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ACCOUNTANTS • CONSULTANTS

# A&A ADVISOR

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## Send Your Accountant Your Proposed Loan Agreement

*By Alex Narcise, Partner*

Having your accountant look at your proposed loan agreement is a good idea. We often find covenants that can't be met that can be negotiated away. (For example, the debt service coverage ratio). Occasionally, loan agreements will ask for accrual basis financial statements. In industries such as real estate, income tax basis financial statements are generally provided. Having the loan provider change the loan agreement to the type of financial statements normally issued by you saves a host of later problems and money. Also in this light, financial covenants need to be fully understood, as it is often the case they are near impossible or expensive to meet. A full understanding of loan provisions beforehand helps both you and the loan provider.

Welcome to our October 2013 edition of the **A&A Advisor**. Our A&A Advisor continues to focus on issues impacting the Commercial, Governmental and Non-Profit Sectors; providing you with insight and guidance on new rules, proposed changes and views of standard setters to assist you in the management of the financial and reporting aspects of your organization. I encourage you to contact us with any comments or questions you may have.

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## Accounting Tips

We would like to share with you our answers to frequently asked questions concerning the accounting treatment for business acquisitions. You should consult with your accountant since facts and circumstances may differ in your potential acquisitions.

### FAQ 1: How do we account for acquisition related cost in a business acquisition?

**Response:** The FASB requires that acquisition related cost should be expensed and should not be capitalized as part of the acquisition with the only exception associated with cost to issue debt and equity securities. Refer to actual guidance below:

As per FASB ASC 958 "Business Combination", 958-10-25-23 Acquisition-related costs are costs the acquirer incurs to effect a business combination. Those costs include finder's fees; advisory, legal, accounting, valuation, and other professional or consulting fees; general administrative costs, including the costs of maintaining an internal acquisitions department; and costs of registering and issuing debt and equity securities. The acquirer shall account for acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received, with one exception. The costs to issue debt or equity securities shall be recognized in accordance with other applicable GAAP.

### FAQ 2: How do we account for earn-outs in a business acquisition?

**Response:** Generally contingency consideration of an acquiree assumed by the acquirer in a business acquisition should be recognized initially at fair value. This is the same for contingency arrangements such as earn-outs that occurs as part of an acquisition. During the initial recording of contingency consideration the company would record a liability at the date of the acquisition with an offset to either an intangible asset such as goodwill or another asset account. You will need to consult with your accountant since there may be instances when recording such contingencies may not be necessary.

Additionally, as noted in FASB 805-30-35, changes resulting from events after the acquisition date, such as meeting an earning target, reaching a specified share price, or reaching a mile stone shall be remeasured to fair value at each reporting date until the contingency is resolved. The changes in fair value shall be recognized in earnings.

**Example of an earn-out calculation:** As part of an acquisition, the buyer and seller agreed to an earn-out provision that requires the buyer to pay the seller $400K per year if revenues for each of those years are greater than $10M. The agreement is for the next five fiscal years. The company on the date of acquisition would need to perform projections and calculate the likelihood of meeting the earn-out requirements. Assume management has determined that they expect to achieve the $10M revenue targets only in years 3, 4 and 5. The company would have an undiscounted liability of $1.2M ($400K for each of years 3, 4 and 5). The company will then use a present value formula to calculate the present value of that liability which in this example would be $1M.

The company would then record at the date of acquisition $1M of intangibles and $1M in liabilities. Assume in year 2 the company realized that it will only meet the $10M revenue target in year five only. The company would adjust the liability in year 2 to reflect the updated liability and would record the adjustment into earnings.

## FAQ 3: Can an asset purchase be considered a business acquisition?

**Response:** That depends if the asset purchase meets the definition of a business. A business per FASB 805-10-55-4 consists of inputs and processes applied to those inputs that have the ability to create outputs. Although businesses usually have outputs, outputs are not required for an integrated set to qualify as a business.

Here are some examples: (assume the purchase agreement indicates that individual A is only buying a store and its assets and not assuming any liabilities)

**Example 1:** Individual A purchased a store from a retail company. Individual A is expecting to enter the same type of industry as the retail company he or she is buying the store from. The store that individual A is buying has employees and he or she will most likely be using the same distributor that the retail company was using. Would you consider this a business acquisition or simply a purchase of assets? Under the FASB guidance, Individual A most likely has purchased a business because he or she would have the inputs which in this case would be the distributor. He or she is also obtaining the employees which would be instrumental for the business process. Finally, once he or she opens the store the store most likely will have a customer base since that store originally serviced the same industry as the buyer is entering into.

Now let's change the facts a little.

**Example 2:** Assume now individual A purchased a store from a retail company. However he or she is planning to enter into a different type of retail industry then the previous retail company. Assume also in this case the store was closed down for years and there were no employees. Additionally, due to the different type of industry individual A is entering into he or she will have a different type of distributor. In this case, there will be a strong indication that individual A is in fact not buying a business instead he or she is buying assets. The reason being, that this store appears not to have inputs and a process as compared to the first example above. Additionally, there will most likely be a different customer base since individual A's plan is to open a retail store in a different industry then the predecessor owner.

## FAQ 4: What is the difference in the accounting between an asset purchase and a business acquisition?

**Response:** As asset purchase is exactly what the name states. It is a purchase of assets and you record the purchase on your financial statements as you do when you purchase your day to day assets except as noted below. In a business acquisition, you are purchasing a business and the accounting for this will be significantly different than an asset purchase. In a business acquisition you would fair value your intangibles, goodwill, record contingency liabilities and etc. These are significant differences. Consult with your accountant.

# Lease Accounting Project Faces an Uncertain Future

As we have discussed, the Financial Accounting Standard Board "FASB" is proposing to modify the leasing standards which would result in companies recording on their balance sheet the assets and liabilities associated with most leases. The only exception would be for operating leases that are 12 months or less. The FASB has issued an exposure draft to the public and is expecting to have a round table discussion on the exposure draft in the upcoming months. However, in late August, the FASB's Investor Advisory Committee declined to support the leasing proposal, stating that the proposal is not an improvement to current accounting. Additionally, the Equipment Leasing and Finance Association are campaigning against this proposal.

This added pressure may influence the FASB decision with respect to capitalizing leases. As of this moment the FASB view is to go ahead with the proposed leasing standards. If anything new develops with respect to the FASB leasing standards we will let you know.

# Odds and Ends from the Government Sector

*By David Gannon, Partner*

## New Jersey Comptroller Requirements

In addition to New Jersey State Statutes and New Jersey Administrative Code, most local governmental units also have specific reporting responsibilities that are required by the New Jersey Comptroller's office. These requirements are often overlooked leaving local governmental units out of compliance. The New Jersey Comptroller's Office requires, in accordance with N.J.S.A 52:15C-10, contracting units must notify the Comptroller's office as early as practicable, but no later than 30 days before advertisement, of any negotiation or solicitation of a contract that may exceed $10 million. Additionally, contracting units must also provide post-award notification for any contract for an amount exceeding $2 million. Notification must be given within 20 days of the award.

Contracting units include: "the principal departments in the Executive branch of the State Government, and any division, board, bureau, office, commission or other instrumentality within or created by such department, any independent State authority, commission, instrumentality and agency, and any State college or university, any county college, and any unit of local government including a county, municipality, board of education and any board, commission, committee, authority or agency, thereof which has administrative jurisdiction over any project or facility, included or operating in whole or in part, within the territorial boundaries of any county, municipality or board of education which exercises functions which are appropriate for the exercise by one or more units of local government, and which has statutory power to make purchases and enter into contracts for the provision or performance of goods or services."

## New Data Collection Form

Auditors and Auditees have not yet been able to submit the federal data collection form for competed 2013 fiscal year federal single audits. The Federal Audit Clearinghouse had announced that the new system would be launched on October 7, 2013 with the final forms being available by late October. The new system and forms are expected to have extensive changes, including:

- A new section of the Data Collection Form that requires additional information about the findings that auditors report, as well as other new information;
- A new Federal Audit Clearinghouse process, user profiles, and password security upgrades;
- New requirements for text searchable, unlocked and unencrypted reporting package submissions and the potential extension of these requirements to auditors' reports.

It is not yet clear how the Federal Government shutdown will impact the release of the new system and final data collection forms.

## FEMA Issues Additional Guidance Regarding Sandy Relief Funds

In response to numerous questions regarding when reimbursement of expenses from FEMA should be reported on the Schedule of Federal Awards, FEMA has provided specific guidance for auditors and auditees to follow. According to the FEMA Office of Chief Counsel, the recording of expenditures on the Schedule of Federal Awards should be based on when the funds are approved. That approval is evidenced on the Award Worksheet. The approval of the Award Worksheet is the triggering event for FEMA to actually obligate the funds to the recipient. As an example, if the expenditures occurred during the 2012 fiscal year, but the Award Worksheet is not approved until the 2013 fiscal year, those expenditures would be reported on the 2013 Schedule of Federal Awards.

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# Hot Off the Press

On October 1, 2013, The Private Company Council (PCC) which was established to ease the accounting for private companies has voted to finalize the accounting for interest rate swaps as well as the accounting for goodwill that resulted from a business combination for private companies.

The interest rate swap proposal by the PCC would allow private companies, other than financial institutions, the option to use a simplified hedge accounting approach. This will allow private companies to account for their interest rate swap and the loan associated with the swap as a separate financial instrument. Additionally private companies in which the swap is the only derivatives would be exempt from certain fair value disclosures.

The goodwill proposal would give a private company that is purchasing another private company an option to amortize goodwill over a period of 10 years or less. Additionally, the proposal will simplify the impairment model for goodwill. This will allow companies to test for impairment only when there is a triggering even.

Before the finalized PCC proposals can be incorporated into U.S. GAAP, the Financial Accounting Standard Board ("FASB") will need to endorse the PCC proposals since the PCC is an advisory body of the FASB.

We will keep you posted on these developments.