PPP LOANS AND ACCOUNTING RELATED ISSUES - FROM BUSINESS COMBINATIONS TO LOAN FORGIVENESS

BDO

BACKGROUND

One of the most highly publicized relief options in the Coronavirus Aid, Relief, and Economic Security (CARES) Act that small businesses and sole proprietors have benefitted from is the Paycheck Protection Program (PPP). The PPP initially authorized $349 billion to be disbursed via federally guaranteed loans administered by the Small Business Administration (SBA). This initial funding was exhausted within the first two weeks of the program. However, on April 27, 2020, the SBA began accepting new applications as the result of an additional $310 billion in appropriated funds.

Generally, eligible borrowers can receive 2.5x their 2019 average monthly payroll costs to help retain workers, maintain payroll and cover certain other existing overhead costs amid the pandemic. As a direct incentive to keep workers employed, all or a portion of the loan may be forgiven if the borrower uses the loan for payroll and select employee benefits, rent, mortgage interest or utilities for an eight-week period after the loan is received. The amount of actual expenses in each category and retention of employees ultimately determines whether the loan will meet the forgiveness criteria[1].

Unforeseen financial and accounting consequences may result should companies fail to perform the following:

- Ensure eligibility under PPP
- Properly calculate eligible loan and forgivable amounts
- Maintain proper documentation, as loan amounts of $2 million or more will be subject to review by the SBA, and loan amounts under $2 million will be reviewed on a sample basis

ACCOUNTING CONSIDERATIONS INVOLVED WITH PPP LOANS

Covenant Compliance Issues with Existing Credit Agreements

Many credit agreements contain restrictions on additional or future borrowings. As a result, receipt of PPP funds, even if ultimately fully forgiven, may trigger a technical default under existing loan agreements. Remedies to the lender may include immediately accelerating the payment of existing loans. Therefore, companies should be proactive and discuss any borrowings expected to be received under the PPP with their current lenders to ensure any necessary modification or waivers are obtained.

In addition, due to the current economic conditions initiated by the COVID-19 pandemic, many companies may also find themselves in default of financial covenants within existing credit arrangements. Similar to other covenant violations, failure to meet financial covenants may result in additional interest being due and / or the immediate acceleration of outstanding borrowings. Even if currently in compliance, companies should refresh budgets and projections to expose any anticipated future violations.

Therefore, companies should discuss with their lenders any borrowings expected to be received under the PPP as well as any current or anticipated debt covenant violations with their lenders to ensure any necessary modifications or waivers are obtained.

1 As of the date of this publication, the House passed legislation that would extend the time period to spend the loan amounts and enhance the forgiveness criteria. The Senate is expected to vote soon on this bi-partisan legislation.

Lastly, modifications of existing debt arrangements which result in a significant change of cash flows in the new arrangement compared to the existing arrangement, will need to be analyzed under Financial Accounting Standards Board ("FASB") ASC Topic 470, *Debt* ("ASC 470") to determine whether the modification should be treated as a troubled debt restructuring, an extinguishment or a modification. While public companies will likely assess the impact of any debt modifications within the current reporting period, many private companies will defer such analysis to year-end. In all cases, we recommend companies perform any needed debt modification analysis timely, as such analyses are often complex and subject to increased scrutiny from the company's independent auditors.

PPP forgiveness – Debt Extinguishment vs. Government Grant

If a company is able fulfill the requirements for loan forgiveness under the PPP, questions have arisen on whether the forgiveness is treated as government grant or as a gain on extinguishment under ASC 470.

Complicating the discussion is the fact that U.S. GAAP does not provide specific accounting guidance to for-profit entities for the classification of government funds received outside of the scope of ASC Topic 606, *Revenue from Contracts with Customers* ("ASC 606"). As a result, there has been diversity in practice with some companies reflecting government grants as another component of revenue while others reflect such funds as a component of other income. Looking for clarity, some companies rely on International Accounting Standards No. 20, *Accounting for Government Grants and Disclosure of Government Assistance* ("IAS 20"). Under IAS 20, companies will need to establish a policy for presentation within its statement of operations, which will likely be presented as a component of other income.

Since the PPP funds are disbursed through legal form debt arrangements, the legal release model under ASC 470 is always acceptable. However, for companies meeting the eligibility criteria under the PPP, grant accounting may be acceptable if the company is able to demonstrate that is it probable (e.g., 75%-80%) that the company will meet the forgiveness requirements under the PPP. Absent meeting the probability threshold, ASC 470 guidance would be applied.

Business Combinations

Questions have arisen about how PPP loans should be treated in business combinations where final resolution of debt forgiveness has not been determined. Under ASC 805, *Business Combinations* ("ASC 805") assets and liabilities are recorded at fair value on the acquisition date. We believe two acceptable views have emerged related to the initial recording of PPP loans and subsequent accounting.

View A
Proponents of View A believe the loan should be recorded at its fair value on the acquisition date without consideration of any potential future forgivable amount. Any subsequent adjustment to the loan as a result of forgiveness by the SBA will be reflected in the statement of operations either as debt extinguishment or government grant as previously discussed.

View B
Alternatively, proponents of View B believe acquirers may consider the initial loan amount recognized as provisional in nature. Under ASC 805, provisional amounts are estimated using the best information available as of the reporting date. As additional information is obtained during the measurement period, these amounts are adjusted through goodwill. Adjustments outside the measurement period are reflected in the statement of operations.

Pending any additional guidance from the FASB or SEC, either approach may be acceptable, depending on individual facts and circumstances.

BDO Insight: While the PPP has provided a potential lifeline during the COVID-19 pandemic, companies may find additional challenges with maintaining compliance with current debt facilities and meeting the stringent requirements under the PPP. Further, the presence of a PPP loan in a business combination may require additional analysis and documentation.

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