AICPA Private Equity/Venture Capital Accounting and Valuation Guide - Update

ASA Advanced Business Valuation Conference

September 14, 2016

Disclaimer

- The views expressed are my own views and do not necessarily reflect the views of the PE/VC Task Force or any other individuals or organizations.

Presentation Contents

1. Introduction
   a. Objectives
   b. Task Force Information
   c. Timeline
   d. Planned Guide Contents
2. Selected Chapter Discussions
   a. Chapter 3, Market Participant Assumptions
   b. Chapter 10, Calibration
   c. Chapter 11, Backtesting
   d. Chapter 12, Factors to Consider At or Near a Transaction Date
3. Questions

Introduction

Why a Practice Guide?

- Concerns on PE/VC portfolio investment valuations
  - Diversity in practice and inconsistent fair value measurements
    - Changes on year to year basis
    - Differences between different preparers for same / similar investments
- Current guidance doesn't cover many PE/VC issues
  - Cheap Stock Guide (June 2013) – focus on equity securities issued as compensation
  - IPEV Valuation Guidelines (December 2012), focused on later stage controlling investments; deferred discussion of enterprise-value allocations
  - AICPA Audit and Accounting Guide: Investment Companies - focused primarily on accounting
  - PEIGG – U.S. Private Equity Valuation Guidelines Industry Assumptions vs. U.S. GAAP/IFRS Fair Value Guidance
- Investors frequently use transaction-specific assumptions, which are not always transparent; however, GAAP focuses on market participant
- Conceptually challenging to reconcile market participant assumptions and investment objectives

Why a New Guide? Existing Guidance is Limited

- AICPA Accounting & Valuation Guide, *Valuation of Privately-Held Company Equity Securities Issued as Compensation* (the "Cheap Stock Guide")
  - ASC 718 focus. Does not cover many issues unique to investment companies.
- International Private Equity and VC Valuation Guidelines (IPEV)
  - Focused on later-stage controlling investments;
  - Deferred discussion of enterprise-value allocations
- Private Equity Industry Guidelines Group (PEIGG)
  - Higher level valuation guidance

Why a New Guide? Differences between ASC 718 and ASC 946 Valuations

1. ASC 946 has an entry transaction into security position
2. Multiple securities that require proper assessment
3. Multiple investors with possible alignment considerations
4. Importance of investor time frame considerations for ASC 946
5. Type of security – common vs. debt, preferred and other
6. Other

Task Force Objectives

- Task Force objectives include:
  - Harmonize the diverse views of industry participants, auditors and valuation specialists
  - Produce a user friendly guide with examples that can be used to reason through real situations faced by valuation specialists and auditors
- Working title:
  - *Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies*

Task Force Members and Observers

Co-Chairs

- Amanda Miller, Ernst & Young
- Sean McKee, KPMG

Valuation Specialists

- Chad Arcinue (Ernst & Young) (Observer)
- Travis Chamberlain (Clifton Larsen)
- Shaan Elbaum (PwC) (Observer)
- John Ferro, (Grant Thornton)
- Massimo Messina
- Ray Rath (Globalview Advisors)

* - Formerly an industry participant as the Chief Accounting Officer of Kleiner Perkins but has moved to KPMG via Rothstein Kass

Industry Participants

- Timothy Curt (Warburg Pincus)
- Quintin Kevin (Adams Street)
- David Larsen (IPEV, Duff & Phelps)

Auditors

- Belanne Ungarelli (PwC)
- Scott Burger (KPMG) (Observer)*
- Jon Howard (Deloitte)

AICPA

- Yelena Mishkevich
- Mark Smith

Task Force – Nature of Guidance

- “Non-authoritative” like other accounting and valuation guides issued
- Must clear AICPA Financial Reporting Executive Committee (“FinREC”). AICPA Forensic and Valuation Services (FVS) Executive Committee is also involved.
- Extensive due process
- Detailed topic discussions
- Example rich document covering many investment types and industries at different phases
- Significant expansion on the concept and use of calibration
- Not rules based

Task Force Target Timeline

- Numerous Task Force meetings and conference calls scheduled
- AICPA Financial Reporting Executive Committee (“FinREC”) Meetings
  - November 2016, January 2017, March 2017, July 2017
  - March 2017 – Target FinREC approval for draft
- Fatal flaw reviews – April/May 2017
- First public release of working draft – July / August 2017
- Targeted comment due date – November 30, 2017
- Target publication of final guide – end of 2018
- Financial Reporting Executive Committee (FinREC) Mission - determine the Institute's technical policies regarding financial reporting standards and to be the Institute's spokesbody on those matters, with the ultimate purpose of serving the public interest by improving financial reporting.
- Sixteen members from accounting firms, preparers of financial statements and other professionals including a valuation observer from the FVS Executive Committee.

Possible Guide Contents

- Introduction and Guide to the Guide
- Chapter 1, Overview of the Private Equity and Venture Capital Industry and Its Investment Strategies
- Chapter 2, Fair Value and Related Concepts
- Chapter 3, Market Participant Assumptions
- Chapter 4, Determining the Unit of Account and the Assumed Transaction for Measuring the Fair Value of Investments
- Chapter 5, Overview of Valuation Approaches and Methods
- Chapter 6, Valuation of Debt Securities
- Chapter 7, Valuation of Equity Securities in Simple Capital Structures
- Chapter 8, Valuation of Equity Securities in Complex Capital Structures
- Chapter 9, Control and Marketability

Possible Guide Contents *(cont'd)*

- Chapter 10, Calibration
- Chapter 11, Backtesting
- Chapter 12, Factors to Consider At or Near a Transaction Date
- Chapter 13, Special Topics
  A. Options and Warrants
  B. Contractual Rights
  C. Enterprise has traded securities
  D. Pricing services / broker quotes / investment banker quotes
  E. Evaluating non-financial incentives when considering transaction dynamics
  F. No recent round of financing and no revenue
  G. Rights and Privileges not enforced
  H. Other
- Chapter 14, Frequently Asked Questions

Possible Guide Contents *(cont'd)*

- Appendix A, Valuation process and documentation – best practices
- Appendix B, Valuation Toolkit
- Appendix C, Example Investment Summaries

1. Leveraged Buy-Out (LBO) – Value of debt for valuing equity
2. Benefits of Adding Leverage – day 2 gain vs. day 360 gain
3. Downside of Leverage – roll-up, backtesting at exit
4. Real-estate development project – value accretion as project progresses
5. Oil & gas development project – value accretion given new information
6. Oil & Gas Bond – significant decrease in volume or activity
7. Joint venture – agency effect when control rests with junior securities
8. Emerging market investment – reliability of financial statements
9. Start-up with a strategic exit – "last man standing"
10. Biotech startup – down-round to strategic sale with earnout
11. Software as a service startup – quick ramp but lots of competition
12. Clean-tech startup – regulatory risks
13. Emerging market startup – opportunities and risks in China
14. BDC debt – straight debt, debt with prepayment penalties, convertible debt, warrants
15. Restricted stock investment (PIPE)
16. Investments in related securities when the enterprise has traded stock

Purpose and Content for Examples

- Illustrate a wide variety of situations
- Each example will include
  - Background on subject entity and securities
  - Initial transaction and calibration
  - Update valuations across time until exit
    - Changes at subject
    - Changes in industry / market
    - Valuation at each measurement date
    - Calibration to prior
  - Present and discuss exit transaction

Selected Chapter Discussions

Chapter 3,
Market Participant Assumptions

Chapter 3, Market Participant Assumptions - Introduction

- ASC 820 prescribes a principles-based fair value measurement that is consistent with market participant assumptions; however, questions arise as to:
  - What typical PE/VC/BDC market participants take into account when pricing an asset?
  - How a typical market participant's investment and exit strategies should be incorporated in a fair value measurement?
  - How illiquidity and risk should be priced?
  - What observable transactions are typically available and how comparability (including differences in market participant assumptions between a source price and target valuation) should be assessed?
- Status
  - Several real-world examples developed to ensure coverage of many different industries, types of investments, investment and exit strategies

Market Participant – ASC 820 Guidance

- FASB ASC 820-10-35-9 states:
  - A reporting entity shall measure the fair value of an asset or a liability using the assumptions that market participants would use in pricing the asset or liability, assuming that market participants act in their economic best interest. In developing those assumptions, a reporting entity need not identify specific market participants. Rather, the reporting entity shall identify characteristics that distinguish market participants generally, considering factors specific to all of the following:

    a. The asset or liability
    b. The principal (or most advantageous) market for the asset or liability
    c. Market participants with whom the reporting entity would enter into a transaction in that market.

Market Participant - Definition

- Market participants are defined in FASB ASC Master Glossary as
  - Buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics:
    a. They are independent of each other, that is, they are not related parties, although the price in a related-party transaction may be used as an input to a fair value measurement if the reporting entity has evidence that the transaction was entered into at market terms;
    b. They are knowledgeable, having a reasonable understanding about the asset or liability and the transaction using all available information, including information that might be obtained through due diligence efforts that are usual and customary;
    c. They are able to enter into a transaction for the asset or liability;
    d. They are willing to enter into a transaction for the asset or liability, that is, they are motivated but not forced or otherwise compelled to do so.

Market Participant – Alignment of Investors

- Alignment of investor interests can influence the determination of market participant assumptions
  - VC / PE investments often involve "club deals" of multiple fund managers. Agreements between investors will help guarantee alignment and reduce risk of discord
- Other considerations
  - Major investors holding different classes of securities will increase likelihood of possible disagreement
  - Investor status can influence likelihood of possible disagreement
    - Time of fund planned termination date
    - Remaining investable fund balances

Market Participant – Multiple of Invested Capital

- Many fund managers are evaluated by prospective investors not only considering the net internal rate of return (IRR) produced, but also on the multiple of invested capital (MOIC) they provide back to their limited partners.
  - If a $50mm investment generates a 20% rate of return in one year, the fund would realize a $10mm profit, representing a 1.2 MOIC. If the same investment generates a 20% rate of return for five years, the fund would realize a $75m profit, representing a 2.5 MOIC.
  - Even at a high rate of return, exiting in a short timeframe will lead to significant reinvestment costs, so investors typically focus on MOIC rather than just rate of return. A 1.05 MOIC in three months isn't that helpful to increasing total fund returns.
- These concepts are consistent with the longer term investment time frame of many fund managers.

Chapter 10, *Calibration*

Chapter 10, Calibration - Introduction

- **Calibration helps confirm the reasonableness of valuations across time**
- Calibration can **reduce / eliminate concerns regarding possible control and marketability adjustments** in the valuation process
- Calibration **uses observed transactions** in the portfolio company's own securities, especially the transaction in which the Fund entered a position, to ensure that the valuation techniques that will be employed to value the portfolio company investment on subsequent measurement dates begin with **assumptions that are consistent with the original observed transaction**
- Calibration essentially involves **taking a transaction price** (or subsequent valuation) and **selecting appropriate methods and assumptions** that tie to the "base" fair value measurement and comparing these to methods and assumptions at a subsequent measurement date

Calibration – Introduction *(cont'd)*

- On the original transaction date, when the transaction price represents fair value, using selected valuation techniques with calibrated inputs will indicate that the fair value of the portfolio company investment equals the transaction price. **At subsequent measurement dates, these input assumptions** (e.g., revenues, EBITDA, projected revenues and EBITDA, or projected cash flows; and market-related inputs such as valuation multiples, cost of capital, or other factors) **should then be updated to reflect changes in the investment** (e.g., portfolio company performance and expectations) and **changes in market conditions** (e.g. valuations, cost of capital, other).
- This process of calibrating the valuation model to the most recent transaction and then updating the inputs from period to period **remains relevant as long as there has not been a significant change** in the circumstances

Calibration – Factors Reducing Relevance

- Calibration stops being relevant when a significant change makes it more appropriate to use a new valuation approach.
  - **Value events** (favorable or unfavorable)
  - **Pending transaction** - Portfolio company is about to be sold, the valuation would consider the likelihood of a successful sale at a given price, potentially supported or triangulated with the income approach or market approach.
  - **Financial distress** - Change in If a portfolio company has entered bankruptcy or market participants would expect the debt to be restructured, the valuation for the debt would consider the expected recovery, timing of that recovery, and a market yield for distressed debt, rather than using contractual cash flows and calibrating to the market yield consistent with the investment and the change in the market yields for the company over the period since issuance.
  - **Significant change makes observable market data more relevant than historical transactions** for the company itself; for example, when the company's business model has changed.

Calibration – Impact on Control / Marketability Adjustments

- Calibration resolves one of the significant challenges faced by the Private Equity and Venture Capital industry – namely, assessing the valuation impact of the level of control and illiquidity associated with an investment. For example, under the income approach, the Fund would initially **estimate the expected cash flows for the investment under current ownership through a liquidity event** or through the maturity of the instrument, and then **calibrate to calculate the required rate of return for the investment on the initial investment date**. Since the transaction price already incorporates market participants' required rate of return, **no additional adjustment for control or illiquidity would apply**. For subsequent measurement dates, the Fund would consider the updated expected cash flows and the updated market participants' return assumptions given current market conditions. A **similar thought process would be used under the market approach**.

Calibration – Areas for Consideration

- When is a transaction a reliable indication of fair value? Is it possible to apply calibration techniques if a transaction is not at fair value?
- How would calibration be applied in valuing a debt or equity investment in a business using the income approach? Using the market approach?
- How long should a transaction be considered relevant for calibration? What factors should be considered in assessing the relevance of a transaction that took place prior to the measurement date?
- What are the implications of calibration when considering how market participants would value an investment given the control features and marketability characteristics of the investment? What are the implications if calibration indicates a discount or a premium to the valuation of the investment relative to the value implied by the comparable company inputs?

Chapter 11, *Backtesting*

Chapter 11, Backtesting - Introduction

- Backtesting can be an important tool to help PE/VC fund management confirm that their valuation process is developing reasonable fair value estimates.
- Backtesting is the process of comparing the valuation implied by an actual realization or liquidity event to the valuation that was estimated for those securities at an earlier measurement date provides a quantification of the amount by which the estimated value differed from the value realized from a subsequent realization or liquidity event date. A large difference does not necessarily mean the earlier estimate lacked sufficient support or rigor.

Backtesting – Areas for Consideration

- Which facts and circumstances were known or knowable as of the Measurement Date?
- What additional facts and circumstances were known or knowable as of the Analysis Date?
- What other metrics might have been considered by the buyer as of the Event Date that may not have been considered by the valuation specialist on the Analysis Date?
- Was the actual buyer included in the market participant universe used as of the Measurement Date? If not, why not?
- Are the assumptions implied by the price on the Event Date reasonably consistent with the assumptions used as of the Measurement Date?
- What other factors (e.g., changes in market conditions for the sector or peer group, general economic or market trends, other company-specific factors) that occurred between the Measurement Date and the Event Date could have had an impact on value?

Backtesting – Possible Examples in Guide

Example 1: Potential Buyer's Synergies Unknown
Example 2: Unidentified Operational Issues
Example 3: Subsequent IPO and Material Price Appreciation
Example 4: Subsequent Rescue of a Company in Financial Distress
Example 5: Bridge Loan Followed by Down-Round Financing
Example 6: Material Non-Public Information with Publicly Traded Shares
Example 7: Subsequent Working Capital Adjustment / Contract Claims
Example 8: Unidentified Market Participant
Example 9: Clinical Trial Results
Example 10: Restatement of Company Financials

Chapter 12, *Factors to Consider At or Near a Transaction Date*

Chapter 12, Transaction Costs - Introduction

- ASC 820-10-35-9B indicates the price in the principal (or most advantageous) market used to measure the fair value of the asset or liability should not be adjusted for transaction costs, which should be accounted for in accordance with the provisions of other accounting guidance.
- The FASB ASC glossary defines *transaction costs* as:
  - the costs to sell an asset or transfer a liability in the principal (or most advantageous) market for the asset or liability that are directly attributable to the disposal of the asset or the transfer of the liability and meet both of the following criteria:
    a. They result directly from and are essential to that transaction.
    b. They would not have been incurred by the entity had the decision to sell the asset or transfer the liability not been made (similar to costs to sell, as defined in paragraph 360-10-35-38).

Transaction Costs – ASC 946 Insights

- **ASC Topic 946 requires that all costs incurred are capitalized as the cost of the investment.** ASC Topic 946-320-35-1 also states that "… **investments in debt and equity securities [are] subsequently [measured] at fair value.**" As a result, questions have been raised about the appropriate accounting treatment for transaction costs in the context of estimating fair value. To some extent, this is due to the apparent divergence or conflict between the ASC 946 requirement to capitalize all costs and the ASC 820 requirement to exclude transactions costs. ASC 946-320-30-1
- With the issuance of ASU 2013-08, *Financial Services—Investment Companies (Topic 946)—Amendments to the Scope, Measurement, and Disclosure Requirements*, the treatment of transaction costs was clarified to state that **"[a]n investment company shall initially measure its investments in debt and equity securities at their transaction price. The transaction price shall include commissions and other charges that are part of the purchase transaction**." ASC 946-320-30-1.

Transaction Costs - Highlights

- For investment companies, the cost of an investment includes transaction costs that are a part of the purchase transaction.
- ASC 820-10-35-9B indicates transaction costs should be accounted for in accordance with the provisions of applicable accounting guidance. As such, based on guidance in FASB ASC 946-320-30-1, transaction costs are capitalized at initial recognition and, therefore, impact the unrealized and realized gains and losses from investments reported in the statement of operations of the investment company at each subsequent measurement date.

- Nuanced topic - what if buyer would will to accept costs incurred by seller and pay $100, then this would be FV
- At subsequent measurement dates, FV measurement excludes transaction costs. FV could be equal to, less than, or more than the all-in cost depending on facts and circumstances.

Transaction Costs – Purchase Example

• Purchase price of asset	$95
• Legal costs	3
• Diligence costs	2
• Broker costs	?
• Total transaction costs	5
• Total costs	$100

- Buyer was willing to pay an “all-in” price of $100
- Day 1 – acquisition date
- Day 2 – first measurement date after acquisition
- Day Last – fair value estimates near the ultimate sale date
- At subsequent measurement dates, whether one day, one month, one quarter, one year, or beyond, a fair value measurement excludes transaction costs. As a result, the fair value at the first measurement date may be equal to, less than, or more than the all-in cost, depending on the facts and circumstances.

Transaction Costs – Sale Example

Purchase Price of Company X (transaction price paid by buyer to seller)	**$200**
Selling transaction costs incurred by Investment Company A:	
Legal fees	4
Investment bank fees	4
Third party valuation fees	2
Total transaction costs	10
Net proceeds	$190

Said another way, if the above deal terms are known as of Investment Company A's measurement date but the deal has not yet closed, the **fair value of Company X as of the measurement date could be deemed to be the $200 sales price**, excluding transaction costs, and not the $190 of net proceeds. As the $10 of transaction costs have not yet been incurred, they would not yet represent a period expense pertaining to the holding in Investment Company A.

Questions

Raymond Rath, ASA, CFA Globalview Advisors

- Ray is a Managing Director in the Irvine, California office of Globalview Advisors. He has over 30 years of financial valuation expertise in the valuation of businesses, securities interests, and intangible assets.
- Ray has performed valuation projects for financial (both US GAAP and IFRS) and tax reporting, transactions, and litigation projects. In addition to performing valuations, Ray has extensive experience in the review of third-party and management prepared valuations.
- Ray has a wealth of experience in a wide range of industries. In recent years, much of his work has focused on technology and Internet firms. Other industries where he has significant project expertise include consumer products, entertainment and media, food services, health care, and manufacturing, in addition to early stage, rapid growth firms.
- Prior to joining Globalview Advisors in 2012, Ray was a Director in the Valuation Services Practice at PricewaterhouseCoopers LLP. He was also a Senior Manager in the Valuation Services Practice at KPMG LLP and KPMG Consulting, Inc., as well as a Manager at Arthur Andersen & Company.
- Ray received his MBA from the University of Southern California and his BS in Business Administration, cum laude, from the University of Kansas. He is an accredited senior Member of the *American Society of Appraisers (ASA)* in the business and intangible assets valuation disciplines as well *as* Appraisal Review and Management, and is also a Chartered Financial Analyst (CFA).

End