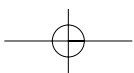
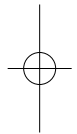
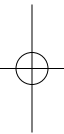


**PART ONE**

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**Bankruptcy and  
Insolvency Environment**



# 1

## Accountant's Role in Perspective

### § 1.1 Introduction

Thousands of businesses fail each year in the United States, and the number grew considerably in the 1980s and early 1990s. The liabilities associated with these failures escalated in the first part of the 1990s, but declined in the late 1990s. In 1998 over 1.4 million bankruptcy petitions were filed. Almost 97 percent of these filings were by consumers, representing the largest number of petitions ever filed in a 12-month period. This increase in filings took place during a period of over eight straight years of economic growth. In 1998, business filings of 44,367 decreased by 18 percent over the filings in 1997. The number of business filings for the year ending June 30, 1999 was only 39,934. For the first time in five years, the number of total filings in 1999 declined. For the year ending June 30, 1999 1,391,964 petitions were filed. It was estimated in 1970 that one out of every five Americans had been involved in bankruptcy proceedings as a bankrupt or a creditor, or was acquainted with someone who had become bankrupt.<sup>1</sup> The number involved today is much higher.

At one time or another, almost all accountants will find that one or more of their clients are experiencing some type of financial difficulty. Because accountants are often the first professional persons to realize that a financial problem exists, they are in a position to render very valuable services. Before accountants can give useful advice to a financially troubled client, they must be thoroughly familiar with the various alternatives available to the client and the ramifications of each alternative.

The purpose of Volume 1 is to analyze in detail the accountant's role in bankruptcy and insolvency procedures, and to provide a practice guide that will assist accountants in rendering professional services in the liquidation and rehabilitation of financially troubled debtors in and outside of bankruptcy court. This volume describes those aspects of bankruptcy and insolvency proceedings of which accountants must be aware, delineating their functions and duties and the procedures they must follow in the auditing inquiry and in the preparation of the various financial statements and reports that are required by the courts. It presents the accounting methods, procedures, and techniques

<sup>1</sup> David T. Stanley et al., *Bankruptcy: Problems, Process, Reform* (Washington, DC: The Brookings Institution, 1971), p. 1.

that may be used and explains the applicability of generally accepted accounting principles (GAAP) and generally accepted auditing standards (GAAS) to bankruptcy and insolvency proceedings. This volume explains how most of the services rendered in bankruptcy and out-of-court workouts fall under the litigation consulting guidelines rather than the attestation standards or accounting and review services guidelines. Finally, it discusses the conflicts and problems in principles and practice.

Volume 2 consists of examples of various aspects of bankruptcy proceedings, including samples of schedules and forms with which accountants and other professionals must be familiar in order to effectively serve their clients and easily handle the administrative aspects of a case.

It is hoped that this work will also benefit nonaccountants, such as trustees, judges, and attorneys, in clarifying the purposes, nature, and limitations of the services of the accountant. Although the primary effort in the development of these books has been directed to the accountant in an explanation of "how to do it" and in a discussion of the ethical problems and responsibilities involved, the coverage of the economic and legal aspects of bankruptcy and insolvency should be of value to other professionals involved in these proceedings.

## § 1.2 Scope of Coverage

The scope of these volumes is, deliberately, fairly broad. The various accounting procedures to be followed under each alternative remedy for business failure are analyzed in detail. To provide a complete and realistic description of the environment within which the accountant must work, the discussion incorporates the economics and the legal aspects of business liquidations and rehabilitations.

The economics of bankruptcy and insolvency proceedings is most important when considering the various causes of financial difficulties. Once the causes have been ascertained, the most appropriate remedy may then be determined. Economic considerations are also important when analyzing what remedies have proven most successful in particular circumstances.

The legal aspects of bankruptcy permeate the entire book, for the Federal Bankruptcy Code (title 11) establishes the framework within which anyone concerned with insolvency must work. As a result, the Bankruptcy Code is explicitly cited in the descriptions of the petitions, forms, and schedules that must be filed; the alternatives and rights available to all parties involved, including the creditors; the requirements of the debtor; and the treatment of the various transactions and property of the debtor, both before and after the proceedings. Bankruptcy and insolvency proceedings cannot be correctly handled unless everyone involved has a thorough understanding of the legal aspects of the case.

Only about 3 percent of the bankruptcy court petitions are filed by businesses. The majority are filed by wage earners; however, it is primarily the business bankruptcy and insolvency proceedings that require the services of an accountant. The book is therefore directed toward business bankruptcies. Although the emphasis is on incorporated businesses, materials covered are applicable to partnerships and proprietaries because the remedies available are basically the same.

## ACCOUNTING SERVICES

### § 1.3 Need for Accountants' Services

The accountant can provide various kinds of services that can be effective in helping the debtor overcome its financial problems and again operate profitably, and that can also assist the creditors and their committees in deciding on the type of action they should take. The accountant may become a party to insolvency and bankruptcy proceedings while serving a client who is having financial problems. Before resorting to judicial proceedings, the debtor may attempt to negotiate a moratorium or settlement of its debt with unsecured creditors. Accountants may be retained by the debtor and/or creditors' committee to perform accounting services.

Reorganization of a corporation under chapter 11 of the Bankruptcy Code involves many parties who may need the assistance of accountants. First, the debtor, who remains in possession, has the right to retain an accountant to perform necessary accounting functions, to develop a business plan that will help turn the business around, and to develop and negotiate the terms of a plan of reorganization. Others include attorneys, trustee, examiner, creditors, security holders, and stockholders.

In liquidation proceedings under chapter 7 of the Bankruptcy Code, the accountant often assists in accounting for the distribution of the debtor's assets. If the liquidation proceedings are initiated involuntarily, the petitioning creditors will need the assistance of an accountant in establishing a case of insolvency, and the debtor will need an accountant's assistance in trying to prove a defense of solvency. An investigation may be required for specific purposes, such as by the debtor to defend a turnover proceeding or by a third party to defend a suit by the trustee alleging a preferential transfer.<sup>2</sup>

The trustee as the appointed or elected representative of the creditors in a bankruptcy court proceeding most frequently finds it necessary to employ an accountant to examine the debtor's books and records and to investigate any unusual or questionable transactions. A corporation's past transactions may need investigation to determine whether any assets have been concealed or removed or any preferences, fraudulent conveyances, or other voidable transactions committed. Often, the debtor may have kept inadequate books and records, further complicating the situation. The accountant may help the trustee develop a business plan, and may negotiate the terms of a plan of reorganization.

Under section 1103 of the Bankruptcy Code, the creditors' committee is permitted to employ such agents, attorneys, and accountants as may be necessary to assist in the performance of its functions. The accountant can provide valuable assistance to the committee by reviewing the business plan and the plan of reorganization of the debtor. At times, the accountant may help the committee develop a plan. The committee may also retain its own accountant to examine the debtor's books and records and to investigate the activities of the debtor. The creditors' committee is expected to render an opinion on the plan

<sup>2</sup> Asa S. Herzog, "CPA's Role in Bankruptcy Proceedings," *Journal of Accountancy*, Vol. 117 (January 1964), p. 59.

of reorganization, and to do so it must have knowledge of the debtor's acts and property. It must know the value of the debtor's assets in liquidation and the nature of the transactions entered into by the debtor before proceedings began. Because accountants are most qualified to establish these facts, they are often engaged to perform an investigation of the debtor's operations so that the committee will be able to give an informed opinion on the actions to take, such as a search for preferences or fraudulent transfers.

The debtor's internal accounting staff is also actively involved in the proceedings. Staff members often provide information or advice that assists the debtor in selecting the appropriate remedy. They also provide the debtor's attorneys with the accounting information needed to file the bankruptcy court petition.

Accounting and financial advising services are needed by a large number of participants in both out-of-court and bankruptcy proceedings. See 1.1 of Volume 2, *Bankruptcy and Insolvency Accounting*, for a list of these parties.

#### § 1.4 "Accountants" Defined

It is not unusual to see several accountants or financial advisors involved in bankruptcy court proceedings. There may be independent accountants for the debtor, internal accountants of a debtor company, independent accountants for the trustee, and independent accountants or financial advisors representing the creditors' committee or individual holder of claims. Many of the accounting functions may be performed by more than one accountant. For example, each of the accountants will want to determine the underlying causes of failure. The term "accountants" is used here to refer to any accountant involved in the proceedings; where the service must be rendered by a particular accountant, the type of accountant or financial advisor is identified either in the text or at the beginning of the chapter. Many individuals who provide financial advice to companies in financial trouble are not CPAs and many of the boutique firms that provide business turnaround, bankruptcy, and restructuring services do not practice as CPA firms, even though a large number of their professional staff are CPAs.

### TOPICAL OVERVIEW

#### § 1.5 Economic Causes of Business Failure

The first topic discussed in Chapter 2 is the economic causes that lead to business failure. A knowledge of the common causes of financial trouble can often enable the accountant to identify a potential problem, and corrective action can be taken before the situation becomes too serious. Methods of detecting failure tendencies are also described.

#### § 1.6 Business Turnaround

Two critical aspects of the process of making a business with problems profitable again involve solving the operational problems and restructuring the

## § 1.7 Alternatives Available to a Financially Troubled Business

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debt and equity of the business. In this book, *turnaround* is used to mean the process of solving the operation problems of a business. It involves improving the position of the business as a low-cost provider of increasingly differentiated products and services and nurturing a competent organization with industry-oriented technical expertise and a general sense of fair play in dealing with employees, creditors, suppliers, shareholders, and customers.<sup>3</sup> Chapter 3 describes the business turnaround process.

*Restructuring* will be used to mean the process of developing a financial structure that will provide a basis for turnaround. Some entities in financial difficulty are able to solve their problems by the issuance of stock for a large part of the debt; such is the case where the company is overleveraged. Others are able to regain profitability by improving cost margins through reduction of manufacturing costs and elimination of unprofitable products. However, the majority of businesses require attention to operating problems as well as changes to the structure of the business. Chapter 4 describes the process of restructuring the business out-of-court and Chapter 6 deals with the process of restructuring the business in the bankruptcy court. The business aspect of the restructuring process is discussed throughout the text.

### § 1.7 Alternatives Available to a Financially Troubled Business

In order to render services effectively in bankruptcy and insolvency proceedings, the accountant must be familiar with the Federal Bankruptcy Code (title 11 of the United States Code). Chapter 5 begins with a discussion of the history of the bankruptcy law in the United States, and the provisions of the Bankruptcy Code are described throughout Chapters 5 and 6.

The debtor's first alternatives are to locate new financing, to merge with another company, or to find some other basic solution to its situation, in order to avoid the necessity of discussing its problems with representatives of creditors. If none of these alternatives is possible, the debtor may be required to seek a remedy from creditors, either informally (out of court) or with the help of judicial proceedings. To ensure that the reader is familiar with some of the alternatives available, they are briefly described in the paragraphs that follow. The general provisions of an assignment for the benefit of creditors are described in greater detail in Chapter 5. Often, debtors prefer to work out their financial problems with creditors by mutual agreement out of court; these settlements are described in Chapter 4. A chapter 11 reorganization, the second major rehabilitation device for a debtor, is analyzed in Chapter 6 and throughout this book.

#### (a) Out-of-Court Settlements

The debtor may request a meeting with a few of the largest creditors and one or two representatives of the small claimants to effect an informal agreement. The function of such a committee may be merely to investigate, consult, and give advice to the debtor, or it may involve actual supervision of the business or liquidation of the assets. An informal settlement usually involves an exten-

<sup>3</sup> Frederick M. Zimmerman, *The Turnaround Experience* (New York: McGraw-Hill, 1991), p. 11.

sion of time (a moratorium), a pro rata settlement (composition), or a combination of the two. The details of the plan are worked out between the debtor and creditors, the latter perhaps represented by a committee. Such extralegal proceedings are most successful when there are only a few creditors, adequate accounting records have been kept, and past relationships have been amicable. The chief disadvantage of this remedy is that there is no power to bind those creditors who do not agree to the plan of settlement.

### **(b) Assignment for Benefit of Creditors**

A remedy available, under state law, to a corporation in serious financial difficulties is an "assignment for the benefit of creditors." In this instance, the debtor voluntarily transfers title to its assets to an assignee who then liquidates them and distributes the proceeds among the creditors. Assignment for the benefit of creditors is an extreme remedy because it results in the cessation of the business. This informal (although court-supervised in many states) liquidation device, like the out-of-court settlement devised to rehabilitate the debtor, requires the consent of all the creditors or at least their agreement to refrain from taking action. The appointment of a custodian over the assets of the debtor gives creditors the right to file an involuntary bankruptcy court petition.

Proceedings brought in the federal courts are governed by the Bankruptcy Code. It will normally be necessary to resort to such formality when suits have already been filed against the debtor and its property is under garnishment or attachment, or is threatened by foreclosure or eviction.

### **(c) Chapter 11—Reorganization**

Chapter 11 of the Bankruptcy Code replaces Chapters X, XI, and XII of the Bankruptcy Act, which applied only to cases filed before October 1, 1979.<sup>4</sup> Chapter 11 can be used as the means of working out an arrangement with creditors where the debtor is allowed to continue in business and secures an extension of time, a pro rata settlement, or some combination of both. Or, chapter 11 can be used for a complete reorganization of the corporation affecting secured creditors, unsecured creditors, and stockholders. The objective of the reorganization is to allow the debtor to resume business in its new form without the burden of debt that existed prior to the proceeding.

One important aspect of the proceedings under chapter 11 is to determine whether the business is worth saving and whether it will be able to operate profitably in the near future. If not, then the business should be liquidated without incurring further losses. The new law allows the debtor—if it is determined that the business should be liquidated—to propose a plan that would provide for the orderly liquidation of the business without conversion of the proceedings to chapter 7 (the successor to straight bankruptcy). Another aspect

<sup>4</sup> Prior law (Bankruptcy Act) used "Chapter" and roman numerals (Chapter VII, Chapter XI, and so on) for chapter identification; the new law (Bankruptcy Code) uses "chapter" and arabic numbers (chapter 7, chapter 11, and so on). Chapters in this book are cross-referenced as Chapter 7, Chapter 11, and so on.

of the new chapter 11 is that the debtor will in most cases be allowed to operate the business while a plan of reorganization is being proposed.

There has been a major increase in the number of prepackaged chapter 11 plans that are filed with the bankruptcy court. Before filing for chapter 11, some debtors develop a plan and obtain approval of the plan by all impaired claims and interests. The court may accept the voting that was done prepetition, provided that the solicitation of the acceptance (or rejection) was in compliance with applicable nonbankruptcy law governing the adequacy of disclosure in connection with the solicitation. If no nonbankruptcy law is applicable, then the solicitation must have occurred after or at the time the holder received adequate information as required under section 1125 of the Bankruptcy Code.

It is necessary for a chapter 11 plan to be filed for several reasons, including:

- Income from debt discharge is taxed in an out-of-court workout to the extent that the debtor is or becomes solvent. Some tax attributes may be reduced in a bankruptcy case, but the gain from debt discharged is not taxed.
- The provisions of section 382(1)(5) and (6) dealing with preserving net operating losses apply only to bankruptcy cases.
- Some bond indenture agreements provide that amendments cannot be made unless all holders of debt approve the modifications. Because it is difficult, if not impossible, to obtain 100 percent approval, it is necessary to file a bankruptcy plan to reduce interest or modify the principal of the bonds.

The professional fees and other costs of a prepackaged plan, including the cost of disrupting the business, are generally much less than the costs of a regular chapter 11. A prepackaged bankruptcy may therefore be the best alternative.

A prepackaged plan is generally thought to be most appropriate for debtors with financial structure problems (often created by leveraged buyouts [LBOs]), rather than operational problems. However, a prepackaged plan may be used in most situations where an out-of-court workout is a feasible alternative. Recently, there has been an increase in the number of prepackaged plans filed. If a prepackaged plan is going to be effective in solving operational problems, it is important that early action be taken before operations deteriorate to the point where a bankruptcy petition must be filed in order to prevent selected creditors from taking action against the debtor that would preclude any type of reorganization. In situations where a petition must be filed in order to obtain postpetition financing to operate the business (such as in a retail operation), a petition will have to be filed before any type of plan can be developed.

#### **(d) Chapter 12—Adjustment of Debts of Family Farmers**

To help farmers resolve some of their financial problems, Congress passed chapter 12 of the Bankruptcy Code. This chapter became effective November 26, 1986, and became law under a provision that allows the law to expire unless the expiration time-period is extended by Congress. Congress allowed

the law to expire October 1, 1998, but subsequently retroactively extended the expiration date to October 1, 1999, so that farmers can continue to use chapter 12. While it is expected that Congress will eventually make chapter 12 permanent, Congress extended the expiration date to July 1, 2000, in October 1999. A family farmer may use this chapter if his total debt does not exceed \$1.5 million. Chapter 12 is designed to give family farmers an opportunity to reorganize and keep their land. Through bankruptcy, the farmers have the protection they need while they attempt to resolve their financial problems. At the same time, the law was passed for the purpose of preventing abuse of the system and ensuring that farm lenders receive a fair repayment of their debts.

**(e) Chapter 13—Adjustment of Debts of an Individual with Regular Income**

The new law allows some small businesses to use chapter 13, which, under prior law, had been used only by wage earners. However, as initially passed, only businesses that are owned by individuals with unsecured debts of less than \$100,000 and secured debts of less than \$350,000 may use this chapter. Effective for petitions filed on or after October 22, 1994, the Bankruptcy Reform Act of 1994 increased the debt limits for the filing of a chapter 13 petition as follows: for unsecured debt, from \$100,000 to \$250,000; for secured debt, from \$350,000 to \$750,000. On April 1, 1998, and at each three-year interval thereafter, the dollar amounts for the debt limits for a chapter 13 petition are to be increased, beginning on April 1, to reflect the change in the Consumer Price Index for All Urban Consumers that has occurred during the three-year period ending on December 31 of the immediately preceding year. The amounts are to be rounded to the nearest \$25 multiple. Effective through March 31, 2001, the unsecured debt limit is \$269,250 and the secured debt limit is \$807,750.

Debtors must have income that is stable and reliably sufficient to enable them to make payments under the chapter 13 plan. As in a chapter 11 proceeding, the debtor will be allowed to operate the business while a plan is being developed that will, it is hoped, provide for the successful operation of the business in the future. The chapter 13 proceeding, a streamlined rehabilitation method for eligible debtors, is also discussed in Chapter 6.

**(f) Chapter 7—Liquidation**

Chapter 7 of the Bankruptcy Code is used only when the corporation sees no hope of being able to operate successfully or to obtain the necessary creditor agreement. Under this alternative, the corporation is liquidated and the remaining assets are distributed to creditors after administrative expenses are paid. An individual debtor may be discharged from his or her liabilities and entitled to a fresh start.

The decision as to whether rehabilitation or liquidation is best also depends on the amount to be realized from each alternative. The method resulting in the greatest return to the creditors and stockholders should be chosen. The amount to be received from liquidation depends on the resale value of the firm's assets minus the costs of dismantling and legal expenses. The value of the firm after rehabilitation must be determined (net of the costs of achieving the remedy). The alternative leading to the highest value should be followed.

**§ 1.9 Retention of the Accountant and Fees****11****Exhibit 1-1** Schedule of Alternatives Available

Unsuccessful Action	Alternatives Available
Out-of-court settlement	Chapter 13 (small businesses only) Chapter 11—reorganization Assignment for benefit of creditors (state court) Chapter 7—liquidation
Chapter 13 (small businesses only)	Chapter 11—reorganization Assignment for benefit of creditors (state court) Chapter 7—liquidation
Assignment for benefit of creditors (state court)	Chapter 7—liquidation
Chapter 11—reorganization	Chapter 11—reorganization (liquidation plan) Chapter 7—liquidation

Financially troubled debtors often attempt an informal settlement or liquidation out of court, but if it is unsuccessful they will then initiate proceedings under the Bankruptcy Code. Other debtors, especially those with a large number of creditors, may file a petition for relief in the bankruptcy court as soon as they recognize that continuation of the business under existing conditions is impossible.

Exhibit 1-1 summarizes the most common alternatives available to the debtor in case the first course of action proves unsuccessful.

**§ 1.8 Comparison of Title 11 of the United States Code with the Bankruptcy Act**

The new bankruptcy law, signed by President Carter on November 6, 1978, and applicable to all cases filed since October 1, 1979, contained many changes from prior law. The new law is codified in title 11 of the United States Code, and the former title 11 is repealed. Exhibit 1-2 summarizes the changes brought about by the first major revision of bankruptcy law in the past 40 years and compares the provisions of the prior law with the new law as amended.

**§ 1.9 Retention of the Accountant and Fees**

Accountants must be retained by order of the court before they can render services in bankruptcy court proceedings for the trustee, creditors' committee, or debtor-in-possession. For out-of-court settlements, the accountant obtains a signed engagement letter. Chapter 7 of this book describes and provides examples of the formal and informal retention procedures, and illustrates how independent accountants must clearly set forth the scope of their examination and not deviate from it. The chapter also enumerates the factors to consider in estimating fees and keeping time records, and describes the procedure for filing a petition for compensation.

**Exhibit 1-2** Comparison of the Provisions of Title 11 of the United States Code with the Bankruptcy Act

Item	Bankruptcy Act (old law)		Bankruptcy Code (new law)
	Chapter XI	Chapter X	Chapter 11
Filing petition	Voluntary	Voluntary and involuntary	Voluntary and involuntary
Requirements for involuntary petition		Must commit an act of bankruptcy	Generally not paying debts as they become due or custodian appointed in charge of debtor's property
Nature of creditors' committee	Three to eleven members elected by creditors	Usually not appointed	Seven largest holders of unsecured claims
Operation of business	Usually debtor-in-possession (at time receiver appointed)	Usually by trustee	Most cases debtor-in-possession
Appointment of trustee	Not appointed	Required if debts exceed \$250,000	May be appointed (or elected) on petition after notice and an opportunity for hearing
Appointment of an examiner	No provision	No provision	(1) On request and after a notice and a hearing or (2) if unsecured debts exceed \$5,000,000 after request. Purpose is to examine the affairs of the debtor
Preferences			
Time period	Four months prior to petition date	Four months prior to petition date	Ninety days prior to petition date (time period extended to one year for insiders)
Insolvency at time of payment	Required	Required	Required, but for 90-day provision insolvency is presumed
Exception for payments for business purposes and terms	No provision	No provision	Provided
Creditors receiving payment required to have knowledge of debtor's insolvency	Required	Required	Not required for 90-day requirement and required for payments to insiders

## § 1.10 Accounting Services

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### Exhibit 1-2 (continued)

Automatic stay	Provided for	Provided for	Provided for with some modifications regarding use of property
Setoffs	Allowed	Allowed	Allowed with new restrictions
Plan Submission	By debtor-in-possession	Normally, by trustee	Normally, by debtor-in-possession. However, if plan not submitted in 120 days or trustee appointed, trustee or creditors may submit plan
Coverage	Unsecured debt	All debt and equity interest	All debt and equity interest
Acceptance	Majority in amount and in number of each class of unsecured creditors	Two-thirds in amount of debt and majority in amount for equity interest	Two-thirds in amount and majority in number of holders in each class of those voting and two-thirds in amount of stockholders voting
Disclosure statement	Not required	Formal statement filed with SEC	Required before can solicit votes for plan
Confirmation requirements	Best interest of creditors, feasible	Fair and equitable, feasible	Class not impaired or accept plan, best interest of creditors, feasible

## § 1.10 Accounting Services

In addition to the usual accounting services performed for the debtor, the accountant provides information needed to negotiate with creditors or to file a petition in bankruptcy court, prepares operating statements, assists in formulating a plan, and provides management advising services. Chapters 8 and 9 provide information concerning the nature of these services.

The creditors' committee often needs an accountant to assist it in protecting the creditors' interest and supervising the activities of the debtor. Some of the services rendered by the accountant, which are described in Chapter 10, include assisting the committee in exercising adequate supervision over the debtor's activities, performing an investigation and audit of the operations of the business, and assisting the committee in evaluating the proposed plan of settlement or reorganization. Additional services rendered by accountants relating to the valuation of the business or its component assets are discussed in Chapter 11.

A list of the services often rendered by accountants in the bankruptcy and reorganization area is presented in 1.2 of Volume 2, *Bankruptcy and Insolvency Accounting*.

### § 1.11 Special Investigation and Financial Reporting

Reporting on insolvent companies requires the application of procedures that vary somewhat from those used under normal circumstances. Emphasis in Chapter 12 of this book is on special procedures that differ from those used under normal conditions and on procedures that assist in the discovery of irregularities and fraud. Chapter 13 describes financial reporting during a chapter proceeding and Chapter 14 describes how to report on the emerging from chapter 11. Chapter 15 describes the nature of the accountant's opinion associated with the reports.

### § 1.12 Tax Awareness

Chapter 16 covers the tax areas that the accountant should consider when rendering services for a debtor or creditor of a troubled company and points out how proper tax planning can preserve and even enlarge the debtor's estate.<sup>5</sup>

Beyond the scope of this book are nonuniform provisions under state or common law for judicial receivership proceedings and specialized provisions of the Bankruptcy Code for municipality, stockbroker, commodities broker, and railroad proceedings.<sup>6</sup>

## RESPONSIBILITIES OF INDEPENDENT ACCOUNTANT

### § 1.13 Responsibilities in General

Independent accountants are aware that their responsibilities to clients often extend beyond merely auditing the books and giving an opinion on the financial statements. They frequently give management an opinion on the progress of the business, its future, and avenues of improvement, not only in the system of record keeping, but in the overall management of the enterprise. The intensity of involvement required depends on several factors, including an individual judgment to be made by the accountant.

Independent accountants owe some degree of responsibility to third parties interested in their clients' affairs. This includes the duty to remain independent so that an unbiased opinion can be rendered. The accountant is also relied on to reveal all those facts that might be relevant and important to other persons. This again involves judgment as to the level of disclosure that is appropriate. (See Chapter 8.)

<sup>5</sup> Wiley also publishes *Bankruptcy and Insolvency Taxation*, written by this author and Gilbert D. Bloom. The book covers in more detail the tax aspects of bankruptcy, and is supplemented annually or more often, if needed.

<sup>6</sup> A receiver may be an official appointed by a state court judge to take charge of, preserve, administer, or liquidate property designated by the court. The Commonwealth of Massachusetts specifically confirms the power of its judges to exercise this equitable remedy to appoint liquidating receivers at the request of creditors of dissolved or terminated corporations or of creditors of corporations that have failed to satisfy outstanding judgments against them. See, for example, Mass. Gen. Laws Ann. ch. 156B, §§ 104-05.

The accountant's position and responsibilities as they relate to a client experiencing financial difficulties and to third parties interested in the proceedings will be introduced in the remaining sections of this chapter.

### § 1.14 Observation of Business Decline

The first and most crucial step in any situation involving a business in financial trouble is recognizing that a problem exists. This is important because corrective action should be taken as soon as possible, to halt any further deterioration in the firm's position.

Many people normally maintain close contact with a business—management, employees, lawyers, accountants, customers, competitors, suppliers, owners, and the government, to list only the most obvious ones. Few of these persons, however, would be in a position to recognize when the enterprise is headed for trouble. Normally, this requires someone who intimately works with the financial data and is trained in analyzing such information. Usually, only the financial managers of the business, such as the treasurer and controller, or the independent accountants employed by the firm have these qualifications.

Some independent accountants who conduct only an annual audit and do not maintain close contact with their client throughout the year are often of little assistance in recognizing a potential problem. However, in many small and medium-size businesses, the accountants not only conduct the annual audit but review quarterly and monthly statements and render various types of advisory services. In these situations, the accountants are aware of what has been occurring in the major accounts, and in the firm as a whole and, because of their education and experience in business finances, they should be able to identify when an enterprise is headed for trouble and alert management to their suspicions. Thus, because of the nature of both the type of work they do and the ability they possess, accountants are in an excellent position to identify any tendencies to failure.

As an example, the independent accountants of a New York garment business had served as auditors for the company for many years. The company had been operative through successive generations of the same family for approximately ninety years. As a consequence of changing fashion styles, the company experienced a few consecutive years of operating losses. The accountants noticed that the company was not taking any action to correct the loss trend—the president, in fact, seemed incapable of reversing the situation. Although there was still some working capital and net worth that might have enabled the company to obtain credit and continue in business, the accountants suggested that the following actions be taken:

- Discontinue placing orders for raw materials for the upcoming season, other than to permit completion of orders on hand.
- Start terminating personnel in the areas of design, production, and administration.
- Offer the plant facilities for sale.

- Liquidate inventories in an orderly fashion.
- Meet with creditors to explain the situation.

The accountants' suggestions were followed and the plants were sold, resulting in a settlement with creditors at 87.5¢ on the dollar. The stockholders received payment in full on a mortgage loan they had made to the company. Had the accountants' suggestions not been followed, further substantial operating losses would most probably have been incurred; the creditors would have been fortunate to receive a distribution of 15 percent; and it is doubtful that the mortgage loan would have been paid in full.

To be able to recognize a potential problem, accountants need to have an understanding of the definition of financial failure, the nature of insolvency, and the most common causes of financial difficulties. They must have a familiarity with the characteristics of business decline, which include lower absolute sales and slower growth in sales, poorer cash flow and weak cash position, deteriorating net income, insufficient working capital, large incurrence of debt, and high operating costs and fixed expenses. These symptoms are normally found in the accounting records, and the accountant is most likely to be first to recognize them.

### § 1.15 Responsibility to Client

At the very first suspicion of pending financial trouble, accountants have a duty to alert management to the situation, submit as much supporting information as is possible, describe the various alternatives available to reverse the deterioration, and advise on what avenue should be chosen as a remedy. All these measures are taken to implore the client to begin corrective action before the situation becomes more serious, and the accountant should be concerned with pointing out to the client ways of avoiding insolvency. The responsibility of the independent accountant where fraud is involved is described in Chapter 12.

Should the situation become serious enough to warrant some type of remedy outside the usual business corrective measures, the accountant must make a thorough analysis to determine the most appropriate action to be taken (Chapter 2). This involves an investigation into the causes of financial difficulty and steps that will correct the trouble. The accountant must therefore be familiar with the various alternatives available and when they are most appropriate. This involvement by the accountant should aid the debtor in adopting the rehabilitation procedure most likely to be successful.

It is also the accountant's responsibility to know the procedures required under each alternative remedy. In an out-of-court settlement, this involves awareness of the methods that have proven successful in particular situations. For example, in an informal composition, the accountant should know when it is best to have all creditors meet and under what circumstances only a representative group is more advisable. When formal proceedings are initiated, it is imperative that the accountant know what information is required on the bankruptcy court petition and what schedules must be filed. Otherwise, it would not be possible to converse with the debtor's attorney, a failure that could conceivably delay the settlement and cause further deterioration in the client's position.

## § 1.17 Other Steps to “Manage” the Proceedings

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Timing is crucial in a situation involving insolvency. Should the accountant fail to alert the debtor to the situation and urge some action, the creditors might move first and attempt legally to seize the assets. Speed is then important if the debtor wishes to file a chapter 11 petition and remain in possession of the business.

## § 1.16 Advice on Selection of Attorneys

One of the first steps of a debtor faced with financial difficulties is the employment of legal counsel. When a company realizes that it will be unable to continue profitable operations or pay liabilities as they become due, it should quickly seek a lawyer to help effect a compromise or an extension of the indebtedness. Because the independent accountant is often the first professional the client contacts concerning financial difficulties, the accountant is frequently asked for advice as to the selection of a special bankruptcy attorney.

There are many advantages to the accountant’s involvement at this point. Frequently, accountants are aware of those attorneys most familiar with bankruptcy and insolvency cases, and can recommend someone with adequate experience and knowledge. By suggesting a lawyer of known reputation, the accountant and the debtor’s creditors are assured of working with someone in whom full confidence can be placed. It is imperative that the accountant and attorney be able to work well together. The accountant should be present at the meetings with the debtor and provide the counsel with an overall view of the debtor’s financial condition and the events that preceded it, including the basic facts and information about the business, its history, and the causes of its present difficulties.

Because they are most familiar with the attorneys best qualified in this field and will be required to work with the lawyer chosen by the debtor, accountants have good reason to be involved in the selection process. However, the situation may give rise to questions concerning an accountant’s independence. If an attorney is recommended more on the basis of friendship with the person than on qualifications, the accountant is not being fair to the client. The accountant must be very careful not to have a vested interest in any attorney suggested. Disregarding this situation, the accountant is a logical person for the debtor to turn to for help in choosing legal counsel.

## § 1.17 Other Steps to “Manage” the Proceedings

Accountants are often intimately involved in every aspect of a bankruptcy or insolvency case. They may “manage” the case from the initial discovery of financial trouble, suggesting the best remedy to seek, advising regarding any necessary alterations or modifications of the plan chosen, and monitoring the operations of the debtor by reviewing the operating results during the proceedings. They maintain close contact with the creditors, working with their committee in an effort to find the most advantageous settlement for them. They then provide all the financial information concerning the debtor’s progress and make sure all interested parties are aware of what is occurring. Accountants can help determine the going concern value of the business. This value is then

used to determine the amount of debt that the entity emerging from bankruptcy can service and also help the interested parties agree on the terms of a plan. Accountants representing the creditors may also be involved in helping the creditors determine the value of the debtor's business. If all parties involved can reach an agreement about the value of the business, the first major step toward agreeing on the terms of the plan has been accomplished. Possibly more than any other outside party, the accountant is responsible for the smooth and successful rehabilitation of the debtor. This is primarily because of a close involvement with all the interested parties, including the debtor, creditors, attorney, trustee, and governmental agencies.

## **PROFESSIONAL CERTIFICATION**

### **§ 1.18 Certified Insolvency and Restructuring Advisors (CIRA)**

The Association of Insolvency and Restructuring Advisors (AIRA) has developed an educational program covering an appropriate common body of knowledge designed specifically for those who specialize in the area of bankruptcy and troubled business. This educational program covers a wide range of subjects, preparatory to a written examination. Completion of the course of study and passing of the examination, in combination with a comprehensive experience requirement, will lead to certification by the AIRA as a Certified Insolvency and Restructuring Advisors (CIRA).

#### **(a) Purpose**

The purpose of the CIRA program is to recognize by public awareness and by certification those individuals who possess a high degree of specialized, professional expertise in the area of business bankruptcy and insolvency. Such experience includes accounting, taxation, law, finance, and management issues related to business bankruptcy and reorganization.

In addition, the CIRA Certification will:

- Provide a special recognition standard for the public, the bankruptcy court system, governmental agencies, and other professionals.
- Differentiate certified specialists from those persons who do not possess the required experience, education, and technical skills.
- Serve as a credential to support the qualifications of those who possess this special certification.
- Promote a higher degree of specialized skills.

#### **(b) Requirements for Certification**

To be eligible to enroll in the course of study and take the examination, the candidate must:

- Be a regular member in good standing in the AIRA.

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- Satisfy one of the following requirements:
  - Be a continued license holder as a Certified Public Accountant, Chartered Accountant (or equivalent license), or Certified Management Accountant.
  - Possess (at least) a bachelor's degree from an accredited college or university and complete four years of accounting or financial experience.<sup>7</sup>

To obtain the certification, the following three requirements must be satisfied:

- 1 Complete five years of accounting experience, or financial experience.<sup>8</sup>
- 2 Complete 4,000 hours, within the previous eight (8) years, of specialized insolvency and reorganization experience.
- 3 Complete the course of study and pass the uniform written examination.

**(c) Course of Study**

The course of study is divided into three parts:

- 1 Managing turnaround and bankruptcy cases
- 2 Plan development
- 3 Accounting, financial reporting, and taxes

Each part consists of a 2½-day course and a 3-hour examination taken during the last half-day of attendance.

Additional information about the CIRA program can be obtained by contacting the Association of Insolvency and Restructuring Advisors, 132 W. Main Street, Suite 200, Medford, OR, 97501, (541)858-1665.

<sup>7</sup> Relevant experience includes public accounting, crisis management, consulting, investment banking, credit management, loan workout or applicable government experience (e.g. financial analyst with Office of the U.S. Trustee, Pension Benefit Guarantee Corporation, FBI and SBA, etc.).

<sup>8</sup> See note 7.

