
A CFO's guide to **transaction readiness**

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For any chief financial officer involved in a mergers and acquisition (M&A) transaction or preparing an initial public offering (IPO), the importance of valuations and quality of earnings has always been a top priority. With the economic disruption and business uncertainty of 2020 and 2021, investors and acquirers demanding a deeper understanding of earnings quality, and auditors increasing their scrutiny of valuations. With the goal of optimizing deal value and avoiding problems that could derail a deal, private sellers increasingly looked to independent accounting firms to prepare sell-side quality of earnings reports, even before they put their business up for sale.

Meanwhile, as special purpose acquisition company (SPAC) combinations reached record levels in 2021, the U.S. Securities and Exchange Commission (SEC) committed to sweeping regulatory reforms. Their aim is to more closely align financial statement reporting in business combinations involving a shell company and a private target with those of traditional IPOs.

In light of the importance of quality of earnings and deal valuations, this playbook will act as a tool for CFOs, highlighting the key due diligence and valuation consideration they should be aware of in private M&A, IPO and SPAC transactions.

More specifically, it will discuss the differences between M&A, IPO and SPAC transactions with respect to recognition and impairment testing of intangibles/goodwill, equity-based compensation rewards, and financial instruments. It will also examine the specific valuation requirements of SPAC financial instruments, such as founder shares, public and private warrants, and private investment in a public entity (PIPE). Finally, the playbook will discuss how working with the right external partner can help mitigate deal risk and optimize the value of private transactions for both buyers and sellers.

By the end of the playbook, readers will understand:

- the importance of due diligence and quality of earnings in M&A, IPO and SPAC.
- the key concern areas in valuations and quality of earnings in M&A, IPO and SPAC.
- how enlisting external experts can optimize deal value for both buyers and sellers and minimize risk in M&A, IPO and SPAC transactions.

Transaction readiness — the importance of due diligence and quality of earnings

While much has been written about the benefits of due diligence and quality of earnings analysis in M&A, the Corporate Finance Institute identifies four key reasons buyers and sellers should undergo due diligence.

- To confirm and verify information brought up during the deal or investment process.
- To identify potential defects in the deal or investment opportunity and thus avoid a bad business transaction.
- To obtain information useful in valuing the deal.
- To make sure the deal or investment opportunity complies with the investment or deal criteria.



Ultimately, it concluded, due diligence contributes to making informed decisions by enhancing the quality of information available to decision-makers, which offers a greater chance of deal success. For the buyer, it provides comfort that their expectations regarding the transaction are correct. Due diligence may also benefit the seller, insofar as going through the rigorous financial examination may reveal that the fair-market value of their company is more than what was initially thought.

Taking the example of tax implications in M&A, as Rajesh Khairajani, partner in the financial reporting and valuation practice at KNAV, explained, “Whether to structure a transaction as an asset purchase or a stock purchase is essential for the buyer not only on a liability perspective but also to assess the tax attributes that can be carried over to the buyer

that ultimately results in higher depreciation/amortization and consequently higher profitability. For the seller, due diligence helps to identify any issues beforehand so that they can do the necessary course correction before they invite offers.”

Additionally, when it comes to quality of earnings, a quality of earnings analysis plays a very important role in due diligence, he said, and it goes hand in hand with understanding business risk. “Take, for example, a company that derives 40% of its revenue from one customer. It’s important for a buyer to understand that there’s a 40% concentration risk that could ultimately impact EBITA.” Also, in terms of cash flow, he added, “it’s important to understand the sustainability of earnings and determine if there are any nonrecurring items that need to be cleaned up.”

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RAJESH KHAIRAJANI, partner in the financial reporting and valuation practice at KNAV



Key concern areas for valuation in M&A, IPO, SPAC

1

Business Combinations (Recognition of Intangible Assets and Goodwill, ASC 805)

PRIVATE M&A

A purchase price allocation exercise is required post-acquisition for reporting in compliance with ASC 805. Auditors often scrutinize various matters such as (1) the allocation of the purchase price to identified assets acquired and liabilities assumed, (2) fair-valuation assumptions and methodology of any contingent consideration, (3) estimation of useful lives, and (4) appropriateness of goodwill or bargain purchases, if any.

IPO AND SPAC

Compliance with ASC 805 is similar to private M&A for all the retrospective deals consummated by an entity in the case of an IPO. For the SPAC entity, the SPAC merger transaction will be accounted for as a business combination in accordance with ASC 805 only in cases where the SPAC entity is determined to be an accounting acquirer.

The SEC will scrutinize various matters such as (1) identification of the accounting acquirer, (2) questions about the allocation of the purchase price to identified assets acquired and liabilities assumed, (3) accounting for any contingent consideration, (4) bargain purchases, and (5) required disclosures.

2

Impairment Testing of Goodwill and Intangible Assets (ASC 350 and 360)

PRIVATE M&A

ASC 350 requires the buyer to annually test for impairment of the goodwill and intangible assets recorded as part of the deal. Auditors will scrutinize various matters such as (1) the qualitative discussion of assumptions used to determine fair value, (2) valuation inputs and (3) the percentage by which the fair value of the reporting unit exceeds its carrying value.

IPO AND SPAC

Compliance with ASC 350 is similar to private M&A for each retrospective reporting period. Besides the auditor's focus areas, the SEC may further scrutinize various matters such as (1) determining the reporting unit, (2) the assessment of triggering events and (3) required disclosures.



3

Equity-Based Compensation Awards (ASC 718)

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Depending on how an acquisition is structured, contingent payments made to employees as part of the purchase consideration may be treated as compensation expenses and hence are required to be accounted for at fair value per ASC 718.

Auditors will scrutinize various matters such as (1) significant factors, assumptions and methodologies used to determine the fair value of the underlying common stock, (2) valuation inputs (volatility, interest rates, future dividends and option life), and (3) their accounting classification.

IPO AND SPAC

IPO registrants are required to measure and report all share-based compensation at fair value to comply with ASC 718. Similarly, any financial instrument (shares or warrants) issued as compensation for services by an SPAC entity, employees or third-party service providers must be accounted for in accordance with ASC 718.

The calculations necessary to measure these instruments include assumptions about the company's share price, volatility, interest rates, future dividends and option life.

The prevalence of complex capital structures in pre-IPO companies due to prior capital infusions often make valuing the company's underlying equity arduous.

During its review, the SEC will focus on what is known as cheap stock, which are stock-based awards or options given as compensation. Companies preparing for an IPO need to carefully review their option-pricing history. Where option exercise prices are significantly less than the price of other equity instruments sold near the dates of option grants, there will be close scrutiny by the SEC.

In sync with ASC 718, compliance with IRC 409A common stock valuation is also critical to mitigating potentially detrimental tax consequences for the employees and simplifying the SEC's analysis.

Typical areas of SEC comment are (1) significant factors, assumptions and methodologies used to determine the fair value of the underlying common stock, (2) the valuation range determined by various methodologies and the combination or weighting of those methods, (3) significant factors contributing to the difference between the fair value as of the date of each grant and the estimated IPO price range, and (4) explanations of why or whether marketability discounts, illiquidity discounts and common stock discounts (due to preferential rights of preferred stock) were used.

4

Financial Instruments Such as Embedded Derivatives, Beneficial Conversions and SPAC Instruments (ASC 480 and 815)

PRIVATE M&A

Valuation of financial instruments is not frequently seen in an M&A deal. However, call or put option contracts are sometimes used as an exit mechanism in such transactions. Depending on the complexity of these terms, fair-valuation requirements follow.

Auditors will scrutinize various matters such as (1) accounting classification, (2) significant factors, assumptions and methodologies used to determine the fair value of the instrument and embedded features, (3) valuation inputs, and (4) required disclosures.

IPO AND SPAC

Registrants are required to measure and report these instruments at fair value upon initial recognition and at the subsequent measurement date depending on their accounting classification and compliance with the applicable ASC. Derivative accounting requires companies to test to see if certain embedded financial instruments such as call/put options, fixed conversion or beneficial conversion must be accounted for separately at fair value.

Typical areas of SEC comment are (1) accounting classification, (2) assumptions used to determine the fair value of the instrument, including the underlying security (e.g., the fair-value calculation of a preferred stock warrant and the underlying price of the preferred stock itself), (3) changes in the valuation of the instrument over time, and (4) variation of the valuation of the instrument from the value of the registrant's common stock.



5

Valuation of SPAC Instruments (Founder Shares, Public and Private Warrants, Private Investment in Public Equity)

PRIVATE M&A

While the targets of a SPAC merger are usually privately held companies, they need to provide financial statements that comply with requirements of Regulation S-X and U.S. GAAP requirements of a public business entity. This may be particularly impactful for target companies that have historically elected private company accounting alternatives since they will be required to retrospectively revise their financials.

IPO AND SPAC

Investments in SPAC securities are no different from investments in traditional public or private debt and equity interests, yet the nuances of such investments must be carefully considered.

There are three categories of SPAC financial instruments commonly observed: warrants, founder shares and PIPE instruments.

SPAC instruments should be assessed under ASC 480, 815-105 and 815-406 to determine whether they should be classified as equity or liabilities. If an instrument is classified as a liability under the selected guidance, it generally will be measured at fair value with changes in fair value recognized in earnings.

Certain valuation requirements for restatement of financial statements would include:

- a. Fair valuation of intangible assets.
- b. Goodwill impairment testing.
- c. Fair valuation of share-based payments (ASC 718 and IRC 409A).

6

Fairness Opinions

PRIVATE M&A, IPO AND SPAC

M&A transactions face complex valuation issues, risk of personal liability for promoters, controlling shareholders, sponsors and board directors, and additional regulatory requirements. To efficiently manage challenges, company executives and boards may consider obtaining an independent financial advisor's fairness opinion during an M&A transaction.

A fairness opinion is a financial advisor's perspective as to whether the price to be paid or received in a transaction is fair to the client's shareholders. While not mandated by law, fairness opinions are frequently used in M&A transactions to assist the company executives, the board, and/or other fiduciaries in evaluating the fairness of the financial terms of a transaction and demonstrating that the decision was indeed made with due care. It is absolutely considered a best practice to obtain a fairness opinion for any material transaction that could affect shareholder value.

Also, both the fairness opinions and their underlying analyses have been subject to increased litigation and scrutiny by the courts as well as the SEC in recent years, due in part to heightened concerns about transparency and objectivity around M&A transactions.





Why hire an external expert?

- Understand the risk and business landscape
- Optimize deal value
- Access industry and country expertise

Why hire an external expert?

Understand the risk and business landscape:

In due diligence, third-party experts will identify and quantify potential risks which under a normal reading of the financial statements might not be apparent. What they can do, which an audit may not, Khairajani said, is make a buyer look at a transaction from both a business and risk perspective. “An audit will attest to whether a transaction is accounted for correctly, but a due diligence review will bring risk ramifications to light,” he said.

Optimize deal value:

A classic example is when a company has related party transactions, Khairajani said. “In a recent due diligence exercise, we found that if the buyer would have left a third party out of the purview of the transaction, there would have been significant leakage. This came to light when we started looking at the transaction between the group entities and realized that it represented almost 30% of the total revenue.”

While there is typically full disclosure of related party transactions on the financial statements, only when you dive deeper can you see the operational risk that some of these arrangements pose to the buyer, he added, and this only comes to light when you're asking the right questions.

Khairajani added "Many deals result in sellers' stock options plans being canceled and this does pose a question to the buyer whether they need to compensate the seller's workforce, who could be extremely critical in realizing the synergies identified at the time of the deal. Bringing such issues to light is important at the time of due diligence. This also has ramifications in impacting the cost of acquisition as such arrangements either form part of the purchase price or as a post combination expense, if linked to continuing employment."

Access industry and country expertise:

External experts can also be valuable M&A partners due to their specific industry and country knowledge. When a potential target is unknown, or the industry or business model falls outside the expertise of in-house M&A teams or finance staff, seeking external expertise is always a good idea, explained Eva Fong, CFO of WELL Health Technologies Corp. "While

most of our M&A due diligence is done in-house, there are certain circumstances when reaching out to a third-party expert makes the most sense. And that's when we don't fully understand the nuances of the regulatory environment in a particular region, or when our team simply doesn't have the bandwidth to conduct adequate due diligence." WELL Health Technologies has completed 50 acquisitions in the past four years, she explained, and as CFO, "it's always important to understand the limits of your internal resources and take advantage of experts who can expedite an acquisition or provide the experience in a country that you just don't have." It's all about minimizing risk, she added.

When it comes to understanding the business practices or regulatory frameworks internationally, KNAV has feet on the ground globally, Khairajani said. "If a U.S. company wants to acquire a business in Singapore, for example, we'll have our Singapore partner take the lead on that." One thing that has always been important is cultural fit, he added, which doesn't fall into the box of accounting due diligence. "In cross-border transactions, knowing the business culture of both the buyer and the seller can make or break a deal."

Conclusion

For any CFO involved in an M&A transaction or preparing an IPO, understanding the underlying quality of earnings and potential transaction risks is a top priority. Third-party experts can identify potential problems for both buyers and sellers that could derail a deal, and they can provide specific industry and country expertise essential in cross-border transactions. At the same time, they can identify specific accounting and regulatory concerns that are likely to be flagged in an audit and by regulatory bodies.

CFOs are encouraged to review the checklist of M&A, IPO and SPAC key due diligence and valuation considerations that are identified in this playbook. For any questions, readers are invited to contact:

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