06 - BK - 050

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02/15/2007 04:23 PM

To Gale Mitchell/DCA/AO/USCOURTS@USCOURTS, Jennifer Noell/DCA/AO/USCOURTS@USCOURTS

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Subject Fw: Comments - Committee on Rules of Practice and Procedure of the Judicial Conference of the United States

BK comment

----- Forwarded by James Ishida/DCA/AO/USCOURTS on 02/15/2007 04:22 PM -----

"Winters, Steve" <swinters@aicpa.org>

02/15/2007 04:19 PM

To <Rules_Comments@ao.uscourts.gov>

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Subject Comments - Committee on Rules of Practice and Procedure of the Judicial Conference of the United States

Secretary Peter G. McCabe:

Please find the attached comment letter to the Committee on Rules of Practice and Procedure of the Judicial Conference of the United States, submitted on behalf of the Consulting Services Executive Committee of the American Institute of Certified Public Accountants. A copy of this submission has also been sent via U.S. Postal Service.

Regards,

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LTR-P McCabe Rules of Practice Procedure Committee 02-15-07.doc

February 15, 2007

Peter G. McCabe, Secretary
Committee on Rules of Practice and Procedure
of the Judicial Conference of the United States
Thurgood Marshall Federal Judiciary Building
Washington, D.C. 20544

RE: Proposed Reporting Requirements under Public Law 109-8

Members of the Committee:

On behalf of the American Institute of Certified Public Accountants ("AICPA") Consulting Services Executive Committee, we appreciate the opportunity to comment on two proposed forms under Public Law 109-8 dealing with (1) the Small Business Monthly Operating Report (Official Form 25C) and (2) the Periodic Report Regarding Value, Operations and the Profitability of Entities in Which the Estate Holds a Substantial or Controlling Interest (Official Form 26).

Members of the AICPA regularly assist small businesses and debtors with the preparation of such forms, and, accordingly, believe that the AICPA may be able to provide the Rules Committee with useful suggestions regarding the information included in the forms and the related instructions.

Small Business Monthly Operating Report (Official Form 25C)

We understand the purpose of the Small Business Monthly Operating Report to provide an easy-to-read financial statement summary of an entity.

We offer the following general recommendations with respect to the Small Business Monthly Operating Report:

- The taxes section appears to be too general. We recommend that each delinquent tax form, the estimated unpaid taxes due, the initial and extended (if any) due dates, as well as the explanation of when the form will be disclosed;
- We recommend that the list of payables and receivables should, at a minimum, provide the detail as of the end of the month and in a separate column the end of the prior month with a summary for each date appearing on the form to allow for easy computation of changes in payables and receivables;
- We recommend that additional disclosure be provided for accrued and unpaid expenses. Major accruals are usually payroll and rent, while payroll would be covered under question three on page one, there is no item on the form covering rent or real estate or other significant leases;

- We recommend that additional disclosures be provided for inventory, which could be a major asset of the estate. In addition, consideration should be given to increased disclosures of real estate holdings (year purchased, cost and depreciation).

Periodic Report Regarding Value, Operations and Profitability (Form 26)

We understand the purpose of the Periodic Report regarding value, operations and profitability to provide the users of the form and insight as to the underlying value of those entities in which an estate holds a substantial or controlling interest and, thus, should assist the user with an understanding as to the underlying value and profits of an affiliated entity. The report itself is broken down into three exhibits containing a valuation estimate for the entity, financial statements, including a balance sheet, statement of income or loss, statement of cash flows, and a statement of changes in shareholder's or partner's equity, and a description of the entity's business operations.

Substantial or Controlling Interest

We understand that "substantial or controlling interest" has been defined as a 20% interest. The Financial Accounting Standards Board is the primary organization that establishes Generally Accepted Accounting Principles ("GAAP"), the basis upon which most entities in the United States report on their financial position and results of operations. GAAP has several criteria that establish what constitutes a "substantial or controlling interest" which may cause conflict between the pre- and post-bankruptcy reporting of an entity; thus an estate may report an interest in an entity pre-bankruptcy consistent with GAAP that it will report their interest in an entity post-bankruptcy consistent with the proposed rule.

GAAP establishes several different criteria to determine whether an entity has a "substantial or controlling interest" for reporting purposes, and we believe the Committee would benefit from understanding the different criteria that may be used by the entity for reporting purposes as the pre- and post-bankruptcy filing of an estate may differ significantly. Thus, an entity that may not be consolidated for financial statement purposes pre-bankruptcy (i.e., less than a 50% controlling interest) may now be subject to an increased reporting and disclosure post-bankruptcy to comply with the new reporting provisions envisioned under Form 26.

To provide the Committee with some understanding as to the varying concepts and principles that are applied for financial reporting purposes pre-bankruptcy, we offer the following information:

General Consolidation Criteria

"An entity presents consolidated financial statements of two or more entities when one of the enterprises in the group directly or indirectly has a controlling financial interest in the other enterprises. The usual condition for a controlling financial interest is ownership of a majority voting interest and, therefore, as a general rule, ownership by one enterprise, directly or indirectly, of over 50% of the outstanding voter shares of another enterprise is a condition pointing toward consolidation." (SFAS C51.102)

A controlling interest, therefore, for financial reporting purposes under GAAP is 50% or more.

Consolidation Criteria for Variable Interest Entities

Additional guidance also exists with respect to consolidation by enterprises that have an interest in a variable interest entity. A variable interest entity has one or more of the following characteristics:

1. The equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support provided by any parties, including the equity holders;
2. Equity holders lack one or more of the following essential characteristics of a controlling financial interest:
    a. The direct or indirect ability to make decisions about the entity's activities through voting rights or similar rights;
    b. The obligation to absorb the expected losses of the entity;
    c. The right to receive the expected residual returns of the entity;
3. The equity investors have voting rights that are not proportionate to their economic interest in the activities of the entity involved or are conducted on behalf of an investor with a disproportionately small voting interest. (SFAS C54 Summary)

Therefore, under GAAP companies are required to evaluate the underlying relationship of variable interest entity to determine whether they hold a substantial or controlling interest. The bright line definition of 50%, as defined in accounting literature, is also subject to other qualitative and quantitative analysis for consolidation purposes.

Investments: Debt and Securities

Another provision of GAAP should also be considered by the committee. GAAP, as discussed above, provide that, where there is more than 50% ownership of an entity, the entity should be consolidated. In those instances where a 20% to 50% ownership, or the entity maintains a significant influence, the equity method of accounting, which requires the inclusion of the pro-rata profits and losses of the interest (as opposed to the cost basis method of accounting), should be used for the related entity. In those instances where there is less than a 20% interest, two sets of rules apply depending upon whether the investment consists of securities or non-securities. If the investments are non-publicly traded securities, such as closely held stock, convertible debt, or redeemable preferred stock, the investments are recorded at cost. The investments are adjusted to the lower cost or market only if there is a significant loss and that loss is other than temporary.

If the investment is in the form of a security (i.e., traded on a public exchange), GAAP places investments and securities into three categories and has separate rules for each category.

1. Debt Securities that the enterprise has the positive intent and ability to hold to maturity are classified as "Held to Maturity Securities" and reported at amortized cost.
2. Debt and Equity Securities that are bought and held principally for sale in the near future are classified as "Trading Securities" and reported at fair value with unrealized gains and losses included in earnings.
3. Debt and Equity Securities not classified as either "Held to Maturity Securities" or "Trading Securities" are classified as "Available – For Sale Securities" and are reported at fair value with unrealized gains and losses excluded from earnings and reported in other comprehensive income. (SFAS I 80)

Therefore, it is possible that an entity that holds less than 20% in a security may report the investment at fair market value.

Other GAAP Pronouncements of Interest

The Committee should also be aware that there are two other pronouncements developed by the Emerging Issues Task Force ("EITF") of the Financial Accounting Standards Board that may have an impact on pre-bankruptcy filing financial reporting. The first EITF pronouncement is EITF Issue 02-14, which deals with whether an investor should apply the equity method of accounting in investments other than common stock and provides that the equity method should be used if two criteria are met: (1) an investor has the ability to exercise significant influence over the operating and financial policies of the investee, and, (2) the investment is either (a) common stock, and/or (b) in substance common stock.

Another pronouncement of the EITF Issue is 03-16, Accounting for Investments in Limited Liability Companies, which provides that an investment of 5% or less in an LLC is accounted for at cost, a 6% to 50% investment in an LLC is accounted for using the equity method, and a greater than a 50% investment in an LLC is consolidated.

Conclusion

While the proposed rule presumes that a substantial or controlling interest is 20%, GAAP provides for a multiple of accounting methods and criteria that may cause pre- and post-bankruptcy financial statements to be dramatically different.

Exhibit A – Valuation Estimate

The Committee has recommended that as part of Official Form 26, a valuation estimate should be provided for the estate's interest in an entity that includes a description of the basis for the valuation, the date of the valuation and the valuation method used. In addition, the valuation must be no more than two years old. We believe the Committee appreciates that there are many factors of the valuation process, depending upon the definition of valuation, as well as the valuation approach and methods, to determine the value. We believe the Committee would benefit from an understanding of the definition of the valuation, the valuation approaches and methods that are used to value an enterprise. Those two elements are described below.

Definition of the Valuation

Among the factors that should be addressed in a valuation are:

Property Valued

The valuation includes a description of the business interest or assets, the type and structure of the business, control or minority interests to be valued, and the degree of marketability (liquidity) of the interest to be valued.

Valuation Date

A valuation is like a balance sheet in that it is prepared as of a specific date; the typical valuation report should indicate the date of valuation.

Purpose of the Appraisal

Valuations are used for multiple purposes, including estate and gift taxes, mergers and acquisitions, divorce, dissenting shareholder or shareholder oppression suits, bankruptcy, litigation, employee stock option plans, and buy-sell agreements. Valuations done for one purpose are often inappropriate if used for a different purpose.

Intended Use

Most valuation reports are valid only as of the valuation date and for stated purposes that are specified. Valuations are frequently restricted as to other uses and users.

Premise of Value

The valuation report should include a statement of the assumption regarding the most likely set of transactional circumstances that may be applicable to the subject of the valuation, including:

- Going concern value;
- Assembled group of assets value;
- Orderly liquidation value;
- Forced liquidation value.

Standard of Value

Finally, the valuation report should identify the type of value being assessed. Among the more common ones are:

- Fair market value;
- Investment value;
- Intrinsic value;

- Fair value.

Valuation approaches and methods to determine enterprise value

Generally, valuations employ three basic approaches to determine the enterprise value, including (1) an income approach, (2) a market approach, and (3) cost or asset approach. The valuation analyst will normally consider the need to provide for discounts and premiums, depending on control or lack of control over the enterprise, or marketability or lack of marketability adjustments.

Conclusion

Given the above short description of both the definition of valuation, as well as the various valuation approaches and methods that can be used to determine a value, it is important that the users of these valuation reports take into consideration the wide diversity and scope of valuation services.

Exhibit B – Financial Statements

The financial statements contemplated under Exhibit B are the generally recognized financial statements for an entity. We recognize that the proposed Rule 2015.3 would allow parties to rebut the presumption that a 20% interest is "substantial or controlling." The court could modify the reporting requirements if the financial information is unavailable; however, we have several observations with respect to the contents of those financial statements:

- A 20% or more interest in an entity may or may not be controlling. If it is not controlling, the shareholder would be a minority shareholder and may have limited rights to information of the entity's affairs.
- While a shareholder may be entitled to financial statements of the company in which it owns a minority interest, the minority shareholder may not be able to dictate the timing of financial statement issuance.
- Valuations of a minority interest may need to be done based upon the financial information that the minority shareholder is able to obtain as the subject company may not be required to obtain valuations or provide them to shareholders.
- The company in question may not be willing to provide additional information to assist in the valuation of the minority shareholder's interest. For example, if the company in question owns intellectual property, real estate interests, investments in other entities, and other appreciable assets, it may be difficult to obtain the market values for such assets unless state law gives the shareholder rights to

- information facilitating a valuation of such assets. It may be necessary to understand minority shareholder rights under state law to ascertain the feasibility of this provision to minority shareholders that do not have effective control of the subject entity.
- Some entities could be foreign businesses, organized under the laws of a foreign country using international or other accounting standards. In such cases, it may make sense to merely require the basis of accounting to be disclosed in the footnotes.
- Some small businesses keep their books on the cash basis; should there be an exception to GAAP for businesses with liabilities or assets under some threshold amount?

Exhibit C – Description of Operations

While most of the requested information contained in Exhibit C seems reasonable in light of the current disclosure requirements for public companies, we recognize that the proposed Rule 2015.3(e) will allow for protective orders to safeguard potential proprietary information from being disclosed.

CPA Reporting Issues

The Committee should be aware that the AICPA has provided guidance on the reporting on operating statements; generally CPAs who assist in the preparation of bankruptcy forms, such as the proposed Form 25C and Form 26 do not require a report (i.e., an audit, review, or compilation report). The current professional guidance indicates that reporting obligations exist only when the CPA:

- Submits financial statements of an entity that are either the representation of management or owners to others who, under the rules of the proceedings, do not have the opportunity to analyze or challenge the accountant's work, or
- Is specifically engaged to submit in accordance with professional standards financial statements that are the representation of management or owners.

Therefore, CPAs who may be involved in the preparation of operating reports may not necessarily report in the traditional sense on those operating reports.

CPA Guidance Being Developed

In the past, the AICPA has prepared two Practice Aids for those CPAs that are involved in providing bankruptcy valuation services:

- Providing bankruptcy and reorganization services (Consulting Services Practice Aid 98-1), and
- Business Valuation and Bankruptcy (Consulting Services Practice Aid 02-1).

Both of the above Practice Aids are in the process of being revised to incorporate the provisions of Public Law 109-8 and will be issued in early 2007. Such information may be of assistance and provide guidance to those professionals who provide services in a bankruptcy forum.

We thank you for the opportunity to comment and provide our observations with respect to the proposals for increased and enhanced reporting consistent with Public Law 109-8.

Respectfully submitted,

AICPA Consulting Services Executive Committee

Submitted via email and U.S. Postal Service