ASK THE EXPERTS WEBINAR

2021 Audit Cycle: Not Quite Back to Normal

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KEY REMINDERS

- Riveron webcasts – past and upcoming – www.riveron.com
- 4 polling questions must be answered to obtain CPE
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- Webinar evaluation form & CPE certificate will be emailed to you
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    - Access to this webinar recording and deck
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Polling Question #1

Is your company anticipating any of the following transactions in the next year?

A. An acquisition
B. A divestiture
C. Going public
D. No anticipated deals

DEAL ACTIVITY

This year's rebounding market has seen increased deal activity

- YTD August 314 Non-SPAC IPOs, 419 SPAC IPOs, and 121 completed deSPACs*
- As of August, 440+ SPACs are searching for a business combination with ~$118b in trust*
- Although companies are still going public through the traditional IPO process, Special Purpose Acquisition Companies ("SPACs") have become a popular vehicle to go public
- A SPAC is a **blank check company** that is listed on a stock exchange with the sole purpose of raising capital and identifying a target company to acquire
- As public companies, SPACs can take targets public without going through the traditional IPO process

Benefits of the SPAC process

- Avoid involvement of underwriters in the going public process
- No marketing roadshows required to generate interest. A shareholder vote demonstrates marketability

Challenges of the SPAC process

- Many targets are nonpublic companies that have not previously contemplated life as a public company

**Source: August 2021 DFIN IPO & Public Listing Report*

CAPITAL MARKETS

There are key areas to consider when taking a target public

TYPE OF BENEFIT	
S-X ACCOUNTING AND DISCLOSURE	All periods presented in an SEC filing must be S-X compliant, which will require additional disclosures
AUDIT PROCEDURES	If the auditor had previously performed procedures under AICPA standards, step-up procedures and additional testing will be required for a PCAOB-compliant audit
QUARTERLY REPORTING	Depending on periods presented, quarterly cutoff procedures will be required for companies that may have only historically performed annual reporting
ACCOUNTING STANDARDS	Depending on qualification as an Emerging Growth Company, the target may need to adopt certain accounting standards on public company timelines. Examples include ASC 842 (Leases) and ASC 326 (CECL)
CROSS-BORDER ACTIVITY	Cross-border activity will require conversion considerations between US GAAP and IFRS
INTERNAL CONTROLS	Although many companies have relief in the first year, a timeline for SOX compliance will be a key to success

TURNOVER AND KEY PERSONNEL

High turnover throughout the year can cause a loss of knowledge among the team and lead to key-person risk

A key person is an individual with uniquely valuable skills or knowledge of a company's history and accounting processes. Key-person risk is the risk associated with losing that person, their institutional knowledge and experience. This is a challenging risk to mitigate.

How to minimize the risk of losing knowledge:
Create desktop procedures to document how to perform key processes
Prepare accounting policies to memorialize the accounting treatment management has adopted and employs
Create a share drive or other centralized location to store all key documents so that they are readily accessible. Include items such as contracts, agreements, financial statements, and audit support provided in prior years

Polling Question #2

Has your team experienced unanticipated turnover or hiring challenges in the past year?

A. Turnover challenges

B. Hiring difficulties

C. Both

D. Neither

PLANNING AHEAD FOR THIS YEAR'S AUDIT

BEGIN AUDIT PROCEDURES DURING INTERIM

- ☑ Reduces staff workload during year end
- ☑ Allows for early detection of issues for correction
- ☑ Audited financial statements can be issued earlier

PREPARE YOUR TEAM FOR YEAR END

- ☑ Deliver trial balances to auditors timely so that materiality and sample sizes can be agreed upon early
- ☑ Review auditor request list and agree upon reasonable delivery dates
- ☑ Reconcile all audit schedules to the trial balance before providing to auditors
- ☑ Prepare technical memorandums in advance of the audit
- ☑ Work closely with specialists to communicate deliverables and obtain updates
- ☑ Ensure transparency with auditors throughout the audit to ensure deadlines can be met

INTERNAL CONTROLS

Many companies are considering a SOX environment for the first time

- Increased capital markets activity over the past year has led many companies to operating in a public company environment in a short timeline
- This has led management teams who have not had to historically prepare PCAOB compliant financials to having to prepare SEC filings that are free from material misstatements
- Although most companies have some immediate relief for full SOX 404 compliance, it is important to start thinking about setting up a controls environment that will set the company up for success in the future
- A baseline analysis of the current controls environment, including identifying any major gaps, such as potential segregation of duties on a small team, will allow the team to identify the major areas to focus on in the near term

TAX – WHAT'S OLD, NEW, AND WHAT TO LOOK OUT FOR...

What stays the same?

- Federal tax rate is 21%, at least for now
- Qualified Improvement Property ("QIP") is eligible for bonus depreciation
- Employee Retention Tax Credit ("ERTC") has been extended through the end of 2021

TAX – WHAT'S OLD, NEW, AND WHAT TO LOOK OUT FOR...

What has changed?

- Net Operating Losses ("NOLs") under the CAREs Act could be carried back 5 years (2019 and 2020 tax years)

- NOL limitation to 80% of taxable income is back in place for 2021 tax years

- Under the CAREs Act, the interest expense limitation was increased to 50% of Earnings Before Interest, Taxes, Depreciation, and Amortization ("EBITDA"). In 2021, the limitation returns to 30% of EBITDA

TAX – WHAT'S OLD, NEW, AND WHAT TO LOOK OUT FOR...

What to look for...

- Beginning in 2022, the interest expense limitation is 30% of Earnings Before Interest and Taxes ("EBIT") instead of EBITDA; potentially reducing the interest expense allowed.

- The Payroll Tax Deferral that was included in the CAREs Act allowed companies to delay paying the employer share of social security taxes incurred in 2020. 50% of those deferred payments are due Dec. 31, 2021 with the remainder due Dec. 31, 2022.

- **PLANNING TIP** – For those taxpayers who have not yet filed their 2020 corporate tax return, paying the deferred payroll tax before filing would allow the deduction to be taken in the 2020 return. For those taxpayers utilizing the 5-year carryback of losses for 2020, this could be a significant benefit.

Polling Question #3

Which tax legislation change has had or do you anticipate having the biggest impact on your company?

A. NOL loss limitation
B. Interest expense limitation
C. Payroll tax deferral
D. A potential tax rate change

DEBT MODIFICATIONS

APPLYING ASC 470

- Borrowers are modifying debt for different reasons – some are struggling yet others want to take advantage of a more favorable rate environment
- The first step in accounting for any debt modification is to determine whether the modification represents a troubled debt restructuring (TDR)
  - TDR: Debtor must be experiencing financial difficulties and lender must have granted a concession
    - If assets or equity are transferred to settle debt, a gain is recognized for the excess of the carrying amount over the fair value of the assets or equity interest
    - If terms are modified, change is accounted for prospectively
    - Undiscounted future cash payments of the new terms < the carrying amount, gain recognized
- When a debt modification does not qualify as a TDR, determine if it is a debt extinguishment
  - An extinguishment occurs when present value of future cash payments is at least 10 percent different than those of the original debt
  - Modifications and extinguishments result in different balance sheet and income statement impact

ENHANCED DISCLOSURE REQUIREMENTS

- Disclosures include the terms of the new debt, whether the old debt was extinguished, and any gains or losses recognized

DEBT VERSUS EQUITY CLASSIFICATION

- Many companies have complex capital structures, which can include multiple classes of shares, preferred shares, convertible notes, warrants, etc.
- An analysis of each instrument to determine the appropriate classification as a liability or as equity will be required
- Currently complex area of US GAAP that FASB is exploring ways to simplify
- Increased time and focus will need to be placed on certain areas:
  - Certain mandatorily redeemable instruments will require companies in the process of going public to consider aspects of ASC 480 for the first time.
  - Third party valuations will likely be required to support the bifurcation of embedded features, such as equity conversion features.
  - Permanent versus mezzanine presentation for certain redeemable equity-classified instruments will also require consideration.
- Audit teams will likely engage specialists and/or national office to ensure appropriate accounting for these instruments.
- The SEC frequently scrutinizes classification and measurement.

BUSINESS COMBINATIONS (ASC 805) CONSIDERATIONS

For acquisitions made during the year, need to have estimate of opening balance sheet items

- If private company, may elect to subsume customer relationships and non-compete agreement intangibles into goodwill
- Auditors often will leverage their valuation specialists in the review process
  - Best practice to engage in dialogue early in the process

Key purchase accounting considerations

ROLLOVER EQUITY	▸ Used as incentive whereby selling shareholders receive shares of acquiring company as part of consideration
	▸ Need to assess fair value of the contributed shares
	  ▸ Consider class of equity
	  ▸ May need a valuation of the acquiring company

EARNOUTS	▸ Used by acquirer's to bridge the gap between their analysis and the seller's
	▸ No uniform structure
	▸ May require the use of complex models
	  ▸ Option pricing
	  ▸ Monte Carlo simulations

IMPAIRMENT

Impairment assessments can be prepared before year-end

- Public companies: Performed annually
- Private companies under ASU 2014-02 test when a triggering event occurs
  - Performing the annual test before year-end can alleviate pressure during the audit cycle

EITHER STANDARD PERMITS A QUALITATIVE OR QUANTITATIVE TEST

QUALITATIVE TEST

Allows management to evaluate relevant items such as macroeconomic conditions, overall performance of the company, and changes in key personnel to assess whether the fair value of a reporting unit is less than it's carrying amount.

- Despite the name, documentation may require quantitative analysis such as comparison of forecast to actuals, assess changes in discount rates and market multiples
- Many companies have relied on this testing approach in recent history

QUANTITATIVE TEST

Determine fair value of reporting units compared to the carrying amount. An impairment loss must be recorded if the fair value is determined to be less than the carrying amount.

- Use typical valuation approaches (income, market, and cost) as appropriate
- Due to the volatility and uncertainty of the current economic environment, many companies will be required to adopt this approach

OTHER ANNUAL CONSIDERATIONS

ANNUAL UPDATES/TESTING

- Indefinite lived intangible assets –ex. trade names, franchise rights
- Equity Awards – if issued new grants or changes/modifications to the plan, likely need an updated analysis
- Earnouts – if multi-year arrangements, will need to update the analysis
  - Depending on the structure, could be complex

LONG-LIVED ASSET IMPAIRMENT

- Triggering event based test as outlined in ASC 360
- Test is comparison of the cash flows of the asset group to its carrying value
  - Need to assess the lowest level of identifiable cash flows to an asset group
  - Not a fair value based test

AREAS OF FOCUS – GOING CONCERN AND RATE REFORM

Going Concern

- Going concern received heightened attention from auditors in 2020. Heightened focus is expected to continue into 2021.
- ASC 205-40 requires a sensitivity analysis to evaluate an entity's ability to continue as a going concern during the look-forward period. This is typically one year after the financial statements were available to be issued.
  - Management must establish a base case, supported by specific assumptions and forecast drivers.

Reference Rate Reform

- ASU 2020-04 was issued in 2020 to assist companies in the transition away from LIBOR and other interbank offered rates to rates such as the Secured Overnight Financing Rate (SOFR).
  - Provides guidance in accounting contract modifications and changes in hedging requirements resulting from the retirement of LIBOR and related reference rate reform.
  - This standard is effective for all entities as of March 12, 2020 and through December 31, 2022.
- LIBOR is expected to be retired at the end of 2021 and all contracts containing LIBOR are required to be completed by June 2023.

UPCOMING AREAS OF FOCUS – LEASES (ASC 842)

Adoption reminder:

- The lease accounting standard (ASC 842) will take effect for private companies in periods beginning after December 15, 2021.

Private company considerations for adoption:

- The lease identification process will require developing an organized, consolidated listing of the company's leases, including all leases that may be embedded in other arrangements, such as service contracts.
- Identifying the population and gathering the agreements can be a very time intensive undertaking, depending on the centralized or decentralized nature of the organization.
- The FASB allows a private company alternative to use a risk-free rate rather than an IBR. This election becomes invalid once a company goes public.

Considerations for those that have already adopted ASC 842:

- Many companies received rent concessions or renegotiated their leases for more favorable terms during the past year.
- Management will need to inventory changes to lease terms across all agreements and consider the accounting impact of those changes.

Polling Question #4

What is your biggest area of concern for this audit cycle?

A. Key person risk
B. Audit coordination
C. Going concern
D. Debt versus equity
E. Taxes

Q&A

ADDITIONAL RESOURCES

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