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Inclusion of Government Grants in EBITDA

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In response to the COVID-19 epidemic, the U.S. government has provided relief to companies through various grant programs. The receipt of these grant proceeds represents a meaningful lifeline to many companies and the revenue provided by these grants can have a significant impact on their accounting statements (including GAAP and non-GAAP financial calculations). Similarly, such financial determinations may also impact various provisions of these companies' credit facilities, particularly in the private credit space. Revenue calculations are key to determining a company's consolidated net income and EBITDA, which are then used to determine such company's financial covenant compliance and incurrence capacity in its loan facilities. EBITDA is a non-GAAP concept but is based on the GAAP calculation of net incomeand, as a result, lenders will want to be comfortable with the basis of such calculation. Further, lenders will want to ensure any addbacks to EBITDA appropriately tie back to, and are not duplicative of, any net income adjustments, especially as such adjustments relate to any government grants.

In determining how government grants are treated under GAAP, we look to the Financial Accounting Standards Board ("FASB") for guidance. Treatment of grant income generally falls into one of four broad GAAP categories, but of these, our review has found that "contribution" treatment governed by either FASB Accounting Standards Codification ("ASC") Subtopic 958 or its comparable International Financial Reporting Standards ("IFRS") 20 (IAS-20) standard is likely the most applicable and relevant. Other treatments of grant income under GAAP that are less relevant but could be applicable include: (a) contractual or revenue benefits (or similar transactions) that qualify as an "exchange transaction" and are governed by ASC 606, (b) treatment as loans and other financing arrangements that are governed by ASC 470, and (c) income-based tax credits or similar benefits governed by ASC 740. However, for purposes of this article, we will focus on the guidance provided by IAS 20 and ASC 958.

Grant Income Under IAS 20 and ASC 958

As an initial matter, although GAAP provides guidance on how proceeds of government grants are recognized for *non-profit* companies through ASC 958-605, it does not provide specific guidance for revenue recognition of government grant proceeds by *for-profit* companies. In the absence of explicit guidance, companies that have adopted GAAP will generally apply other comparable positions within FASB and GAAP, or lacking guidance there, to external financial standards, including IFRS.

IFRS specifically addresses the treatment of government grant proceeds through IAS-20, and "The Big 4" accounting firms have stated that many companies likely already apply IAS-20.[1] As a result, unless a *for-profit* company historically applied ASC 958 for government grants, IAS-20 will likely be the applicable standard that companies apply for such government grants.

Under IAS-20, a company may recognize income from a government grant when there is "reasonable assurance" that the company will comply with the conditions to the grant and the grant will be awarded. Unfortunately, IAS-20 does not (nor does IFRS) define "reasonable assurances", and as a result, companies will likely look back to FASB and GAAP for further guidance. Given the lack of either directly applicable IFRS or GAAP guidance, the "reasonable assurances" standard is generally considered to be analogous to the "probable" standard provided in ASC 450 (*loss contingencies standard*).[2] As an alternative, ASC 958-695 (*non-profit grant standard*) could be applied, which sets a more demanding threshold permitting grant income to be recognized only when the conditions to receiving the grant have been "substantially" met.[3] These differing standards may not be as significant when accounting for one-off grants, but the "substantially" met standard would likely be difficult to satisfy with respect to grants that require continuing ongoing compliance.

Assuming a company is able to meet the conditions to the grant with “reasonable assurance”, pursuant to IAS-20, the grant income will be allocated on a “systematic and rational basis” over the periods during which the recipient company recognizes the related cost that the grant is designed to address, rather than such grant income being recognized all at once. If the grant relates to the purchase, development or financing of a long-term asset, grant proceeds will be treated as deferred income at the time of recognition, with such deferred income recognized over the useful life of the asset or deducted from the carrying amount of the asset during its useful life. In practice, companies appear to generally recognize such grant as a deduction to carrying amount (i.e., a reduction to depreciation) rather than as an income stream over time.[4] If, however, the grant relates to a non-capital asset, IAS-20 provides that such revenue should be allocated as either a credit to income (either operating or non-operating, as applicable) or as a reduction to the related expense the grant is intended to defray (a “contra-expense” or reimbursement to an expense) when the revenue is recognized.

In contrast, if a company were to apply ASC 958 guidance for income recognition, income would then be recognized when the conditions to satisfy the underlying grant have been “substantially met” or no items of substance are left to satisfy to qualify for the grant. This “substantially met” standard could also be applied under the IAS-20 analysis discussed above as a more conservative standard for interpreting whether the “reasonable assurances” standard for revenue recognition has been satisfied. Further, ASC 958 does not appear to make the distinction between grant proceeds being related to capital assets (i.e., taken over time) or non-capital assets (i.e., deemed received all at once). Instead, the entire amount of the grant proceeds would be immediately recognized upon the “substantially met” standard being satisfied as an addition to gross revenue without the company having the right to elect alternatives to adjust such revenue treatment or allow for multiple standards for when such revenue is recognized. [5]

***Key Takeaway**: Lenders should have a dialogue with borrowers that want to recognize government grant proceeds as income to determine which accounting principle is being adopted and ensure that the applicable standards for such recognition are being satisfied. Assuming the borrower is relying on IAS-20, because it provides companies with flexibility in determining the timing for recognizing and allocating such government grant proceeds as income, lenders should review each company's financial reporting closely to confirm compliance with IAS-20 and such company's historical accounting practices.*

EBITDA Considerations for Grant Income under IAS-20 versus ASC 958

As noted above, IAS-20 allocates grant income based on whether the grant is related to a capital asset versus a non-capital asset and whether the company wants to take such recognition as an increase to income as opposed to a deduction to carrying amount or expenses. These alternatives to revenue treatment can create a concern of "double-counting" of EBITDA addbacks in credit agreements. Many credit agreements have customary EBITDA addbacks that may give non-GAAP credit to certain events (e.g., one-time costs and losses related to equipment or personnel) that the government grants were intended to counteract. If, for example, the company receives a grant that provides compensation for certain one-time costs incurred by the company, and the company recognized the grant as an income credit on their financing statement (rather than as a cost deduction or deduction to carrying amount) that would be included in "net income", the company may then either intentionally or inadvertently also take the benefit of the related EBITDA addback for one-time costs noted above; this results in the company benefiting from recognizing the impact of the grant twice, both as a boost to net income (pre-EBITDA calculation) and as an addback to EBITDA. Though most credit agreements are drafted to prevent this, lenders should ensure such treatment is correctly applied when the company reports its financial calculations and pay particular attention to the basis for net income calculations as well as the EBITDA addbacks.

Unlike IAS-20, ASC 958 recognizes the entire amount of the grant proceeds as additional gross revenue. This has an important implication under a company's credit facility, as the one-time, atypical nature of such revenue could be interpreted as being "unusual" or "non-recurring" revenue or gain. Such "unusual" or "non-recurring" revenue or gain is often deducted or excluded from the calculation of EBITDA under credit facility documents. As a result, the amount of the grant may be subject to exclusion from the company's EBITDA.

Given the strict revenue recognition standard of ASC 958, the lack of flexibility in how revenue is recognized (relative to IAS-20) and the possible exclusion of such income based on how "unusual" or "non-recurring" revenue or gain is treated in most EBITDA definitions, companies will likely continue to opt for IAS-20 treatment until further FASB guidance or GAAP requirements dictate otherwise.

Key Takeaway*: Lenders should be aware that government grants will likely be recognized under IAS-20 and generally flow through net income automatically under the GAAP interpretation of such income, rather than by means of a consolidated net income adjustment or EBITDA addback under the credit agreement. As such, unless a credit agreement explicitly carves out income from CARES Act or other COVID-19-related government support, lenders should pay close attention to a company's financial calculations underlying net income (prior to calculating EBITDA), as well as net income credits and deductions related to EBITDA addbacks associated with any applicable government grant income recognized by the company.*

Conclusion

Due to the variety of ways a company may account for government grants in its financial statements, lenders should closely review all financial reporting information and compliance certificates delivered by companies under their credit facilities. This may be particularly important for healthcare and related companies whose financial results may be more materially affected by various CARES Act grants and other COVID stimulus items relative to companies operating in other industries. Further, given that income treatment for grants affects the calculation of net income (prior to any EBITDA adjustments), lenders may need to utilize their information covenants to obtain additional information and support for a company's net income calculation and compare such calculation against the company's EBITDA calculation (including any addbacks taken in such calculation) to ensure consistent and non-duplicative treatment of any grant income.

At the same time, lenders should be aware that the income treatment of many of these CARES Act and similar government grants are still open for definitive interpretation and there is no current universally agreed accounting treatment for such items. As such, we encourage lenders to engage proactively with companies on their approach to these calculations and address how companies are making these determinations even before financial reports may be due. Finally, many aspects of the above analysis may be clarified or changed in the future as treatment of government grants become more formalized by FASB. Lenders should also keep apprised of such changes and how they may affect financial calculations.

Proskauer's Private Credit Group has been continuously monitoring and evaluating the ever-changing landscape on COVID-19 related matters and how they are affecting financial calculations by company borrowers under credit agreements, including the above discussed income recognition under government grants. We are focused on providing our clients with support and solutions for determining appropriate treatment by companies of governmental grants and other benefits that companies may receive related to COVID-19, including relief under the CARES Act. Clients with questions on these matters should be encouraged to reach out to the various deal teams in the Private Credit Group at Proskauer on such matters, particularly since such matters will likely continue to affect new and ongoing credit agreements and their underlying calculations for the foreseeable future.

[1] See Deloitte, pg. 72; E&Y, pg. 32; Price Waterhouse Coopers – In Depth - Cares Act: Accounting for the Stimulus (No. US 2020-03, April 2, 2020 (updated May 20, 2020)) ("PwC"), pg. 16; KPMG – Hot Topic: Coronavirus – Healthcare entities' accounting for government aid (April 23, 2020), pg. 6.

[2] PwC pg. 17, Deloitte pg. 72.

[3] PwC pg. 17.

[4] PwC, pg. 17.

[5] PwC, pg. 17.

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