embark

Technical accounting subjects to know for an acquisition

Do you remember?

Technical accounting subjects to know for an acquisition

The beads of sweat that trickled down your clammy forehead as you approached the counter of your local fancy-pants coffee bar for the first time? You absolutely craved that caffeinated deliciousness but the staggeringly complicated vocabulary involved was foreboding enough to make you seriously think of just sticking with your regular morning swill.

Of course, that all now seems like a silly and distant memory as you can now mindlessly blurt out your order, no matter how complicated–venti, latte, swirls, a splash of this and dash of that–without even looking up from the hypnotizing glow of your cell phone screen. At Embark, we feel your pain and enjoy those high end, wallet-draining morning rushes as much as the next friendly neighborhood team of accountants.

To that point, the complex world of acquisitions is made even more intimidating by a barrier of stark semantics that can make you feel just as you did standing at the coffee counter, just with higher stakes than a mere cup of morning bliss. However,just as you successfully managed to navigate your way over the harrowing, snow-capped peaks of caffeinated terminology, your friends at Embark are here to guide you through intense vocabulary of the acquisition world.

We promise you it's not nearly as confusing as it might seem

Variable interest entities

Technical accounting subjects to know for an acquisition

Take a trip back in time about a decade or so and try to recall the bleak, decimated wasteland of the financial environment. The once lucrative sub-prime market collapsed through the implosion of extraordinarily complex, endlessly layered debt instruments that created a cascading effect throughout the entire global economy.

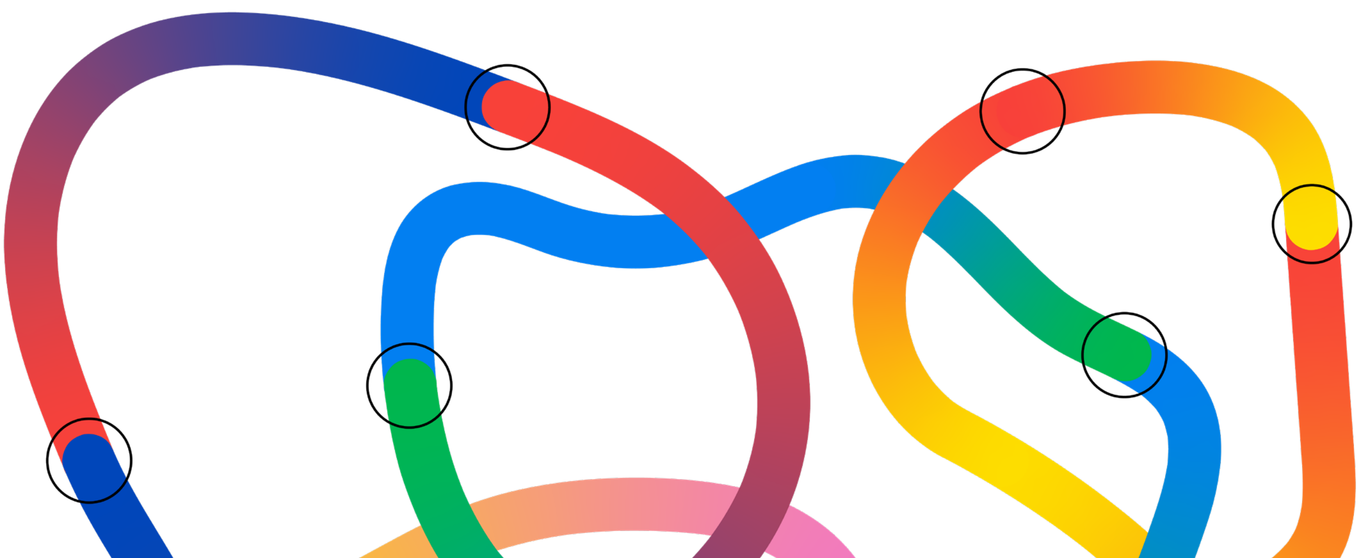
Now fast-forward back to the present day and take another look around at the much improved but still exceedingly cautious financial world. Corporations of all sorts–financial institutions in particular–still crave exposure to the siren song of those sub-prime markets but, due to a number of different factors, are weary of having that particular neon sign glaring on a balance sheet.

This simplified but insightful example demonstrates the ongoing need for variable interest entities–VIE for short. In essence, a VIE creates a necessary level of insulation that protects a company that has a controlling interest in a separate entity but not by holding a majority of voting rights.

Simply put, the controlling party is the primary beneficiary of the VIE and holds most of the variable interests, which typically include revenue streams, costs, or even securing debt for the separate, smaller entity.

As stated in the example, VIEs are common with financial institutions that use them for exposure to the sub-prime mortgage markets. However, the scope of the VIE model is so broad that many other types of entities and arrangements in all industries may be subject to evaluation under the model, including, for example, equity-method investees, franchises, partnerships, joint ventures, and trusts, among others. Determining whether an entity must be consolidated under the VIE model can be highly complex and carries numerous potential pitfalls, and so bears careful consideration.

Equity method investments



Technical accounting subjects to know for an acquisition

In such a complicated financial environment, companies often get heavily intertwined within a variety of other firms simply through their invested financial interests. When this occurs, the equity method is often used to help a company determine any profits earned by those investments within other firms. Income that is generated from those investments is reported on the income statement while the reported value of those investments is reported at fair value (subsequent to the adoption of ASU 2016-01). Any profits reported are always proportional to the size of the equity investment itself.

The equity method has become the standard accounting technique used when one company's invested assets in another are sufficiently large enough–usually 20 to 25% or more of the other company stock–to wield significant influence over that second company's operating and financial policies. That significant influence can take the form of having representation on the company's Board of Directors or being involved in policy development and managerial decisions.

However, like many areas of accounting, the determination of whether the equity method of accounting for a minority investment applies does depend on facts and circumstances, and careful consideration should be made as to whether the investee is a VIE which may require the investor to consolidate.

Noncontrolling interest

Technical accounting subjects to know for an acquisition

When a company acquires enough equity into another company to have a controlling interest but not enough to take total ownership–**something more than 50% but less than 100%**–that left over equity that wasn't acquired is considered a noncontrolling interest and gets reported as such on the parent company's financials.

In other words, although the majority owner essentially controls any decisions made over the subsidiary's operations, it still wields significant power over all of that subsidiary's equity, even the portion they don't directly own. However, since they don't in fact own that left over equity, it's recorded as an NCI rather than directly-owned shares.

Business combination versus asset purchase

Technical accounting subjects to know for an acquisition

Thanks to recent guidance from the FASB via ASU 2017-01, distinguishing between the sale of an asset and disposal of a business is now far less murkier than it was before. Accountants are particularly thankful for this new guidance since it is now easier to decide when a set of assets isn't considered a business. In short, the guidance states that such a set is not a business when the fair value of the gross assets acquired or disposed of is concentrated in either a single asset or group of substantially similar assets.

Furthermore, the guidance also established new requirements for a set of assets to be considered a business. At minimum, there must be both an input–this could include people, IP, or raw materials–as well as a substantive process. Collectively, the input and process can be considered a course of business or operations that results in the creation of outputs. With the new guidance, a buyer's capacity to replace either of those components–inputs or processes–with its own isn't enough to be considered a business. Both must be in place before any sale occurs or, otherwise, the acquired entity cannot be defined as a business but simply assets.

Although the guidance doesn't specifically state that outputs are required for an asset to be considered a business, outputs–of course–are generally considered vital elements of an actual business. Whether they're manufactured goods or services provided, outputs provide some form of return to investors through dividends, lower costs, or other economic benefits.

Further guidance

Technical accounting subjects to know for an acquisition

Since the initial guidance, the FASB has completed the second stage of the project, updating the standards to help businesses clarify how to account for sales and disposals of non-financial assets like real estate. Going forward, the third stage of the project will concentrate on clearing up confusing, overlapping guidance that has previously muddled accounting standards for the acquisitions of assets and businesses.

Furthermore, ongoing research from the FASB will focus on three specific areas of guidance that vary widely for determining assets versus business combinations, including transaction costs, in-process R&D, and contingent consideration–fair value on the date of acquisition in a business combination but recognized when completed in an asset acquisition. Unfortunately, for corporations with a global footprint, such guidance will likely create another instance of divergence between US GAAP standards and international accounting standards.

Once the updated definition of a business is fully in effect–2018 for public companies and 2019 for private ones–more transactions will be treated as asset acquisitions rather than business combinations. From an accounting perspective, the implications of such changes will be significant.

Foreign currency remeasurement versus translations

Technical accounting subjects to know for an acquisition

While foreign currency remeasurement and translation might sound remarkably similar at first glance–at least strictly from appearance–they are actually two vastly different concepts with respect to gains and losses. When a domestic company acquires a foreign entity that transact in a foreign currency, a key first step is to determine the functional currency, or the currency of the primary economic environment, of the foreign entity.

The outcome of this decision point determines the subsequent accounting for transactions denominated in that foreign currency. If the foreign entity's functional currency is the same as the domestic parent's reporting currency, we remeasure foreign currency-denominated account balances and transactions. If the foreign entity's functional currency is different than the domestic parent's reporting currency, we're required to translate the foreign entity's financial statements.

Foreign currency remeasurement results in gains or losses when any given transaction is denominated in a foreign currency in the settlement date occurs after the transaction date. Any fluctuation in the exchange rate of the foreign currency in that gap in time between the transaction and settlement dates–no matter how small–can result in a gain or loss.

When we're required to translate an entity's foreign currency-denominated financial statements for the purpose of consolidation, translation adjustments are reported as a Cumulative Translation Adjustment, a component of other comprehensive income. Accumulated foreign currency translation adjustments only impact net income upon the sale or liquidation of the investment in the foreign entity.

Okay, so we might have exaggerated a bit by saying that some of the technical language behind acquisitions is as simple as ordering a coffee. However, we certainly hope we've been able to clear up a bit of the confusion regarding these concepts and assure you that, no matter what you might still think, you're fully capable of efficiently handling all of them. Scout's honor.

embark

embarkwithus.com