

Kevane mailbag

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Our Kevane mailbag is your link to all our communications related to the operations of businesses in Puerto Rico. Our purpose is to offer you up-to-date information concerning tax, accounting and any other matters that might have an impact on the way you conduct business in Puerto Rico.

The Alerts contained in our mailbags can also be accessed through our website under the Publications tab\Professional Articles section or by downloading our business and tax application for mobile, tablets and iPad for free through the App Store and Google Play. We welcome your feedback at kgt@pr.gt.com

Navigate with us...experience the difference!

Audit

The Financial Accounting Standards Board is proposing an update to change the disclosure requirements for income taxes.

 [Read more](#)

Tax

Puerto Rico Governor signed into law the creation of a Specialized Chamber to handle tax affairs and economic crimes.

 [Read more](#)

Advisory

In a M&A negotiation the working capital is often left behind until the end of the deal process. Learn what you should consider before you close the transaction.

 [Read more](#)

Outsourcing

Our team is ready and able to help you from the inception of your business to establishing and running an accounting department.

 [Read more](#)

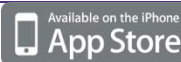
General Information

Please note that our complimentary webcast – Update on PR Tax Incentives will be held on: **Tuesday, September 20, 2016** at 2:00 pm AST. More information will follow during the next weeks.

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Audit Alert: Proposed ASU to enhance income tax disclosure requirements

The Board issued proposed ASU, [*Disclosure Framework – Changes to the Disclosure Requirements for Income Taxes*](#), which is intended to enhance disclosure requirements for income taxes. The proposed ASU would both modify existing disclosure requirements and provide additional required disclosures.

The key provisions of the proposed ASU would:

- replace the term public entity in ASC 740, Income Taxes, with the term public business entity, as defined in the Master Glossary of the ASC.
- require all entities to make (1) additional qualitative disclosures related to tax law changes and changes in assertions about the indefinite reinvestment of foreign earnings, and (2) additional quantitative disclosures of earnings, income tax expense or benefit, and income taxes paid on a disaggregated basis between domestic and foreign sources, along with cash held by foreign subsidiaries.
- require all entities to disclose the description of any legally enforceable agreement with a government that could reduce its tax burden On the Horizon 2.
- require all public business entities to disclose (1) cash settlements separately from deferred tax asset settlements of

uncertain tax positions, (2) the amounts of unrecognized tax benefits and the line items in the balance sheet where they are presented, (3) the amounts and explanations of the valuation allowances recognized and/or released during the period, and (4) the amount of unrecognized tax benefits that offsets deferred tax assets for carry forwards.



- require all public business entities to disclose the tax effected (deferred tax assets) and not tax effected amounts of federal, state, and foreign carry forwards by time period of expiration for each of the five years after the reporting date, as well as a total for any remaining years; all other entities would only be required to



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disclose the not tax effected totals of these amounts, along with their expiration dates.

- eliminate the requirement for all entities to (1) disclose the nature and estimate of the range of the reasonably possible change in the unrecognized tax benefits balance in the next 12 months, and (2) if applicable, state that an estimate of the range cannot be made.
- modify the existing rate reconciliation requirement for public business entities to be consistent with the rules of SEC Regulation S-X.

The Board will determine the effective date and whether the proposed guidance may be early adopted after it considers feedback on the proposed guidance. Entities would be required to adopt the guidance prospectively.

Comments on the proposed guidance are due September 30, 2016.

Source: Grant Thornton, *On the Horizon*, August 4, 2016

We are committed to keep you updated of all developments that may affect the way you do business in Puerto Rico. Please contact us should we may be of further assistance in relation to this or any other matter.

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Tax Alert: Act 123 – Specialized chamber on tax-related matters

Recognizing the need to establish mechanisms to ensure the efficient and uniform implementation of Puerto Rico tax law precepts, and to advance the resolution of tax controversies arising under the Puerto Rico Internal Revenue Code of 2011, as amended, as well as the various tax incentives legislations, the Governor of Puerto Rico signed on August 5, 2016, Act No. 123 (“Act 123-2016”).

Act 123-2016 effectively amends Article 5.005 of the Puerto Rico Judiciary Act (Act No. 201 of August 22, 2003) to allow the creation of the Specialized Chamber on Tax Affairs and Economic Crimes (the “Special Court” or “Court”). With the establishment of this specialized courtroom, the Puerto Rico government strives to provide an adequate forum for the expeditious resolution of tax disputes while carefully considering the merits of each case and ensuring the uniform interpretation of the applicable Tax Law, as well as the handling of economic crimes.

According to Act 123-2016 Statement of Motives, an *economic crime* is any kind of unlawful conduct committed by natural or legal persons, that affect the assets of individuals, the financial system, the Commonwealth of Puerto Rico or the general public. Each of these offenses can be punished by a fine and/or fifteen (15) years in prison.

The amended Article 5.005 states that the Court, which will be situated in the Superior

Court of San Juan, will be directed by judges who are well-versed on matters such as finance, accounting, auditing and tax law, among others.

The Special Court will handle civil tax disputes arising under (i) any state or municipal law that imposes or levies a tax and (ii) any special law that bestows tax exemptions and credits through the issuance of a tax grant.



Also, it will intervene in criminal cases arising from violations to the PR Internal Revenue Code of 2011 [Act No. 1-2011] and special laws that govern complex matters such as (i) the Puerto Rico Banking Law [Act 55-1933], (ii) the Puerto Rico Savings & Loan Cooperatives Act [Act 255-2002], and (iii) the Puerto Rico Securities Act [Act 60-1963], among others, as well as any other matter which the Chief Justice of the Puerto Rico Supreme Court determines that will fall under the Special Court’s purview.

Please contact our Tax Department should additional information is required. We will be glad to assist you.



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For assistance in this matter, please contact us via maria.rivera@pr.gt.com, francisco.luis@pr.gt.com, lina.morales@pr.gt.com or isabel.hernandez@pr.gt.com



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Advisory Alert: Pitfalls of M&A-working capital can hurt sellers

Introduction

Working capital adjustments can cause material value change for buyers and sellers, but they are often not clarified or negotiated until it is fairly late in the deal process. In a typical deal, working capital is only mentioned in the letter of intent (LOI), and the terms are left for the buyer and seller to negotiate prior to close. Working capital sometimes can be complicated and tricky to determine and model. In this article we will explain the basics of the working capital adjustment from the seller's perspective, and discuss some pitfalls and takeaways.

Basics

Many transactions are closed on a cash-free/debt-free basis. In basic terms, this means that the seller keeps all cash (and investments) and pays off all debt (and debt-like items) at the time of the sale. Working capital, on a simplified basis, is often thought of as current assets minus current liabilities, excluding cash and debt-like items. In determining working capital for the purchase agreement, there are often further adjustments for non-business, related-party, tax and other items.

Based on historical working capital analysis that is typically performed during due diligence, a working capital target (or peg) is negotiated between buyer and seller. The peg is often determined based upon triangulation of working capital average levels and projected working capital levels at close. Setting the peg is a negotiated outcome, and practices vary widely. At close, the difference

between the closing working capital and the peg is often a dollar-for-dollar adjustment to the total purchase consideration. As a result, the working capital adjustment can potentially be a significant component of the total consideration transferred between buyer and seller.

A few major considerations in establishing the working capital peg and mechanism are discussed below. There are many other potential considerations, and we recommend that you consult with your transaction service professional, as not all possible scenarios can be covered in a short article.



Revenue recognition: Revenue recognition in certain arrangements can be quite complicated and subject to significant



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professional judgment. Many sellers believe that their accounting policies are in conformance with GAAP because they have audited accounts and/or they have never been challenged on their accounting policies before. In reality, we often find in due diligence that there is some divergence with GAAP even with audited financial accounts. Small differences can cause significant adjustments in working capital. For example, some companies use a bookkeeping convention of recognizing a full month of maintenance revenue in the month for which the contract begins; while consistent application of this bookkeeping may not materially change reported earnings, it may cause a significant increase in the value of deferred revenue when it is trued up at close. Revenue recognition is one of the most common causes of large unexpected adjustment to working capital.

Adjustments: As discussed, a peg is often utilized as part of the working capital mechanism, and there is wide difference in practice on setting and agreeing to the peg. A common approach is to reference the average level of working capital, after certain adjustments, in the most recent 12 months. Twelve months is a popular time frame because it is a relatively recent period, and it reflects a full year of working capital, averaging out many elements of seasonality. A little counterintuitive, but the seller will want a lower peg, as that is the reference amount that is subtracted from the closing working capital balance to determine the working capital adjustment. There are typically adjustments to the average working capital for one-time items that are uncommon, non-operational or nonrecurring in calculating the peg. An example of a typical adjustment to working capital is to exclude related-party balances, debt and tax accounts. The seller should make certain that significant one-time current assets are also adjusted out of the peg, such as non-

recurring prepaid assets, employee receivables and unusually large receivable balance. Seller should also make sure to include in the adjustment any potentially missing accruals such as PTO, commissions, and bonus. It is up to the seller to identify adjustments that are favorable to the seller; these adjustments can decrease the working capital peg significantly. Failure to identify the adjustments will result in an artificially high peg and result in the seller paying the buyer for the difference.

Seasonality: Understanding the seasonality of working capital requires the buyer to complete a fairly granular financial analysis. The seller should not be surprised or alarmed at buyer concern and diligence surrounding working capital seasonality as this is one of the important risk areas for the buyer. Two most common seasonality drivers are customer billings and employee bonuses. For example, if a large percentage of customer renewals / billings occur in the fourth quarter of each year, then any transaction that closes at the beginning of the calendar year will see less cash flow from customers in the near term. Moreover, timing of annual bonuses can be a large cash outflow that the buyer needs to anticipate. For the most part, the risk to the buyer of not understanding seasonality is greater than to the seller. If the buyer does not properly understand seasonality, the buyer may find themselves needing to inject unexpected additional working capital into the business. The seller should be prepared to discuss seasonality and cash flow trends.

Seller takeaways

As shown, the working capital mechanism can result in considerable value transfer, and is subject to risk for both buyer and seller. The seller has considerable exposure with respect to revenue recognition and can mitigate this risk by making sure that its revenue recognition policies are in accordance with

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GAAP. Favorable adjustments to working capital should be identified by the seller.

While not always possible, negotiating the working capital mechanism and peg during the LOI process will reduce seller risk. Moreover, agreeing that past practices for accounting will prevail over GAAP in calculating the closing working capital will help the seller mitigate the risk of a large adjustment. However, to reasonably agree on a working capital mechanism and peg in the LOI will require substantial financial information to be disclosed to the buyer so that the buyer can get comfortable with the peg and seasonality.

Use of a transaction professional can be very helpful to the seller in navigating the working capital process. It is often helpful to a company to obtain a fresh, third party perspective on revenue recognition practices, seasonality analysis, commentary on the purchase agreement, and the final working capital calculation.

Adapted from:
<http://www.grantthornton.com/issues/library/articles/technology/2016/pitfalls-of-software-m-and-a.aspx#sthash.Caopcy31.dpuf>

Call us to make an appointment with one of our experienced advisors. We will be glad to assist you.



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Outsourcing Alert: Are you aware of all the services we can offer you?

While you probably know us as audit, tax and advisory experts, our outsourcing team can provide a full range of services designed to add value to your business, anticipate your needs and exceed your expectations.

Our outsourcing experienced team is capable in helping you from the inception of your business to establishing and running an accounting department.

Following is a list of the outsourcing services provided by the Firm:

- support in the start-up of a business,
- registration with corresponding agencies,
- processing or reviewing of accounting records and periodic financial analysis,
- payroll processing,
- payroll tax returns preparation,
- informative returns preparation,
- supervision of accounting departments and review of compliance with laws and regulations,
- recruiting of financial professionals,
- personnel training,
- preparation of financial statements (monthly, quarterly or annual),
- full outsourcing services, including payment to employees and suppliers, billing, bank reconciliations, payroll and payroll tax deposits, among others.

Our working methodology for outsourcing services will transfer to our professionals the accounting administration of your business, taking your business standards to a new level of quality.

Even though it may seem like an additional cost, outsourcing your accounting duties could actually end up saving you money by freeing your time to do what you do best, running your business.

Our services can be engaged **monthly, quarterly or annually**, however bear in mind that well-prepared financial records are essential and gain significance as your business grows; these provide you with:

- critical information needed to help you manage business, budgeting and financial decisions,
- help track revenues and expenses in order to identify opportunities and inefficiencies,
- aid in better cash flow management by keeping track of receivables due from customers, as well as payments due to suppliers,
- make compliance with Federal and State payroll tax rules more accurate,
- provide potential lenders or investors with a way to evaluate your business.

At Kevane Grant Thornton we provide our clients with personalized attention, valuable advice and recommendations, and tailored solutions. We will help you resolve issues and identify opportunities.



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