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Expert Webinar:

Why You Need to Pay Attention to New Reporting Rules

How several new and imminent changes to accounting and valuation rules require **immediate and proactive measures** from CFOs and the finance team

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This is an edited, truncated transcript of a 45-minute expert webinar presented in November 2018 by three RSM experts.

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Privcap: What are some important aspects of the new AICPA Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies?

Melissa Brady, RSM: One of the key topics in the new exposure draft is calibration. You need to look at both market movements as well as company performance. For example, will the company outperform its peers at the same degree as it has done historically? Calibration really does work if you have a buy-in multiple that is reflective of a fair value, meaning the original transaction was done at arm's length. When valuing a fund investment, there are many unobservable inputs. Calibration is a great tool to help refine the fundamental valuation inputs based on calibrating company performance and market performance over time, and taking into account the buy-in.

One thing that we see with a number of our audit clients is that they look at a median valuation of the public peers, they slap on a 20 percent discount, and that's their effective multiple. Calibration and the AICPA guidance is trying to move away from these explicit discounts by fine-tuning discounts within the multiple itself. This is a great tool to prevent these very subjective discounts.

Timothy Byhre, RSM: There is also a big focus on the valuation of equity investments in complex capital structures. The guidance formalizes and defines the approaches that we already use in practice. In addition, it doesn't say that any method is technically superior. It says that any methodology is really dependent upon the facts and circumstances of the particular investment, and the guide recognizes this trade-off in selecting one approach over another. As a matter of fact, "facts and circumstances" is mentioned over 125 times in the guide. It generally prohibits the rule-of-thumb approach that some of us have seen in the past for these types of investments.

Let's define a complex capital structure relative to a simple capital structure. A simple capital structure is defined by the guide as one that has a single primary class of equity. In a simple capital structure, the value of equity in the portfolio company is typically calculated using the current-value method, which we all know as a waterfall method. However, in a complex capital structure, which is defined by the guide as one involving multiple classes of equity—also including liquidity preferences and other rights—the guide suggests that the valuation of equity in these structures entails the determination of the facts and circumstances in order to determine whether the waterfall method can be used as the sole valuation methodology. In fact, one of the most frequently asked questions regarding the guide is, "Can we simply use the waterfall method?" The answer to this question continues to be: "It depends."

Regarding the current-value method, or the waterfall method, the guide suggests it is limited primarily to two types of circumstances. The first is when a liquidity event is imminent. The second is when the fund's position in the portfolio company has both (a) seniority over the other classes of equity and (b) the investors who hold this class of equity have effective control over the timing of the exit.

Let's talk about another methodology outlined, called "scenario-based methods." The guide outlines three of them: s-implified, relative and full scenario. In a

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simplified-scenario analysis, this is sort of a binary scenario, where the upside scenario is high enough that everything converts, the downside scenario is there's virtually no value. In a relative-value scenario, some of the downside scenarios still have value. A full-scenario analysis could entail an array of potential outcomes, including an IPO, a merger, sale, dissolution, or continued operation of the company as a private company until a later exit date.

Next is the option pricing method. Unlike the scenario-based methods, the option pricing method actually begins with the current equity value and then estimates a range of future outcomes. The option pricing method is generally more complex, but it provides a more explicit valuation of various classes of rights and preferences.

The fourth method is called the hybrid method. Let's say you had a company where you had a clear idea of a near-term exit, but if that near-term exit doesn't happen, then the future is a bit muddled and cloudy as to what's going to happen next. In that case, a hybrid method would entail valuing the exit under the anticipated value, then doing an option pricing model for that other scenario, where you say maybe a three-year time to an unknown liquidity event, and applying probabilities to both those scenarios could be used in such an example there.

There are new rules regarding revenue recognition for private companies. What are some important aspects to note for private equity investors?

Stacy Dow, RSM: The guidance is known as ASC 606. It's a new comprehensive revenue model for all companies and all industries, so it's one single standard. The biggest change is that there needs to be more judgment in estimating a transaction price.

Under the standard, transaction price would include both fixed consideration and also variable consideration. Variable consideration would be revenue like usage-based fees, milestone payments, etc. But there are areas that would impact the transaction price in a negative way, like if the company makes concessions. Why that's important is that where you're estimating the ultimate consideration that you're going to get related to revenue, in many cases, you'll be recognizing revenue earlier than you would under legacy GAAP. So there may be a bit more variability in the earnings process if you have a lot of variable consideration where you're estimating amounts.

This standard also affects how you allocate the transaction price to what we would have commonly referred to as elements in the arrangement. You're going to allocate it based on an estimate of what you would sell each item for on a standalone basis. For companies that are selling multiple elements or multiple products and services that are bundling together, they need to allocate any discounts that they provide to all items in the arrangement on a proportional basis, which could affect the recognition of different items that you may have been monitoring in the past. So for a private equity group, if you were monitoring nonrecurring revenue versus recurring revenue, this allocation methodology changes some of those metrics going forward. This will be most applicable for private companies in industries like technology or life sciences—industries where you're selling multiple elements.

Another important change is that there was a cost standard that was implemented at the same time as the revenue standard. The reason this is important is that, in many cases, it requires certain costs to be capitalized, and one of those that has drawn attention is commissions. For example, let's say that we charge a 10 percent commission on the original contract and we only pay a 5 percent commission on a maintenance renewal. The standard would say that rate is not commensurate, and you would have to capitalize those commissions and most likely amortize them over some estimate of the customer life. You're not only affecting the nature and the timing of the revenue recognition in the amount, but you're also impacting costs. So EBITDA is obviously impacted as a result of this standard, from both a revenue perspective and a cost perspective.

As for private equity, as we get closer to the effective date of this standard, you'll want to be thinking about how you structure your debt covenants and what changes there are coming forward with respect to the standard. And one thing you want to be particularly mindful of is, how is EBITDA going to change once I implement this standard, and how do I want to structure those debt covenants now to make sure that obviously I can comply?

There are also new rules on lease accounting. How might those affect a private equity investor?

Dow: For calendar-year private companies, you will be adopting the new revenue-recognition standard effective January 1, 2019. The leasing standard is one year after that. The biggest applicability for this standard is on lessees. So when you are leasing either equipment, real estate, the biggest change is that it's requiring all leases, whether they are a capital or operating, to be on the balance sheet and to reflect a right-of-use asset associated with those leases. What that means is obviously that we're going to gross up the balance sheet. The standard is attributable to the balance sheet more so than the income statement.

As we all know, operating leases in the past were more of a disclosure item. Now all of those leases are going to have to be accumulated and presented on the balance sheet.

When we talk about financial metrics associated with the new leasing standard, you're going to think about debt covenants, interest coverage ratios, and EBITDA/EBIT levels.

This standard has also addressed the issue of embedded leases—any service contract that could involve the use of an asset. You have to evaluate whether use of an asset qualifies actually as a lease and that would also be required to be capitalized. ■

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