

PUBLIC COMPANY

COMPANY

PERSPECTIVES

2
M&As Trickier
with FAS
141R

2
Seminar: SEC
Legal Update,
A&A Update

3
Watch for
Repricing
Warrants and
Options

4
FASB's New
Codification

Fearless Forecasting: 5 Keys to Financial Projections

By Michael S. Blake, CFA

As the calendar year-end approaches, many companies will be applying FASB Statement No. 157, *Fair Value Measurements* ("SFAS 157") for the first time in their impairment tests of goodwill, intangibles, and long-lived assets. In most cases, the income approach will be used.



Michael Blake

Under SFAS 157, management must determine fair value assuming highest and best use on an exit price basis using market data or assumptions of a market participant in the principal or most advantageous market. Market participants are buyers or sellers in the principal or most advantageous market for the asset who are unrelated parties, knowledgeable about the asset being sold, and able and willing to purchase the asset.

In developing and assessing the validity of an income based valuation, it is important to carefully analyze key inputs and assumptions. The following checklist can help detect and correct or prevent weakness in the financial forecast.

1. Revenue and revenue growth. Revenue forecasts are tricky because selling is such an imprecise operation. Some points to consider when validating revenue projections include:

- Are the projections "top down" (we just need 1% of the market in China) or "bottom up" (these operations lead to x-number of leads with x% conversion rate resulting in calculated unit sales). Bottom up projections are far more robust.
- Do revenue forecasts reflect historical revenue growth? If not, is the story behind the change credible?
- Do revenue forecasts reflect market participant assumptions, frequently gleaned from independent forecasts of industry and economic growth? Scrutinize when the revenue growth path is materially different from industry and/or economic forecasts or historical averages.

2. Capital Expenditures and Depreciation. Capital expenditures should be part of a plan for overall growth or maintenance of operating capacity.

- Are forecasted expenditures sufficient to support growth and future operations?
- Are depreciation schedules realistic?

3. Working Capital. Financial projections are most commonly produced on an accrual basis, while valuations are cash driven.

- Have working capital requirements been sufficiently addressed in the

M&As Trickier with FAS 141R

FASB's Statement of Financial Accounting Standards No. 141R (SFAS 141R) became effective for business combinations when the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008.

Some of the most significant changes between the old and the revised standard include:

Business Combination Definition. A business combination is defined more broadly and includes any transaction or event in which an entity takes control of another business. This includes situations where consideration is not exchanged, where the acquirer gains control because minority veto rights lapse, or control is obtained by contract.

Fair Value Accounting on Acquisition Date. All assets and liabilities of the target, as well as non-controlling interests, are recorded at fair value on the date the acquirer gains control; the "acquisition date." In a business acquisition completed in stages ("step acquisition"), all assets, liabilities and non-controlling interests are recorded at fair value on the acquisition date. Under SFAS 141, some assets and

liabilities in a step acquisition were re-recorded at historical cost while others were recorded at fair value.

Transaction Costs. Acquisition related costs, such as legal, investment banking, accounting, valuation and consulting costs which could previously be capitalized must now be expensed as incurred.

Contingent Consideration. Contingent consideration must be estimated at the closing of the transaction. Differences between the contingent consideration estimate and the actual payments are recognized through earnings rather than a purchase price adjustment.

Bargain Purchase. Under 141R, all assets and liabilities are recorded at fair value and any excess credit is recognized as a gain in the period the acquisition occurs and no longer recorded as negative goodwill.

To maximize value from an acquisition, companies should be particularly attentive to the new standard.

As you consider your next M&A transaction, count on HA&W to help. To learn more, contact Marc Welch at (404) 814-4990 or marc.welch@hawcpa.com.

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Charles D. Vaughn, Esq.

Nelson Mullins Riley & Scarborough, LLP, Atlanta, Georgia

Accounting & Auditing Update

Ray G. Stephens, DBA, CPA, CMA

Professor of Accountancy, Ohio University

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8 hours A&A CPE

Watch for Repricing Warrants and Options

EITF 07-5 is effective for 2009 and because it relates to derivatives, it will likely be overlooked by a number of companies. It's easy to think that a company that doesn't have foreign exchange or interest rate hedges doesn't have to worry about SFAS 133 but it can rear its head where it is least expected. The SEC staff pointed out a "sleeper issue" recently that could significantly affect companies with outstanding warrants or options issued to investors.

Some companies have issued warrants or written call options to investors with a "reset" feature. These instruments are typically, but not always, issued in conjunction with the sale of preferred stock or

convertible debt. The reset feature specifies that if the company later sells stock for less than the warrant or option price, the strike price of the option is reset to the lower price realized in the subsequent stock sale. Example 8 in EITF 07-5 makes it clear that such warrants and options are not exempt from SFAS 133 under paragraph 11(a) as contracts indexed to a company's stock. Accordingly, the written call option or warrants must be recorded on the financial statements at fair value at each balance sheet date with the change in fair value recorded in net income. This guidance applies to freestanding instruments as well as options and warrants embedded in debt or equity instruments.

Forecasting continued from page 1

cash flow projections – either by way of providing projected balance sheets or estimating working capital as a function of revenue growth?

- ❑ Have working capital projections and debt-related cash flow been isolated from operational cash flow?

4. Variable vs. Fixed Expenses. Classifying variable expenses as fixed will overstate value if revenue is growing and classifying fixed expenses as variable will understate value.

- ❑ Do variable expenses have the proper relationship to revenue or other factors?
- ❑ Are fixed expenses reflective of inflation and expiration of contracts, such as leases and labor agreements?
- ❑ Are expense ratios consistent with market participant expectations, frequently conveyed by industry benchmarks?
- ❑ Are expense ratios consistent with historical performance? If not, do you believe the "story" behind the change?

5. Discount Rates. Discount rates are notoriously difficult, yet have a profound impact on value. Some questions to ask:

- ❑ Was market participant data used to produce the discount rates?
- ❑ How do discount rates match up against benchmarks such as in the QED Report¹?
- ❑ Have discount rates based on long-term equity return data taken current market conditions into account?

Of course, no two sets of forecasts are exactly the same. However, you don't have to be an expert in financial theory or strategic management to intelligently develop or analyze financial forecasts. By simply ensuring that straightforward questions are addressed at the outset, you will be equipped to produce sound projections that not only satisfy fair value requirements, but will be a helpful tool in the day to day management of your business.

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¹Plummer, J. (1987), *QED Report on Venture Capital Financial Analysis*, Palo Alto, CA, QED Research.

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FASB's New Codification

On July 1, the Financial Accounting Standards Board (FASB) launched the *FASB Accounting Standards Codification*TM as the single source of authoritative nongovernmental U.S. generally accepted accounting principles (GAAP).

The Codification, which comes after years of development, is effective for interim and annual periods ending after September 15, 2009.

While the Codification does not change GAAP, it introduces a new structure that is organized in an easily accessible, user-friendly online research system. The FASB expects that the new system will reduce the amount of time and effort required to research an accounting issue, mitigate the risk of noncompliance with standards through improved usability of the literature, provide accurate information with

real-time updates as new standards are released, and assist the FASB with the research efforts required during the standard-setting process.

The new Codification reorganizes the thousands of U.S. GAAP pronouncements into roughly 90 accounting topics and displays all topics using a consistent structure. It also includes relevant Securities and Exchange Commission (SEC) guidance that follows the same topical structure in separate sections in the Codification.

To prepare constituents for the change, the FASB has provided a number of tools and training resources, which you can find on their website: www.fasb.org and you can view the Codification online at asc.fasb.org.

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