution during the proceedings the *AICPA* requires the issuance of financial statements including a balance sheet, a statement of operations, and a statement of cash flow.[173] The statements have to be drawn up in accordance with SOP 90-7. This essentially leads to a segregation of reorganization items and ongoing business items. The distinction between transactions and events that are directly associated with the reorganization from those which are related to ongoing operations ought to enhance the quality of financial information thereby provided.[174] In an earlier section the importance of projections have already been pointed out. The issuance of forecasts based on reasonable - and disclosed - assumptions goes beyond showing the feasibility of the plan. The projections that have been part of the disclosure statement serve as a basis for comparison of the estimates with the results actually accomplished by implementing the plan. Although the *AICPA* suggests only the presentation of comparative financial statements on a year to year basis,[175] it seems to be obvious that this is not sufficient to evaluate the progress of the reorganization and to estimate the probability of a successfull satisfaction of the creditors. Because of that, the projections have been drawn up in accordance to the layout of the statements the debtor has to issue during the actual implementation. In so far there will be a comparison made between the estimates and the results. In this sense *Newton* remarks: "At the end of each period, the debtor will submit a report comparing the actual results with the projected estimates. The accountants for the creditors' committee will normally review this reports and discuss their analysis with the committee."[176] The purpose of such a comparative approach is clear: Firstly, it enables the parties-in-interest to make an informed judgement on the progress of the reorganization and secondly, it puts the creditors' committee in a position to reveal what is actually occuring making it possible to detect any undesirable events much more quickly. To match that purpose, a gap analysis should be carried out. Applied to the financial statements it will appear as follows.

[173] Comp. AICPA (1990), rem. 23, 27, and 31. The requirement to draw up such statement is also set by the guidelines for the Districts of New York, Conneticut and Vermont. See Newton (1994a), p. 329.

[174] Comp. Kearns et al. (1993), p. 38, and Jensen-Conklin (1992), p. 38.

[175] Comp. AICPA (1990), rem. 40.

[176] Newton (1994a), p. 354.

Figure 11: Gap analysis of projected balance sheet.

Gap Analysis of Projected Balance Sheet

In re _____. Case No._____.

Assets and Liabilities	Projected Period 1			Projected Period ...		
	Esti-mation	Result	Gap	Esti-mation	Result	Gap
Assets						
Current assets						
Cash						
Accounts receivable, net						
Inventory						
Other current assets						
Total current assets						
Property, plant and equipment, net						
Goodwill						
Total Assets						
Liabilities and Shareholders'Deficit						
Liabilities not subject to compromise						
Current liabilities:						
Short-term borrowings						
Accounts payable-trade						
Other liabilities						
Total current liabilities						
Liabilities subject to compromise						
Total liabilities						
Shareholders' deficit:						
Preferred stock						
Common stock						
Retained earnings (deficit)						
Total Liabilities & Shareholders'deficit						

Source: Own Table.

Figure 12: Gap analysis of projected statement of operations.

Gap Analysis of Projected Statement of Operations

In re _____. Case No._____.

Revenues and Expenses	Projection period 1			Projection period ...		
	Esti-mation	Result	Gap	Esti-mation	Result	Gap
Revenues:						
Sales						
Cost and Expenses:						
Cost of goods sold						
Selling, operating and administrative						
Interest (contractual 15)						
Earnings before reorganization items and income tax benefit						
Reorganization items:						
Loss on disposal of facility						
Professional fees						
Provision for rejected executory contracts						
Interest earned on accumulated cash resulting from Chapter 11 proceeding						
Loss before income tax benefit and discontinued operations						
Income tax benefit						
Loss before discontinued operations						
Discontinued operations:						
Loss from operations of discounted products segment						
Net loss						
Loss per common share:						
Loss before discontinued operations						
Discontinued operations						
Net loss						

Source: Own Table.

Figure 13: Gap analysis of projected statement of cash flow.

Gap Analysis of Projected Statement of Cash Flow

In re _____. Case No._____.

Cash and Cash Equivalents	Projection period 1			Projection period ...		
	Esti-mation	Result	Gap	Esti-mation	Result	Gap
Cash flows from operating activities:						
Cash received from customers						
Cash paid to suppliers and employees						
Interest paid						
Net cash provided by operating activities before reorganization items						
Operating cash flows from reorganization items:						
Interests received on cash accumulated because of the Chapter 11 proceeding						
Professional fees paid for services rendered in connection with th Chapter 11 proceeding						
Net cash used by reorganization items						
Net cash provided by operating activities						
Cash flows from investing activities:						
Capital expenditures						
Proceeds from sale of facility due to Chapter 11 proceedings						
Net cash provided by investing activities						
Cash flows used by financing activities:						
Net borrowings under short-term credit facility						
Repayment of cash overdraft						
Principal payments on prepetition debt authorized by court						
Net cash provided by financing activities						
Net increase in cash and cash equivalents						
Cash and cash equivalents at beginning of period						
Cash and cash equivalents at end of period						
Reconciliation of net loss to net cash provided by operating activities						
Net loss						
Adjustments to reconcile net loss to net cash provided by operating activities						
Depreciation						
Loss on disposal of facility						
Provision for rejected executory contracts						
Loss on discontinued operations						
Increase in postpetition payables and other liabilities						
Increase in accounts receivable						
Net cash provided by operating activities						

Source: Own Table.

Whereas the formal structure of the financial statements is not supposed to be a matter of controversy, some problems remain. Due to the fact that the debtor prepares these statements, reports may be inadequate and draw a misleading picture of the company's profitability. To confront that problem, the debtor may be urged to sign each statement, enabling the creditors to propose dismissal or conversion in case of deliberately issuing wrong information.[177] Much more problematic seems to be the interpretation of the gap that will occur in most cases. Such a gap can be measured in absolute and relative terms. The problem that arises is twofold: Firstly, it is questionable whether a general line between a still bearable and an unacceptabble gap exists and secondly, it remains unclear which gap to focus on. To start with the latter, *Newton* finds that the areas requiring immediate attention will vary.[178] But as a rule of thumb one may assume that the creditors' committee will identify key data such as "earnings before reorganization items and income tax benefit", "loss before income tax benefit and discontinued operations", "net loss (profit)", "net cash provided by operating (investing) ((financing)) activities", and "cash at end of period". With regard to the size of the gap that may still be acceptable in order to ensure a successfull reorganization according to the original plan, nearly every suggested figure would be arbitrary unless the success or failure of the implementation is obvious. In addition, it has to be taken into consideration that an apparently unbearble gap can also be due to a change of assumptions underlying the estimates. In so far, it would not be the fault of the debtor implementing the plan and it may be possible that some counteraction can be taken to keep the ship afloat. But in the very end, it is solely up to the court to decide on the request of the proponent, if the gap between the plan proposal and the actual results is sufficient to dismiss or convert a case.

c. *Character and disclosure*

The character of the comparative statements and the matter of disclosure have not been discussed extensively so far. As a matter of fact, neither the *AICPA* nor the Bankruptcy Code require a gap analysis as proposed above. In contrast, some authors are in favor of establishing proper controls to put the debtor under surveillance. Most important in this respect is close supervision of the debtors' revenues and expenses as well as the receipts and disbursements.[179] But none of the proposed statements is mandatory. Note, however, that the *AICPA* and the guidelines for the Districts of New York, Conneticut, and Vermont require monthly financial statements regardless. From this point of

[177] Such a proposal would be in accordance to 11 U.S.C. § 1112 (b) (8): Material default by the debtor with respect to a confirmed plan.

[178] Comp. Newton (1994a), p. 357.

[179] Comp. Newton (1994a), pp. 355.

view, comparative statements are not far away. Considering the additional information that can be achieved by drawing up such comparisions, the creditors' committee in particular will be well advised to pursue this effort. Referring to the disclosure of any comparative statement it has to be stated that the provided information is highly confidential. In so far, the remarks given with regard to the disclosure statement apply: Only the affected parties-in-interest do have to receive the necessary information to judge the progress of the proceedings. A further disclosure - to the media, competitors or even the general public - cannot be deducted at all.

VII. Summary

Financial reporting on reorganizations under the Bankruptcy Code has remained an untouched area for quite a long time. Until the issuance of SOP 90-7 by the *AICPA* that may be seen as milestone, accounting practices have been diverse. This has led to nontransperancy, incomparability, and worse, arbitrariness in bankruptcy accounting.

In distinguishing the process of a court-supervised reorganization in a time-oriented way, four phases are visible: Filing a petetion, filing a plan, confirming a plan, and supervising a plan. Undoubtedly, all of the above mentioned phases necessitate some sort of financial reporting and quantifying to put the economic decisions that have to be made by the participants on a solid analytical basis. In this paper, the current procedures in terms of financial reporting have been examined. Remarkably, some reporting issues are broadly discussed whereas on other parts literature is quite silent. Where the latter applies, suggestions have been formulated to standardize and simplify the procedure without neglecting the parties-in-interest's need for reliable information.

Financial reporting with regard to filing a petition is very sophisticated. This is due to a strictly standardized procedure U.S. courts require. The financial information has to be turned in by filling out specific forms and answering the given questions. A problematic issue is the valuation of assets and liablilities. It can be observed that although assets ought to be valued at their current price, a tendency to state the book value exists.

With regard to financial reporting on filing a plan, 11 U.S.C. § 1125 plays an important role. The law requires the approval of a written disclosure statement that contains adequate information enabling the parties-in-interest to make an informed judgement about the plan. The meaning of adequate information and thereby the contents of such a statement has been a matter of controversy in literature even though some authors argue that such a decision can only be made in a case-by-case

approach. Since the *AICPA* has issued SOP 90-7 it has been clear that at least two pillars of financial information should be provided. Firstly, historical and prospective data must be drawn up to illustrate and quantify the narrative part of the plan. Secondly, liquidation and reorganization value has to be estimated in order to determine the path of the procedure and the format of the pro forma balance sheet. Especially the latter turns out to be problematic because finding the reorganization value and allocating it to certain assets in case of fresh-start reporting seems to be subjective and hard to verify.

The court plays an important role when it comes to confirming the plan. The action of the court should be objective and the method of problem solving comparable in every case. The law requires that the plan has to be proposed in good faith and it should be feasible. Both requirements can hardly be quantified. Because of that, courts have shown a tendency to see the good faith standard matched when the contrary is not obvious and sufficient financial information, i.e. the disclosure statement, have been provided. Feasibility is even more problematic: However, in most cases courts are satisfied when an assumption-based forecast of cash flow prove the ability of the debtor to fullfill the disbursements to the creditors proposed by the plan.

Referring to the supervision of a plan, literature provides only a few inconsistent ideas to measure the progress of the actual implementation, although the necessity of monitoring the debtor's activities is not controversial at all. This paper suggests drawing up comparative financial statements that refer to the projections that have been made in the disclosure statement. In accordance to the recommendations of the *AICPA* the proponent has to distinguish transactions and events that are directly associated with the reorganization from those operations that relate to the ongoing business in order to enhance the quality of the information. Keeping this in mind, the actual progress of implementing the plan can be judged on a solid basis: Firstly, the monthly balance sheet, income statement, and statement of cash flow clarifies the financial position of the debtor. Secondly, the comparison between the estimation of the plan and the actual results may serve as an indicator of the progress of the reorganization and the satisfaction of the creditors. Moreover, a comparative statement may be used to support a creditor's proposal for dismissal or conversion in case the debtor seems to be unable to accomplish the objectives that have been set in the original plan of reorganization.

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