

COMMERCIAL LENDING REPORT



YEAR END 2011

After the dust settles

Accounting issues for business combinations

The lowdown on depreciation

Spotting customers ripe for a turnaround

'Tis the season for succession planning

AFTER THE DUST SETTLES

Accounting issues for business combinations

Imagine this scenario: You're a borrower's best friend when the company acquires another business. But after the deal closes, you don't hear from the borrower until next year's financial statements appear on your desk. Suddenly, things look much different than before.

Why borrowers' financial statements often look markedly different following a merger or an acquisition is connected to the accounting rules for business combinations. Here are some points to keep in mind as you review your borrowers' financial statements.

THE BASICS OF PURCHASE PRICE ALLOCATION (PPA)

Accounting Standards Codification (ASC) 805 (formerly Statement of Financial Accounting Standards No. 141R) dictates how borrowers report business combinations under Generally Accepted Accounting Principles (GAAP). In short, these rules require companies to allocate the purchase price paid in a merger or acquisition to all acquired assets and liabilities based on their fair values.

Although this mandate seems straightforward, it's complicated in practice. Consider these factors:

Price. PPAs start by estimating a cash equivalent purchase price. If the buyer pays 100% upfront, the purchase price is already at a cash equivalent value. But if the seller accepts noncash terms — for example, via an earnout, a noncompete agreement or stock in the newly formed entity — the cash equivalent price is less clear and may require a discounted cash flow analysis to bring it to its net present value.

List of assets and liabilities. The buyer's next step is to identify all tangible and intangible assets and liabilities acquired in the business combination. The seller's presale balance sheet will report most tangible assets and liabilities, including inventory, equipment and payables.

But pinpointing intangibles is trickier. ASC 805 provides a list of possible marketing-, customer-, artistic-, contract- and technology-based intangibles to consider. These range from leases and Internet domain names to patents and customer lists.

Intangibles are reported only if they're purchased in a business combination. Because most companies' intangibles are generated internally, lenders rarely encounter them on their borrowers' financial statements.

Fair value. The fair value of each item is quantified, usually with the assistance of a valuation professional. All the assets and liabilities are added to the company's postcombination balance sheet, based on their fair values on the acquisition date. The difference between the sum of these fair values and the purchase price is reported as goodwill.



Goodwill and other indefinite-lived intangibles — brand names, in-process research and development, and so on — aren't amortized for GAAP purposes. Instead GAAP generally requires companies to test goodwill for impairment each year. If a borrower reports an impairment loss, it may mean that the business combination has failed to achieve management's expectations.

STICKING POINTS

A business combination is not only the most significant transaction a private business will ever encounter; it's also among the most unfamiliar and complicated. Here are some areas where a borrower's in-house accounting personnel might need some help:

Earnouts. Earnouts typically extend three to five years beyond the acquisition date and are reported as a liability based on the net present value of expected payments to the seller. It's common in an uncertain market for a portion of the purchase price to be contingent on future performance.

The fair value of an earnout may require adjustment if budget and actual results vary. If the liability

decreases, it signals the business combination hasn't lived up to the buyer's expectations.

Deferred tax assets and liabilities. These show up on the balance sheet when financial statement items — such as depreciation or intangible asset amortization — are treated differently for GAAP and tax purposes. Deferred taxes are a timing difference, not usually a difference in the sum of actual tax payments.

Bargain purchase prices. Today, deals abound for borrowers with excess cash. If the purchase price is *less* than the sum of the fair values of the acquired net assets, the borrower doesn't report negative goodwill but takes a one-time extraordinary gain.

BUSINESS VALUATION EXPERTISE

Business appraisers are essential when borrowers need to develop objective, reliable PPAs. It's common for identifiable intangibles and goodwill to constitute 60%, 70% or even 80% of the purchase price. Although lenders seldom rely on intangibles as collateral, inaccurate PPAs will create accounting headaches in the future. So it's best for borrowers to get it right the first time around. \$

THE LOWDOWN ON DEPRECIATION

Changes in tax rules for depreciation may have unexpected effects on your borrowers' financial statements. If you don't understand their potential impact on property, plant and equipment (PPE) costs and reported profits, your response to borrowers' financials might be off the mark.

WHAT'S CHANGED?

Legislation was signed into law in 2010 that allows small businesses to immediately expense up to \$500,000 of qualified fixed-asset purchases in 2011

under the Section 179 deduction. It's subject to a total purchase limit of \$2 million per taxpayer. Beyond that, the deduction is reduced dollar for dollar.

The two limits are scheduled to drop to \$139,000 and \$560,000, respectively, in 2012. The Sec. 179 deduction can't be used to reduce net taxable income below zero.

Larger companies and those with insufficient taxable income can turn to bonus depreciation, which

has been bumped up to 100% for qualified assets, generally if placed in service through Dec. 31, 2011. Bonus depreciation isn't subject to a spending threshold and can create a taxable loss, but it generally can't be applied to *used* assets.

For 2012, bonus depreciation is scheduled to drop to 50%, though an extension of the full 100% has been proposed. Check with your tax advisor for the latest information.

WHAT'S MOST RELEVANT?

Most relevant to lenders are the effects these deductions will have on some borrowers' financial statements. Compared with the standard Modified Accelerated Cost Recovery System (MACRS) depreciation method, Sec. 179 and bonus depreciation speed up tax deductions on qualified PPE purchases.

These deductions affect companies' balance sheets and income statements. The effects are different for borrowers who provide tax-basis financial statements than for those who use Generally Accepted Accounting Principles (GAAP).

WHAT'S THE BALANCE SHEET EFFECT?

For borrowers that use the same depreciation methods for tax *and* financial statement purposes, there's a large spread between the value of PPE on their balance sheets and the assets' fair market values. If a borrower takes advantage of the expanded Sec. 179



and bonus depreciation deductions, it may be able to write off the entire purchase price of qualifying PPE placed into service in 2011, thus minimizing taxable income.

As a result, the Sec. 179 and bonus depreciation deductions may cause the borrower's PPE — a

LEND TO COMPANIES WITH LEASEHOLD, RESTAURANT OR RETAIL PROPERTIES?

These borrowers may be taking advantage of temporary depreciation-related breaks you should be aware of:

Section 179 expensing. For 2011 (but as of this writing not for 2012), owners of such properties can expense under Sec. 179 up to \$250,000 of qualified leasehold-improvement, restaurant and retail-improvement property.

Bonus depreciation. For 2011 and 2012, qualified leasehold-improvement property is eligible for bonus depreciation.

Accelerated depreciation. For 2011 (but as of this writing not for 2012), accelerated depreciation (a shortened recovery period of 15, rather than 39, years) is available for qualified leasehold-improvement, restaurant and retail-improvement property. This might be beneficial for property in excess of the Sec. 179 expensing limits and ineligible for bonus depreciation.

common source of loan collateral — to appear fully depreciated. But qualifying PPE may continue to provide value for many years based on customary MACRS depreciation schedules.

Borrowers who prepare GAAP financial statements use different depreciation methods for book and tax purposes. This discrepancy will give rise to deferred tax liabilities on the balance sheet. A deferred tax liability tells you that a borrower took a large tax deduction in the current period that it will have to make up in future periods.

HOW IS THE INCOME STATEMENT AFFECTED?

Tax-basis borrowers that take Sec. 179 or bonus depreciation deductions will show lower profits in 2011. In fact, while Sec. 179 can be taken only to the extent that a company has taxable income, bonus depreciation can be used to derive a taxable *loss* for the year. Lenders should know about this tax planning strategy to avoid an automatically negative response when borrowers report a taxable loss due to bonus depreciation deductions.

The one-time hit against earnings from Sec. 179 and bonus depreciation deductions also will cause future income fluctuations. Tax-basis borrowers that use these accelerated depreciation deductions are likely to report higher earnings in future periods, because they won't be able to deduct any depreciation expense for PPE that was already deducted under Sec. 179 or bonus depreciation in 2011.

THE BOTTOM LINE

If a borrower reports lower than expected profits, don't panic — higher than normal depreciation deductions may be the culprit. To find out, review the borrower's depreciation expense on its tax return and financial statements.

Taking advantage of the expanded Sec. 179 and bonus depreciation is savvy tax planning. The less money borrowers pay in taxes, the more cash available for debt service in an uncertain economy. Also, the drop in profits is a temporary artificial accounting consequence that will reverse itself in future periods. \$

SPOTTING CUSTOMERS RIPE FOR A TURNAROUND

As the economy continues to mend — sputtering along the way — commercial lenders must remain ever-vigilant in identifying customers that show signs of financial distress. An ailing customer may be a good candidate for a financial workout, or a “turnaround.”

DETECTING PROBLEMS EARLY

Early detection increases the chances of turning around a financial plight. Many warning signs can foretell bankruptcy filings. Is the customer experiencing cash flow problems? Pay close attention to the statement of cash flows. If a company reports

a trend of negative (or erratic) cash flows from operations, it usually signals problems.

Also watch for businesses that stay afloat by selling off assets (cash flows from investing activities) or by overleveraging themselves (cash flows from financing activities). And take these three steps:

1. Notice missing financials. No news isn't always good news. When financial statements are late, it could be a sign of management apathy, incompetence or denial. Follow up on financial statement status, but don't be surprised if distressed borrowers “forget” to return your calls. They may be keeping

their heads down, hoping to turn things around in the interim.

2. Add up the IOUs. Distressed businesses often fall behind on payments to suppliers and stretch out credit terms. Eventually, disgruntled vendors will demand cash on delivery for shipments — or they'll refuse future shipments until outstanding invoices are paid in full. It may be difficult to repair strained supplier relations. So, it's imperative to catch and remedy payables problems as early as possible.

3. Watch out for employee departures. Employees are the first to know when a company isn't meeting its goals. Financial woes manifest themselves as late paychecks, idle machines and stressful work environments. These negatives may entice workers — especially top performers — to seek greener pastures. As employees leave, morale and productivity often worsen.

THE WORK OF THE TURNAROUND TEAM

Once you've gotten a customer to admit there's a problem, it's time to assemble the turnaround team. You can submit a list of approved turnaround consultants, from which your customer will choose. Usually, the consultant will stay at the customer's site during the turnaround to protect collateral for you.



The customer's first step is to assign a chief restructuring officer (CRO). Independent outside CRO candidates not only offer fresh ideas and experience, but also add credibility to the company's turnaround plan. CRO is a temporary position that leads the rest of management on the road to recovery.

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The CRO's initial charge is to create daily cash budgets. By taking control of cash disbursements, the CRO alleviates the imminent crisis, enabling management to chart an immediate course of action. The turnaround plan may include cost-cutting measures, asset sales and debt restructurings.

SEEING THE BIG PICTURE

Negotiating new, lower or extended credit terms restores liquidity. The CRO may, for example, meet with lenders, suppliers and tax authorities to restructure debt. He or she also must communicate regularly with the management team and frontline employees. A successful turnaround hinges on the buy-in of these stakeholders.

The "big picture" objective of a workout is to give management the requisite knowledge and tools for ongoing success. After liquidity and profitability are restored, the CRO can work with management to tackle strategic issues, such as portfolio management, marketing and staffing.

THE LENDER'S ROLE

As a lender, you can't be part of management decisions during the turnaround, but you can try to ensure that your customer has the tools for a successful turnaround. And, most important, you can isolate issues for your customers — and help them work through them — before a turnaround becomes necessary. \$



BACK TO BASICS

'TIS THE SEASON FOR SUCCESSION PLANNING

Year end is a time of planning for many business owners. Right now, your borrowers are strategizing about ways to grow, minimize tax and budget for the year ahead. An important part of this process is succession planning and preparing the next generation of management for what lies ahead.

You, of course, have a vested interest in your borrowers' successors. After all, how will your borrowers repay their debt if no one is there to take over the reins — or if the next generation is unqualified to run the show?

EXPECT THE UNEXPECTED

Succession planning isn't just for business owners nearing retirement. Many small businesses rely on the skills and knowledge of a few key individuals — or maybe just one "rainmaker." They may be unprepared if something were to unexpectedly happen to a key person.

Ask your borrowers which individuals are expected to eventually take over the business. Then meet with the anticipated successors to gauge their qualifications. Beware of borrowers who expect their children to run the business without providing the requisite on-the-job training.

If a borrower has been gifting business interests to family members, ask whether heirs will take an active role in the business or serve as passive investors, perhaps with a seat on the company's board of directors, after the current owner leaves the business.

INSIST ON INSURANCE

Many borrowers purchase key person insurance to bridge business interruption losses or fund buyouts after an owner's death or disability. If

a borrower has insurance, inquire whether coverage is based on formal metrics — such as projected revenue decline, business value and replacement costs — or merely gut instinct.

For uninsured borrowers, consider revising your loan covenants to require coverage. Key person insurance provides an influx of cash, which can be used to service debt after a key person dies.



EVALUATE BUY-SELL AGREEMENTS

Every company with multiple owners can benefit from a buy-sell agreement. The agreement spells out the terms under which ownership interests will change hands when an owner leaves the business.

Even with an agreement in place, a shareholder dispute could arise if, for example, the agreement hasn't been followed in the past or contains an outdated, oversimplified valuation formula. A valuation professional can review what's currently in place to ensure its adequacy.

DISCUSS SUCCESSION PLANS TODAY

It's never too soon to ask your borrowers about succession planning. If they haven't started the process or put the details in writing, refer them to professionals who can help bridge any gaps and plan for business continuity. \$