Accounting & Valuation Guide: Determining Fair Value of Portfolio Company Investments Held by Venture Capital and Private Equity Firms

Task Force Update

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Task Force Members

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Auditors
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Task Force Mission

Task Force objectives are —

- Harmonize the diverse views of industry participants, auditors and valuation specialists
- Produce a more user friendly guide with examples that can be used to reason through real situations faced by valuation specialists and auditors

Preface

This guide is expected to be titled —

Determining Fair Value of Portfolio Company Investments Held by Venture Capital, Private Equity and Other Investment Companies

- **Where investment company is defined in ASC 946-10**
- **Examples include hedge funds, private equity funds and venture capital funds**
- **The investments made and securities held by these investment companies will be referred to as portfolio company investments**

Why a New Practice Guide?

Concerns

- Diversity in practice contributes to fair value measurements that are not consistent or comparable between investment companies year-over-year

Current Guidance

- Cheap Stock Guide (June 2013), which is limited to 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, which is 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

Existing Body of Knowledge

International Private Equity and VC Valuation Guidelines (IPEV)

- The guide sets out recommendations intended to represent best practice on the valuation of later stage private equity type investments
- It provides a high-level overview of valuation framework and application guidance
- In the December 2012 Update it elects to defer the discussion of allocation methods for non-controlling early stage investments

Limitations	Relevancy
• The guidance only provides high-level content but lacks hands-on application details • Does not address issues faced by early-stage VC investments	• Sections on the determination of enterprise values for later stage PE investments • Discusses the concept of calibration • Provides a discussion of the unit of account for controlling interest investments

Existing Body of Knowledge (cont.)

Private Equity Industry Guidelines Group (PEIG)

- The guide provides managers a framework for valuing investments in portfolio companies at fair value
- The guide was created jointly by managers (i.e., general partners) and investors (i.e., limited partners) incorporating feedback from a wide number of industry participants

Limitations	Relevancy
• The guidance provides high-level content but lacks hands-on application details • A guide to assist managers and investors in establishing a valuation framework • Does not provide guidance on methods to allocate fair value to shares (see Relevancy) • A reflection of industry and investor perspective rather than auditors and fair value specialist	• Fair value should be determined by allocating value to shares based upon relative economic and control rights • A guide that reflects the industry and investor perspective – a view of the market participants • Moving fund managers from a cost or latest round method to fair value as promulgated by FASB

Existing Body of Knowledge (cont.)

Valuation of Privately-Held Company Equity Securities Issued as Compensation (the "Cheap Stock Guide")

- The guide was designed to provide guidance to privately- held enterprises at all stages of development regarding the valuation of and disclosures related to their issuances of equity securities as compensation
- Though the guide is not intended to focus on estimating the value of an enterprise as a whole, it provides relevant guideposts and toolsets to be considered for valuing portfolio company investments

Limitations	Relevancy
• Specifically designed primarily for ASC 718 • Not directly applicable to PE/VC type investments	• Provides frameworks related to valuing shares issued by privately-held companies: • Option pricing models (OPM) • Probability-weighted expected return method (PWERM) • Estimation of discount for lack of marketability (DLOM) • Provides information pertaining to different stages of enterprise development and the corresponding rates of returns

Projected Time Line

1. Outline draft	2. FinREC approval	3. Drafting	4. FinREC review/appr.	5. Issue proposal
Jan 2013	Mar 2013	Mar 2013 — Apr 2016	Spring 2016	Summer 2016

See subsequent slides for detailed outline

Coordination

- Periodic meetings
- Frequent calls

Strategy

- Subgroups tackle controversial topics
- AICPA staff and TF members draft the guide

Objective

- The mission of FinREC is to determine AICPA's technical policies re: financial reporting standards with purpose of serving public by improving financial reporting
- FinREC reviews and approves all financial reporting aids, guides, etc. and proposals thereof

Comments

- All stakeholders invited to comment
- Task Force carefully analyzes all comments and modifies the Guide as necessary
- Revised guide is reviewed and approved by FinREC for final issuance

Outline

I. Introduction
   A. Purpose & scope – evolving, but focused on equity and debt investments held by Investment Companies
   B. U.S. GAAP and other sources
   C. Background – industry, typical types of investments strategies
II. Fair value and relevant concepts
   A. U.S. GAAP and other sources
   B. Best practices
III. Market participant assumptions
   A. Industry participants
   B. How investments are evaluated
   C. Holding period and exit strategies
   D. Pricing, risk, illiquidity
IV. Unit of account
   A. ASC 946, ASC 820, and control considerations
   B. Examples

Outline (continued)

IV. Overview of method
   A. Market, income, asset, and models
V. Valuations of equity and debt in simple capital structures
   A. Typical pricing methods and calibration
   B. Enterprise value as a starting point
   C. Updating fair value measurement in the absence of recent transactions and other common pitfalls
VI. Valuations of equity and debt in complex capital structures
   A. Typical pricing
   B. Differing rights and privileges
   C. Allocating equity value
VII. Control and marketability
VIII. Calibration
IX. Special situations
X. Appendices

Current Focus

Unit of Account

- U.S. GAAP largely silent on the unit of account for investments in debt and equity securities, and many complexities arise
  - ASC 820: For all investments with Level 1 input, P x Q, otherwise look to other topics (individual securities or higher level of aggregation?)
  - ASC 946 provides limited guidance, e.g., defaulted bonds and interest coupons, but no prescriptive guidance or principle
  - Using market participant assumptions to establish unit of account, and assuming that they are acting in their economic best interest
- Examples of complicating factors include:
  - Controlling interest and subordinated debt
  - Change-in-control provisions
  - Club deals
  - Significant deferred tax assets
  - Multiple investments in different classes of equity
- Status
  - TF established principles and applied them to examples
  - Draft chapter will be discussed in November 2013

Current Focus (continued)

Market Participant Assumptions

- 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 mocked up to ensure coverage of many different industries, types of investments, investment and exit strategies

Current Update

- Live meeting held October 9th and 10th at the AICPA's office in New York
  - Focus on working Task-Force drafts of Unit of Account and Market Participant chapters
  - Subgroup efforts are ramped up in advance of live meeting
- Subgroup efforts will continue throughout 2013
- More controversial matters/issues (i.e., principles that may not be clearly established in U.S. GAAP or examples/topics that are not addressed in U.S. GAAP), potentially will be discussed with FinREC and other interested parties

Summary of Key Takeaways

- Looking to issue an exposure draft in 2016
- Task Force includes many members with diverse backgrounds to ensure industry, auditors, and valuation professionals are represented
- Goal is to harmonize the views and approaches of the stakeholder group
- Leverage existing guidance to the extent possible, but recognize the gaps in existing guidance so that they can be filled to provide industry participants, auditors and valuations specialists with a one-stop resource