

FAIR VALUE CHALLENGES

COMPLEX FINANCIAL INSTRUMENTS



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CHALLENGES YOU ENCOUNTER

Increasing regulation requires companies to perform thorough and objective valuation analyses for various tax and financial reporting purposes. Companies are subject to an ever growing number of fair value related regulatory requirements, including new guidance for treating contingent consideration and liabilities under purchase accounting, as well as existing guidance on share-based compensation, debt impairment, derivatives and convertible instruments, guarantees, and complex capital structures.

Companies are being required to perform complex financial analyses involving sophisticated quantitative modeling techniques. To comply with these ever increasing regulations, companies must be confident in their understanding of accounting guidance and tax regulations and have dependable resources at their disposal to perform supportable and rigorous quantitative financial analysis. Maintaining compliance can result in dedicating your critical personnel time and resources away from the key functions of operational and strategic management.

OUR SOLUTION

Valuation professionals can play a crucial role in helping companies meet the highly technical and evolving standards required by regulators. BDO Valuation Advisors, LLC has in-depth experience in working with companies to meet their valuation needs, regardless of the complexities. Our experience, along with our knowledge of accounting, auditing requirements and tax regulations, makes us well-positioned to address the needs of public and private companies. Additionally, as an affiliated company of BDO, the fifth largest accountancy and consulting network in the world, our professionals have extensive experience working with auditors and regulators, bolstering our understanding of the importance of strict compliance with reporting deadlines.

ASC 805 – Business Combinations – Contingent Consideration Provision

Accounting Standards Codification (“ASC”) 805 - Business Combinations (formerly FASB Statement of Financial Accounting Standards (“SFAS”) 141, revised 2007), revises numerous financial reporting requirements stemming from business combinations, such as mergers or acquisitions, and may have implications on how transactions are structured. One such revision is the requirement to recognize contingent consideration at fair value on the acquisition date and to remeasure such contingent consideration in future reporting periods until the contingency is resolved. Changes in recorded fair value can impact the acquirer’s earnings. Estimating the fair value of a contingency may require forecasting the likelihood and timing of specific events such as earn out provisions.

Section 409A – Taxation of Deferred Compensation – “Cheap Stock” Valuation Provision

U.S. Internal Revenue Code Section 409A governs the taxation of non-qualified deferred compensation. Failure to comply with the requirements of Section 409A may result in deferred compensation being included in employees’ income and being subject to an additional tax. Because of the impact 409A may have on a company and its employees, it is important to estimate the fair value of a company’s stock accurately. Awards granted substantially in the money may be considered to be “cheap stock” by the Securities and Exchange Commission. Companies that are determined to have granted cheap stock may have their IPO plans derailed due to the effect on earnings.

ASC 310 – Receivables – Loan Impairment Provision

ASC 310 - Receivables (formerly SFAS 114 - Accounting by Creditors for Impairment of a Loan), an amendment of ASC 450 and 470 (formerly SFAS 5 and 15, respectively), requires that debt instruments be analyzed based on the likelihood that the debt issuers will be unable to repay all amounts due, according to the contractual terms of a loan, to determine if an impairment should be recognized. In cases of impairment, measurement of the impairment amount is required at fair value, which takes into account the nature and future expected performance of the loan, in addition to an analysis of the likelihood of collection of the loan. This



analysis may require an estimation of the value of the underlying company or collateral, as well as modeling expected future cash flows.

ASC 460 – Guarantees

ASC 460 - Guarantees (formerly FASB Interpretation 45 - Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others), governs a guarantor's recognition of a guarantee, which shall be measured at fair value as of the inception date of the guarantee. Fair value of a guarantee requires consideration of the underlying risks, with respect to their probability and magnitude, as well as appropriate discount rates. Furthermore, option theory or Monte Carlo simulation may be used to estimate the fair value of guarantees.

Convertible Instruments

A convertible instrument can be converted into a predetermined amount of the company's equity at certain times during its life. Although convertible bonds typically pay a low coupon rate, the bondholder is compensated with the potential to convert the bond to common stock if the company's stock performs well in the future. Valuing different features of a convertible instrument, such as the value of its conversion feature, generally requires sophisticated models, such as Monte Carlo simulation or lattice models.

ASC 718 – Stock Compensation

ASC 718 – Stock Compensation (formerly SFAS 123, revised 2004 - Share-Based Payment), requires a change in the way that companies interpret, report and value employee stock options, which shall be measured at fair value, with an increased focus on analytical rigor within the valuation model employed, as well as the support for and consistency of valuation model inputs. The recent economic downturn has left a significant number of options far out-of-the-money (underwater). Some awards are so deep underwater that it is unlikely that these options will become in-the-money again before expiration. As a result, many companies are exploring avenues to modify their underwater options or ways to introduce new award structures to incentivize employees while balancing the concerns of shareholders.

Complex Capital Structure/Equity Allocation

Privately held companies often have complex capital structures, including various classes of preferred financial instruments based on multiple financing rounds that may, among other characteristics, be convertible, have liquidation preferences, or have participation rights. Due to the different economic and control rights associated with different classes of equity, valuing preferred and common equity securities for privately-held companies with complex capital structures is often a challenging exercise.

Pursuant to ASC 718, privately-issued financial instruments, such as stock options and preferred stock, shall be measured at fair value, and therefore, a "Rule of Thumb" approach cannot be used to estimate the value of the various classes of equity. The valuation model used to allocate value should in most instances be forward-looking and consider the economic rights and terms of the preferred financial instruments, including their seniority, liquidation preference, dividends, conversion rights, and participation rights.

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