New Pushdown Accounting Proposal Provides Clarity for Private Equity Firms

On April 28, 2014, the Financial Accounting Standards Board (FASB) released Business Combinations (Topic 805) Pushdown Accounting, a proposed Accounting Standard Update (ASU) that provides guidance on when and how an acquired entity can apply pushdown accounting in its separate financial statements. If adopted, the effective date will be determined after considering feedback on the proposed ASU. Comments are due by July 31, 2014.

Background

Pushdown accounting is the practice of adjusting the standalone financial statements of an acquired entity to reflect the accounting basis of the investor rather than the acquired entity’s historical costs. The “new basis” generally is the fair value of the identifiable assets acquired and liabilities assumed and may also include the recognition of the debt and equity impact of the transaction. If the investor pays an amount in excess of fair value, the target carries the excess on its books as goodwill.

Current U.S. GAAP offers limited guidance for determining when, if ever, pushdown accounting should be applied. The guidance on accounting for business combinations contained in FASB’s Accounting Standards Codification (ASC) Topic 805, Business Combinations, only addresses the accounting by the buyer and not the target. This has led to diversity in practice regarding accounting by the acquiree when it continues to issue separate standalone financial statements. This frequently occurs with private equity groups where the target remains a standalone operating company separate from other investee companies.

SEC Guidance

The Securities and Exchange Commission (SEC) guidance for registrants indicates that if a purchase transaction results in an entity becoming “substantially wholly owned,” its standalone financial statements should be adjusted to reflect the acquirer’s basis of accounting, as noted in the table below:

<table>
<thead>
<tr>
<th>% Ownership</th>
<th>SEC Pushdown Accounting Guidance</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt; 80%</td>
<td>Prohibited</td>
</tr>
<tr>
<td>80% - 94.9%</td>
<td>Optional</td>
</tr>
<tr>
<td>≥ 95%</td>
<td>Required</td>
</tr>
</tbody>
</table>
New Pushdown Accounting Proposal Provides Clarity & Flexibility

The SEC encourages, but does not require, pushdown accounting when a target retains significant outstanding public debt that affects the parent’s ability to control the form of ownership. Qualitative and quantitative factors would be evaluated to determine the significance of outstanding public debt—there are no bright lines. The assessment would be updated as facts and circumstances change—if the public debt were subsequently retired, for example, then pushdown accounting would be required.

The SEC’s pushdown accounting rules apply to public companies reporting under U.S. GAAP. Pushdown accounting is not required for private companies unless their standalone financial statements will be included as part of a public company’s financial statements, e.g., for compliance with the requirement for registrants to provide standalone financial statements for significant acquisitions under Rule 3-05. In addition, certain financial institutions are required by their regulators to apply pushdown accounting in certain circumstances. There is no authoritative guidance on pushdown accounting for non-SEC registrants.

Proposal

The proposed ASU would apply to the separate financial statements of an acquired entity, both public and nonpublic, that is a business or not-for-profit activity when an acquirer or holding company obtains control of the acquired entity or operating company. Entities would have the option at the change-in-control threshold to apply pushdown accounting. The proposal leverages the concept of change-in-control from existing consolidation and business combination guidance for new basis reporting, rather than adopting the SEC’s “substantially wholly owned” concept.

Goodwill

If the investor pays an amount in excess of fair value, the target or operating company would recognize goodwill in its financial statements. FASB believes the goodwill represents the future benefits of a combination, and as such, the benefits are realized by both the acquirer and by any other interest holders in the acquired entity. Therefore, goodwill should be recognized in the separate financial statements of the acquired entity or operating company as well as in the consolidated financial statements of the acquirer or holding company.

In rare circumstances, an acquirer strikes a favorable deal and pays less than the aggregate fair value of purchased net assets. The bargain purchase gain would be attributable to the acquirer and would not be reflected in the acquired entity’s income statement. The standalone financials of the acquired entity would reflect an adjustment to equity.

Acquisition Debt

Any acquisition-related debt incurred by the acquirer or holding company should be recognized in the acquired entity’s separate financial statements only if the acquired entity or operating company is required to recognize a liability for that obligation in accordance with other applicable U.S. GAAP.

This proposal may represent a change from current practice. FASB felt requiring an acquired entity to recognize acquisition-related debt in all situations could provide misleading information to the users of the acquired entity’s separate financial statements. In deliberations, FASB highlighted SEC staff guidance requiring the debt only to be recognized by an acquired entity when certain facts and circumstances are present, such as when (a) the acquired entity assumes the debt either presently or in a planned transaction in the future, (b) the proceeds of the debt or equity offering by the acquired entity will be used to retire all or a part of the acquirer’s debt or (c) the acquired entity guarantees or pledges its assets as collateral for the acquirer’s debt.
Disclosure

If pushdown accounting is elected by an acquired entity for its separate financial statements, the acquired entity would be required to provide financial statement users information to evaluate the effect of the pushdown accounting in the financials. An acquired entity should provide the disclosure required in Topic 805, as applicable.

If the acquired entity elects not to apply pushdown accounting in its separate financial statements, it would disclose in the current reporting period that the entity has done both of the following:

- Undergone a change in control event whereby an acquirer has obtained control of the entity during the reporting period
- Elected to continue to prepare its financial statements using the historical basis existing before the acquirer obtained control of the entity

To comply with the second disclosure provision, an acquired entity would be required to assess at each reporting date whether an acquirer has obtained control of the entity since the last reporting date, even though it may elect not to apply pushdown accounting for such an event.

Transition

An acquired entity would have the option to apply pushdown accounting prospectively to all change-in-control events occurring after the effective date of the final standard. Retrospective application would not be permitted. The guidance should not be treated as a one-time accounting policy election—an entity should separately evaluate the option to apply pushdown accounting at each individual change-in-control event. An acquired entity would make its election based on facts and circumstances and the needs of users based on each change-in-control event.

For further information, contact your BKD advisor.

Contributor

Anne Coughlan
Director
317.383.4000
acoughlan@bkd.com

Matt Daniels
Senior Manager
502.581.0435
mdaniels@bkd.com