

Accounting Issue in Bankruptcy

The objective of this exercise is to understand the bankruptcy process, some bankruptcy terminology, various accounting issues for companies in bankruptcy and a brief look at KMart. **Make sure to do the questions on the last page.**

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A Chapter 11 filing is a voluntary action taken by a United States company to resolve financial problems, such as excessive debt or major liabilities.

Chapter 11 is often used by companies that are faced with large numbers of product liability suits in multiple jurisdictions since it provides a practical way to address the potential liabilities in one place. A Chapter 11 filing immediately stops all lawsuits against a company and prevents creditors from taking action against a company to enforce claims or to collect any monies or property that might be owed.

Chapter 11 provides a process for a company to define and resolve its liabilities under a court-supervised process. Under a Chapter 11 bankruptcy filing - unlike a "Chapter 7" filing - a company continues its normal business operations. A Chapter 7 filing is a straight bankruptcy, which may be voluntary or involuntary involves the liquidation of all assets, while the Chapter 11 seeks to reorganize the business.

Under a Chapter 11 proceeding, an operating company will immediately seek authority to continue to provide employees with the salaries and benefits that existed prior to the Chapter 11 filing. It is also able to do business with suppliers and customers in a routine manner so that it can continue to create funds to satisfy creditors. The court gives amounts owing to suppliers for material or services provided after a Chapter 11 filing preferential status so that they may continue to be paid under normal terms. Although a company generally cannot pay suppliers for materials or services provided before the Chapter 11 filing, this generally applies only to suppliers in locations where the firm has filed for Chapter 11 protection.

After a company files Chapter 11, one or more official committees that represent the interests of general unsecured creditors and/or other creditors may be appointed. Normally these committees are actively involved in the process to monitor and protect the interests of unsecured and certain other creditors during the Chapter 11 proceedings.

Another major step in the Chapter 11 process is providing notice to anyone who believes they have a claim, financial or otherwise, against a company. Notice procedures are

established by the court and notice is given to people with claims alerting them that their claims must be brought forward by a certain date. By the end of the notice period, all claims must be submitted or they will be barred forever.

The Chapter 11 process will end when the court has approved a plan of reorganization for a company. This plan is usually developed by a company in conjunction with its creditors. In cases with complex asbestos liabilities, it has taken several years to complete this process. The approved plan of reorganization establishes the amount, type and timing of payment that will be made to the holders of allowed claims, as well as the capital structure of the reorganized company. Upon emergence from bankruptcy, the amounts reported in subsequent financial statements may materially change due to the restructuring of assets and liabilities as a result of the Plan of Reorganization and the application of the provisions of Statement of Position ("SOP") 90-7, "Financial Reporting by Entities in Reorganization under the Bankruptcy Code," ("SOP 90-7") with respect to reporting upon emergence from Chapter 11 ("Fresh-Start" accounting).

FINANCIAL REPORTING DURING REORGANIZATION

A primary objective of financial reporting for an entity undergoing a reorganization is to reflect the financial evolution of the entity throughout this process. *Financial statements for periods including and subsequent to the Chapter 11 filing should clearly distinguish between items, events, and transactions directly associated with the reorganization and those associated with ongoing operations of the entity.* According to SOP 90-7, reorganization proceedings do not affect or change the application of GAAP to the preparation of entity financial statements. *As a result, during reorganization, an entity in Chapter 11 should apply the principles of historical cost accounting.*

Balance Sheet

The balance sheet clearly should distinguish pre-petition liabilities subject to compromise from those that are not and identify post-petition liabilities. Pre-petition liabilities are obligations incurred by the entity prior to the filing, including those considered as such by the court. These obligations are considered subject to compromise unless they will not be impaired under the reorganization plan, e.g., when the value of

the security interest is greater than the claim. Post-petition liabilities are those incurred subsequent to the bankruptcy filing that are not associated with pre- bankruptcy events.

Liabilities that may be affected by the plan of reorganization should be reported at amounts expected to be allowed, even when ultimately they may be settled for a lower amount. The amount allowed is court- determined and may differ from the actual settlement amount. While it might be argued that pre-petition claims should be reported at their estimated settlement amounts, these claims are required to be reported at allowed amount since they continue to represent the amount of the liabilities until they are settled. Further, use of allowed amounts is consistent with measurement principles used for other pre-petition liabilities and, therefore, comparability is enhanced. Additionally, the conclusion to use allowed amounts is consistent with SFAS 5, "Accounting for Contingencies." Claims not subject to reasonable estimation should also be disclosed and stated in accordance with SFAS 5.

In determining the net carrying amount of debt, debt discounts or premiums as well as debt issue costs should be considered as valuation amounts associated with the debt. When the amount of an allowed claim associated with the debt differs from its carrying amount, the net carrying amount should be adjusted to the allowed amount, including adjustments to premiums or discounts and issue costs. Any gain or loss that results from the adjustment should be reported in "reorganization items" on the statement of income.

Income Statement

All income determinants associated with the reorganization and restructuring should be reported separately as "reorganization items," except for those required to be reported under the captions discontinued operations and extraordinary items following APBO 30, "Reporting the Results of Operations--Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions."

SOP 90-7 eliminates requires that professional fees and similar costs be expensed as incurred. These costs should be reported under the reorganization items caption in the statement of income.

Interest expense is not a reorganization item. It should be reported only to the extent that interest will be paid during the proceeding or that it is probable that it will be either an allowed priority, secured or unsecured claim. To the extent that reported interest differs from contractual interest, the difference should be disclosed; for SEC registrants, this disclosure should be made parenthetically on the face of the statement of income.

To the extent that interest income is earned that would not have been earned without the proceeding, it should be reported as a reorganization item. To the extent that interest can be deemed related to normal invested working capital, it should be reported as a component of operating income.

K-Mart
CONSOLIDATED STATEMENTS OF OPERATIONS
YEARS ENDED JANUARY 29, 2003, JANUARY 30, 2002 AND JANUARY 31, 2001

	2002	2001	2000
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	(DOLLARS IN MILLIONS)		
Sales.....	\$30,762	\$36,151	\$37,028
Cost of sales, buying and occupancy.....	26,258	29,853	29,732
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Gross margin.....	4,504	6,298	7,296
Selling, general and administrative expenses.....	6,544	7,588	7,366
Equity income (loss) in unconsolidated subsidiaries.....	34	--	(13)
Restructuring, impairment and other charges.....	739	1,091	--
	-----	-----	-----
Continuing loss before interest, reorganization items, income taxes and dividends on convertible preferred securities of subsidiary trust.....	(2,745)	(2,381)	(83)
Interest expense, net (contractual interest for fiscal years 2002 and 2001 was \$426 and \$352, respectively).....	155	344	287
Reorganization items, net.....	386	(183)	--
Benefit from income taxes.....	(24)	--	(148)
Dividends on convertible preferred securities of subsidiary trust, net of income taxes of \$0, \$0 and \$25, respectively (contractual dividend for fiscal years 2002 and 2001 was \$65 and \$72, net of tax, respectively).....	--	70	46
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Net loss from continuing operations.....	(3,262)	(2,612)	(268)
Gain from discontinued operations, both net of income taxes of \$0.....	43	166	--
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Net loss.....	\$ (3,219)	\$ (2,446)	\$ (268)
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K-Mart
CONSOLIDATED BALANCE SHEETS
AS OF JANUARY 29, 2003 AND JANUARY 30, 2002

	2002	2001
	-----	-----
	(DOLLARS IN MILLIONS, EXCEPT SHARE DATA)	
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents.....	\$ 613	\$ 1,245
Merchandise inventories.....	4,825	5,796
Other current assets.....	664	800
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TOTAL CURRENT ASSETS.....	6,102	7,841
Property and equipment, net.....	4,892	6,093
Other assets and deferred charges.....	244	249
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TOTAL ASSETS.....	\$11,238	\$14,183
	=====	=====
LIABILITIES AND SHAREHOLDERS' (DEFICIT) EQUITY		
CURRENT LIABILITIES		
Accounts payable.....	\$ 1,248	\$ 89
Accrued payroll and other liabilities.....	710	420
Taxes other than income taxes.....	162	143
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TOTAL CURRENT LIABILITIES.....	2,120	652
Long-term debt and notes payable.....	--	330
Capital lease obligations.....	623	857
Other long-term liabilities.....	181	132
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TOTAL LIABILITIES NOT SUBJECT TO COMPROMISE.....	2,924	1,971
Liabilities subject to compromise.....	7,969	8,093
Company obligated mandatorily redeemable convertible preferred securities of a subsidiary trust holding solely 7 3/4% convertible junior subordinated debentures of Kmart (redemption value of \$648 and \$898, respectively).....	646	889
Common stock, \$1 par value, 1,500,000,000 shares authorized; 519,123,988 and 503,294,515 shares outstanding, respectively.....	519	503
Capital in excess of par value.....	1,922	1,695
(Accumulated deficit) retained earnings.....	(2,742)	1,032
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TOTAL LIABILITIES AND SHAREHOLDERS' (DEFICIT) EQUITY.....	\$11,238	\$14,183
	=====	=====

FINANCIAL REPORTING WHEN ENTITIES EMERGE FROM CHAPTER 11

Entities whose plans of reorganization have been confirmed by the courts should apply the following principles as of the confirmation date, or as of a later date when all material conditions precedent to the plan have been resolved.

Fresh-Start Reporting

Fresh-start reporting for an entity emerging from Chapter 11 should be used when the reorganization value of the assets of the entity immediately before the confirmation is less than the total of all post-petition liabilities and allowed claims, and when existing voting shareholders immediately before the confirmation receive less than 50% of the voting shares of the emerging entity. The loss of control in these cases should be substantive and not temporary for fresh-start accounting to apply.

During the period the court is determining the adequacy of the disclosure statement of a plan of reorganization, information about reorganization value should be disclosed in the financial statements so that shareholders and creditors can make informed judgments about the plan. Reorganization value most likely should be reported in the pro forma balance sheet that generally is part of the disclosure statement.

The following principles apply in fresh-start accounting.

- 1. The reorganization value of the entity should be allocated to assets of the entity using the principles enumerated in APBO 16, "Business Combinations," as relates to the purchase method. Any portion of the reorganization value that cannot be attributed to specific tangible and intangible assets should be reported as an intangible asset entitled "reorganization value in excess of amounts allocable to identifiable assets;" this excess should be amortized pursuant to the provisions of APBO 17, "Intangible Assets."**
- 2. Each liability that exists at the plan confirmation date (except deferred taxes) should be reported at the present value of amounts to be paid, discounted using appropriate current interest rates.**

Notes to the initial financial statements when fresh-start reporting is used should disclose the following:

- 1. Adjustments made to the historical amounts of individual assets and liabilities.**
- 2. The amount of debt forgiveness.**
- 3. The amount of prior retained earnings or deficit eliminated.**
- 4. Significant matters associated with determining reorganization value (e.g., valuation methods and sensitive assumptions).**

Entities Not Using Fresh-Start Reporting

When the criteria for fresh-start accounting are not met, liabilities compromised by confirmed reorganization plans should be reported at the present value of amounts to be paid. Any forgiveness of debt should be reported as an extraordinary item.

Changes in accounting principles required under generally accepted accounting principles ("GAAP") within twelve months of emerging from bankruptcy are required to be adopted at the date of emergence. Additionally, the firm may choose to make changes in accounting practices and policies at this time. For all these reasons, the financial statements for periods subsequent to emergence from Chapter 11 will not be comparable with those of prior periods.

The following is a brief overview of the major steps that take place through the Chapter 11 process - from filing through formulation of a plan of reorganization and ending with confirmation of the plan of reorganization and emergence from the Chapter 11 proceedings.

Phase 1 -- Filing

- **The firm voluntarily files a petition for reorganization under Chapter 11 of the United States Bankruptcy Code.**
- **The filing triggers an "automatic stay" which freezes all lawsuits and collection actions against the firm.**
- **The firm arranges a new "Debtor in Possession" credit facility. Upon court approval, these funds are available to help ensure that the company meets all of its ongoing operating obligations, including payroll and benefits, payments to vendors and suppliers for goods and services provided after the filing date, as well as routine capital expenditures.**
- **All facilities conduct normal business operations.**

Phase 2 - Formulation of a Plan of Reorganization

- **Creditors' committees are formed to work with the firm on reorganization-related issues. The bankruptcy court resolves any conflicts.**
- **A notice is sent out to anyone who may have financial or other claims against the firm requesting that they submit "proof of claims" so that a master list of creditors can be developed.**
- **The firm finalizes its long-range strategic business plan and a plan of reorganization, which will provide economic value to the stakeholders.**

Phase 3 - Confirmation of a Plan of Reorganization and Emergence

- **The firm submits its proposed plan of reorganization and a disclosure statement, outlining its current and projected financial condition, for approval of the creditors and bankruptcy court.**
- **Creditors have an opportunity to vote to accept or reject the plan. Upon creditor approval, the bankruptcy court confirms the plan of reorganization and sets a date for the firm to emerge from Chapter 11. The firm emerges from Chapter 11 process with its liabilities resolved as to amount and funding requirements, removing uncertainty and creating greater flexibility for the future.**

Exit Financing

At the end of the bankruptcy process is the need for exit financing, the money needed for the new business plan. Getting the financing is the final step required to get out of bankruptcy and often isn't easy.

One company looking for exit financing is MCI (WCOEQ), formerly known as WorldCom Inc. The telephone and data services company was pushed into the bankruptcy court in July 2002 by a massive accounting scandal. Since then, it has installed a new management team, streamlined an overblown cost structure, and worked out a reorganization plan with the goal of getting out of Chapter 11 bankruptcy protection in late 2003.

Unlike other telecoms falling into court protection, MCI has a viable, good business and is likely to put together a new capital structure reflecting the operation reality of today, not yesterday. Indeed, the difference between then and now is key. New lenders will question if a company's current restructuring is enough of a fix. The strength of management is a hugely important issue.

The growing trend of commercial banks getting into the investment-banking business has increased the amount of lenders doing exit financing. If a bank can establish a relationship with a restructured company right on the ground floor, it may pick up its other banking businesses in the future. Since 2001 the nation's top 10 bankruptcy-exit lenders arranged a total of \$11 billion in loans for 35 companies to come out of Chapter 11. Retailers and makers of consumer products were the sectors that received the most loans, while technology and energy companies received the least.

By extending new loans to a restructured company, lenders often demand that the loans be fully secured by the borrower's hard assets. They also get to dictate what the borrower's future capital structure will look like. Often, lenders require that the company balance its borrowing capacity with its cash-flow prospects.

The Largest Bankruptcies 1980 – Present

Company	Bankruptcy Date	Total Assets Pre-Bankruptcy
Worldcom	07/21/02	\$103,914,000,000
Enron	12/2/01	\$63,392,000,000
Conseco	12/18/02	\$61,392,000,000
Texaco	4/12/1987	\$35,892,000,000
Financial Corp of America	9/9/1988	\$33,864,000,000
Global Crossing	1/28/2002	\$30,185,000,000
UAL	12/9/2002	\$25,197,000,000
Adelphia Communications	6/25/2002	\$21,499,000,000
Pacific Gas and Electric	4/6/2001	\$21,470,000,000
MCorp	3/31/1989	\$20,228,000,000
First Executive	5/13/1991	\$15,193,000,000
Gibraltar Financial	2/8/1990	\$15,011,000,000
Kmart	1/22/2002	\$14,600,000,000
FINOVA	3/7/2001	\$14,050,000,000
Home Fed	10/22/1992	\$13,885,000,000
Southeast Banking	9/20/1991	\$13,390,000,000
NTL, Inc.	5/8/2002	\$13,003,000,000
Reliance Group	6/12/2001	\$12,598,000,000
Imperial Corp	2/28/1990	\$12,263,000,000
Federal-Mogul	10/1/2001	\$10,150,000,000
First City Bancorp	10/31/1992	\$9,943,000,000
First Capital Holdings	5/30/1991	\$9,675,000,000
Baldwin-United	9/26/1983	\$9,383,000,000

A list of term for bankruptcy:

Asbestos Committee

The Asbestos Committee is comprised of representatives of the asbestos claimants. This committee represents the asbestos claimants, consults with the debtor in possession, reviews and gathers information about the debtor in possession's activities and financial condition, and participates in the negotiation of a Chapter 11 plan of reorganization.

Automatic Stay

The filing of a Chapter 11 petition automatically triggers a halt or stay in the continued prosecution of pending lawsuits and the commencement of new law suits based on the pre-filing conduct. This would include all asbestos-related litigation.

Bankruptcy Code

The federal bankruptcy statute is commonly referred to as the Bankruptcy Code.

Bankruptcy Court

A unit of the United States District Court specializing in the handling of bankruptcy cases.

Bankruptcy Petition

The legal instrument filed with the bankruptcy court that initiates a bankruptcy case.

Business Plan

A strategic plan prepared by company management that states the company's objectives as well as the specific steps taken to achieve those goals.

Chapter 11

The chapter in the United States Bankruptcy Code that contains the provisions for court-supervised reorganization of debtor companies.

Claim

A right to payment, either fixed or not, contingent, liquidated, disputed or matured.

Class of Creditors

A group of creditors entitled to similar treatment under a Chapter 11 plan.

Confirmation

The final approval by the bankruptcy court of a debtor's plan of reorganization. Confirmation takes place after the reorganization plan has been approved by creditors.

Creditor

A party, such as a supplier, bank lender or bondholder, to whom a debt is owed by a debtor.

Creditors' Committee

The Creditors' Committee is comprised of representatives of the unsecured

creditors. This committee represents the unsecured creditors, consults with the debtor in possession, reviews and gathers information about the debtor in possession's activities and financial condition, and participates in the negotiation of a Chapter 11 plan of reorganization.

Debtor

The person or company who files a voluntary petition or against whom an involuntary petition is filed.

Debtor-in-Possession (DIP) Financing

DIP financing is special financing available only to companies in Chapter 11 and is used to fund post-filing trade and employee obligations as well as the company's ongoing operating needs during the bankruptcy process.

Disclosure Statement

A document that is presented to the bankruptcy court, and ultimately to creditors, that discloses the terms of the company's plan of reorganization. The disclosure statement has sufficient information so that holders of claims against the company can make an informed decision as to whether to vote for or against the reorganization plan.

Exclusivity Period

The 120-day period of exclusivity, after the filing of a Chapter 11 petition, during which time the debtor is the only party able to file a Chapter 11 reorganization plan. The exclusivity period may be extended or shortened by the bankruptcy court. Typically, in large Chapter 11 cases such as this one, the exclusivity period is routinely extended.

Plan of Reorganization

The reorganization plan that sets forth how the claims of each class of creditors and interest holders will be treated.

Proof of Claim

Proof of claim is the form filed with the bankruptcy court or claims agent designated by the court setting forth a pre-filing claim.

Reorganized Debtor

The debtor company after it has confirmed a Chapter 11 reorganization plan and is no longer in Chapter 11.

Schedule of Assets and Liabilities

Lists of assets and liabilities, which every debtor is required to file with the bankruptcy court.

United States Trustee

A United States Trustee is appointed by the U.S. Attorney General to supervise all bankruptcy cases filed in a particular district. The role of the U.S. Trustee is: to interview the debtor shortly after the filing of the case; to schedule the first meeting of creditors; to inform and ensure that the debtor complies with its duties and responsibilities; to appoint creditors' and equity-holder committees; to apply to the bankruptcy court for appropriate relief; and to make recommendations to the bankruptcy court.

Questions:

- 1. What is bankruptcy?**
- 2. What is the primary difference between Chapter 13 and Chapter 7?**
- 3. Why does K-Mart report a balance sheet account "Liabilities subject to compromise" in the amount of \$7,969?**
- 4. Why did interest cost decline in fiscal 2002 for KMart?**
- 5. Describe SOP 90-7.**
- 6. Describe DIP Financing.**
- 7. Who would provide DIP financing?**
- 8. What is exit financing?**
- 9. List three characteristics of firms who may be candidates for exit financing.**