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INTRODUCTION TO THE

MONTHLY OPERATING REPORT

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BACKGROUND

The enactment of the Bankruptcy Reform Act of 1978 heralded sweeping changes in the statutory framework governing the administration of bankruptcy cases in the United States. The years since have witnessed a continuing series of legislative enactments and rules amendments designed to further refine and modify the legal requirements governing this important area. With this focus on statutes and rules, however, it is easy to lose sight of the simple fact that a bankruptcy filing is most often precipitated by financial rather than legal problems. In order to successfully reorganize, a debtor must identify its basic financial problems, ensure adequate cash flow and develop a feasible plan to return to profitability based on realistic financial projections. The monthly operating report forms required by the Office of the United States Trustee

have been designed to assist debtors in achieving these goals. In addition, the reporting forms provide creditors with relevant and detailed information regarding the financial condition of the debtor, whereby facilitating meaningful creditor participation in the reorganization process. Finally, the reporting forms provide the United States Trustee with the critical information necessary to properly perform the statutory oversight and monitoring function.

A significant amount of time and consideration was devoted to devising a format for the monthly operating report that would be appropriate for the majority of businesses. Realizing, however, that it is almost impossible to design a reporting format that would be an exact match for every type of business, a certain degree of flexibility and common sense must be utilized in allowing the debtor to “custom tailor” the forms to his or her particular line of business.

Since the financial reporting requirements in bankruptcy cases differ from the norm, the monthly operating report forms have been designed to highlight several specific areas of concern in a chapter 11 reorganization case. A careful review was made of the American Institute of Certified Public Accountants (AICPA) financial reporting requirements (SOP 90-7) and the cash flow statements requirements promulgated by the Financial Accounting Standards Board (FASB 95). While the precise format recommended by each of these groups was not utilized, elements from each were incorporated in the monthly operating reports.

The monthly operating report forms package includes a balance sheet, an income statement, a cash flow statement, and various supporting schedules that provide additional financial information that highlights specific areas of concern in a bankruptcy reorganization.

MOR-1, COMPARATIVE BALANCE SHEET

The simplest way to think of the Comparative Balance Sheet (hereafter "Balance Sheet") is as a "still picture" of the assets, liabilities and equity of a business at one precise moment in time. A credit manager utilizes the balance sheet to determine the financial condition of a business. A balance sheet reflects the historical cost of assets for a business. The realizable proceeds from the sale of assets under a liquidation can vary significantly from the balance sheet values. Many assets on the balance sheet are valued at their cost to the business, and this does not necessarily reflect their current fair market values.

The balance sheet is divided into three sections. The first lists all the assets owned by the business, the second section

shows all the liabilities owed and the final section shows the owner's equity in the business. The total of the assets must equal the sum of the liabilities plus the equity. This is often referred to as the balance sheet equation:

Total Assets = Total Liabilities + Total Equity

The asset section of the balance sheet is divided into three categories: current assets, property, plant and equipment and other assets. Current assets consists of cash and other assets that will be converted into cash during one operating cycle or one year. The operating cycle of a business is the basic sequence of producing products, selling those products, collecting accounts receivable and then converting those

accounts back to cash. Assets that are commonly included on the balance sheet as current assets include cash, accounts receivable, inventory and pre-paid expenses.

The second category, property, plant and equipment (fixed assets), is defined by assets that will be used in the operation of the business over a period of years. Assets included in this category are land, buildings, machinery, trucks, office equipment, timber, oil, and gas properties, computers and other assets. For balance sheet purposes, the cost of property, plant and equipment (except land) is spread over the useful life of the asset. The monthly or annual spending of the cost of fixed assets is known as depreciation. The periodic decrease in the value of assets, such

as timber or oil and gas properties, is called depletion. In the property, plant and equipment section, the balance sheet shows the historical cost of the assets minus the accumulated depreciation or accumulated depletion. The remaining value in the asset account is termed the net book value. Net book value bears no relationship to the fair market value of an asset. As a result, the fair market value of an asset may be more or less than the net book value. The net book value simply reflects the amount of cost that has not been carried to the income statement as an expense in the form of depreciation or depletion. The recognition of depreciation and depletion expenses are shown on the Income Statement (MOR-2) under the “other income and expenses” section.

The final section of the asset portion of the balance sheet is designated “other assets.” This is the “catch all” section for reporting assets that do not fit within one of the first two categories. Assets that would commonly be listed in this section include goodwill, covenants not to compete, investments in subsidiaries or partnerships, officer receivables and other miscellaneous items. Certain of these assets are amortized. Amortization is the periodic decrease in value of an intangible asset. Assets such as goodwill and covenants not to compete are considered intangible assets because they typically have no value except to their holder. The costs associated with these assets are spread over several accounting periods. In each accounting period, a portion of the total costs is recognized as an expense in the “other income and expenses” section of the Income Statement

(MOR-2).

Depreciation, depletion and amortization are known as “non-cash expenses.” These three items reflect the periodic reduction in the value of an asset. These are not expenses in the traditional sense, in that the business does not have to write a check to a creditor each month. Nevertheless, a reduction in the value of the assets has occurred and must be recognized for reporting purposes. In the analysis of the cash flow for a period, these three non-cash expenses (which are recognized as expenses on the Income Statement) are added back to the net profit figure when determining the amount of cash generated from operations.

In summary, the three sections of the asset side of the balance sheet are current assets, property, plant and equipment and other

assets. Added together, these constitute the total assets of a business.

The next section of the balance sheet relates to the liabilities of the business. Liabilities are the debts owed by the business. Liabilities can also be thought of as the creditors' claims on the assets of the business. The liabilities section of a balance sheet ordinarily lists the debts of a business in two categories: current and long-term.

Current debts are those that must be paid within one year from the date of the financial statement. Long-term debts are financial obligations that are due and payable more than one year from the date of the financial statement.

The traditional breakdown between current and long-term debt has little value when monitoring the progress of a Chapter 11 debtor. The format selected for the monthly operating report requires the grouping of liabilities as pre-petition liabilities and post-petition liabilities. Pre-petition liabilities are defined as any amount owed prior to filing bankruptcy, while post-petition liabilities are debts incurred after filing bankruptcy. Although this method of reporting liabilities is not in accordance with the AICPA's SOP 90-7, it serves the same function and it is believed to be the easiest way for the majority of Chapter 11 debtors to report financial information. This format is also more useful to parties attempting to monitor the debtor's compliance with the requirement of the Bankruptcy Code and the progress toward confirmation.

The final section of the balance sheet is the equity section. There are many terms that are used to refer to this section of the balance sheet. Depending on the type of legal entity with which you are dealing, the equity section might appear as net worth, stockholder's equity or partner's equity. Equity is basically the difference between the value of the total assets and the amount of the total debt owed. It can also be thought of as the owner's claim against the assets of the business.

The equity section of the balance sheet provides a great deal of historical information relating to the operations and capitalization of the business. It reflects the owner's financial investment in the business and serves as a collecting point for the profits and losses from the operation of the business. Investments made by the

owners of a business include purchasing stock or contributing additional paid-in capital. The owners, of course, hope to receive a return on their investment through such vehicles as dividend payments.

Retained earnings are those corporate earnings which have not been distributed to the shareholders as a return on their investment, but instead have been retained by the company to support various corporate objectives. Retained earnings increased when profits are retained and decrease when losses are incurred or profits are distributed. Since the debtor acts as a fiduciary for the benefit of the creditors, the net profit from the continued operation of a business in Chapter 11 should be retained. The equity section should increase each month by the amount of the

net profits shown on the Income Statement or only decrease by the amount of the net loss.

Any report in the equity section (or elsewhere) regarding treasury stock should always be carefully examined. Treasury stock is stock of the corporation that is held by the corporation. It includes shares of stock reacquired by the corporation, as well as authorized but unissued shares. There are many legitimate reasons for a business to reacquire its own stock and hold it. However, especially in the context of a small, privately-held corporation, it is important to have the debtor explain how the value of the shares was determined and when the money was paid to the former holder of the stock.

The equity section of the balance sheet is a very important area to review each month. A simple reconciliation of this section can give the analyst clues regarding trends in the operation of the business. It can also show whether the debtor is retaining all profits. The formula to determine if all profits have been retained is easily applied. Start with the equity figure from the prior month. Then add (or subtract) the net profit (or net loss) for the current month. The total should equal the equity shown for the current month.