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American Institute of Certified Public Accountants. Accounting Standards Executive Committee

Practice Bulletin 11
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Accounting for Preconfirmation Contingencies in Fresh-Start Reporting

An Interpretation of SOP 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code*

Accounting Standards Executive Committee
and
Reorganization Task Force

AICPA
American Institute of Certified Public Accountants

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Practice bulletins of the Accounting Standards Division are issued to disseminate the views of the Accounting Standards Executive Committee on narrow financial accounting and reporting issues. The issues dealt with are those that have not been and are not being considered by the Financial Accounting Standards Board or the Governmental Accounting Standards Board. Practice bulletins present the views on such issues of at least two-thirds of the members of the Accounting Standards Executive Committee, the senior technical body of the AICPA authorized to speak for the AICPA on financial accounting and reporting.

The Financial Accounting Standards Board and the Governmental Accounting Standards Board are the bodies authorized to establish enforceable standards under rule 203 of the AICPA Code of Professional Conduct. However, practice bulletins provide guidance on narrow issues that practitioners are encouraged to follow to enhance the quality and comparability of financial statements.

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Accounting for Preconfirmation Contingencies in Fresh-Start Reporting

Introduction

1. This practice bulletin interprets certain provisions of AICPA Statement of Position (SOP) 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code.* SOP 90-7 provides guidance for financial reporting by entities that file petitions with the Bankruptcy Court and expect to reorganize as going concerns under Chapter 11 of title 11 of the United States Code. The SOP was issued on November 19, 1990, and is effective for financial statements of enterprises that filed petitions under the Bankruptcy Code after December 31, 1990.

2. SOP 90-7 states that an entity should adopt fresh-start reporting upon emergence from Chapter 11 reorganization if the reorganization value of assets 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. 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 restructuring. The reorganization value of an entity is the amount of resources available and to become available for the satisfaction of postpetition liabilities and allowed claims and interest, as negotiated or litigated between the debtor-in-possession or trustee, the creditors, and the holders of equity interests.

3. SOP 90-7 identifies the principles to be applied in adopting fresh-start reporting, which include the following:

- Reorganization value of the entity should be allocated to the entity's assets in conformity with the procedures specified by Accounting Principles Board (APB) Opinion No. 16, *Business Combinations*, for transactions recorded on the basis of the purchase method. Any reorganization value in excess of amounts allocable to identifiable assets should be amortized in conformity with APB Opinion 17, *Intangible Assets.*

- Each liability existing at the plan confirmation date, other than deferred taxes, should be stated at the present values of amounts to be paid.

4. SOP 90-7 does not provide specific guidance on accounting for contingencies existing at the date fresh-start reporting is adopted.[1] Some believe that the effects of adjusting or resolving all such contingencies should be included in postconfirmation earnings. Others believe that accounting similar to that in FASB Statement of Financial Accounting Standards No. 38, *Accounting for Preacquisition Contingencies of Purchased Enterprises*, should be applied. Such accounting could result in adjustments to reorganization value in excess of amounts allocable to identifiable assets. The Accounting Standards Executive Committee (AcSEC) has been asked to clarify the issue.

Interpretation

5. Certain uncertainties that were not resolved during the Chapter 11 proceedings may continue to exist at the confirmation date. For purposes of applying SOP 90-7, such uncertainties are referred to as *preconfirmation contingencies*, defined as contingencies[2] of an entity that emerges from Chapter 11 reorganization and applies fresh-start reporting, and that exist at the date of confirmation of the plan. A preconfirmation contingency can be a contingent asset, a contingent liability, or a contingent impairment of an asset.

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[1] See paragraphs 35 and 55 of SOP 90-7.

[2] FASB Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, defines a contingency as an existing condition, situation, or set of circumstances involving uncertainty concerning possible gain or loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur.

6. Preconfirmation contingencies include uncertainties concerning—

- Amounts ultimately to be realized upon the disposition of assets designated for sale by the confirmed plan; proceeds upon disposition may vary from values estimated at confirmation.
- Nondischargeable claims (for example, environmental issues).
- Claims that are disputed, unliquidated, or contingent and that are unresolved at confirmation; these claims may be estimated for purposes of voting on the plan. The confirmed plan may provide for issuance of shares (or release of shares from escrow) in resolution of certain claims.

7. Preconfirmation contingencies do not include—

- Allocation of reorganization value to the entity's assets. The initial allocation of the value of the reconstituted entity to individual assets in conformity with the procedures specified by APB Opinion 16 may require the use of estimates. Those estimates may change when information the entity has arranged to obtain has been received—for example, once appraisals of certain assets of the reconstituted business have been received.
- Deductible temporary differences or net operating loss and tax-credit carryforwards that exist at confirmation. FASB Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes*, and paragraph 38 of SOP 90-7 specify the accounting for those items.

8. After the adoption of fresh-start reporting, adjustments that result from a preconfirmation contingency shall be included in the determination of net income in the period in which the adjustment is determined. Such adjustments can result from resolution of a contingency or changes in estimates of amounts initially recorded at emergence from Chapter 11 (see paragraph 5 herein).

9. Adjustment of preconfirmation contingencies should be included in income or loss from continuing operations of the emerged entity and should be separately disclosed.

10. This practice bulletin is effective for adjustments of preconfirmation contingencies made after March 31, 1994. Earlier application is encouraged.

Basis for Conclusions

11. Paragraph 58 of SOP 90-7 states, in part, ". . . in the reorganization process, extensive information available to the parties in interest, the adversarial negotiation process, the involvement of the Bankruptcy Court, the use of specialists by one or more of the parties in interest, and the fact that all elements of the determination are focused solely on the economic viability of the emerging entity result in an objective and reliable determination of reorganization value." Thus, all contingencies that are significant to the reorganization proceedings are identified and generally estimated by the confirmation date.

12. FASB Statement No. 38 describes an *allocation period* as the time required by a purchaser of a business to identify and quantify the assets acquired and the liabilities assumed. The allocation period ends when the acquiring entity is no longer waiting for information that it has arranged to obtain and that is known to be available or obtainable. Any adjustment after the end of the allocation period that results from a preacquisition contingency is included in earnings. AcSEC believes that in reorganization proceedings the analogous allocation period for contingencies is the reorganization period, which ends at the confirmation date. Therefore, adjustments to the amounts initially recorded for preconfirmation contingencies at the adoption of fresh-start accounting should be reflected in earnings.

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