New Reporting Rules

Privcap/

New AICPA Guidance

Valuation of portfolio company investments of venture capital and private equity funds and other investment companies

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Chapter 3 - Calibration – Equity Example

	June 30, 2017	December 31, 2017
Enterprise Value	$500 million	$560.75 million (average of LTM and NFY)
Initial transaction / selected multiple	10x EBITDA (LTM) 8.33x (Implied NFY)	10.5x EBITDA (LTM) 8.5x (NFY)
Median market multiple	8x EBITDA (LTM) 7x EBITDA (NFY))	9x EBITDA (LTM) 7.5x (NFY)
EBITDA	$50.0 million (LTM) $60 million (NFY)	$55.0 million (LTM) $64 million (NFY)

Investment Summary

- Initial investment date: June 30, 2017
- Measurement date: December 31, 2017

Calibration

- The median multiple increased from 8x to 9x. Mathematically, the calibrated initial input of 10x would be adjusted to a multiple of 11.25x.
- However, because some of the planned improvements had already been realized, the fund selected 10.5x.
- Market participants would no longer expect the company to outperform the public companies to the same degree.

Chapter 3 - Key Takeaways

Topic	Guidance observations	Relevant sections
Unobservable inputs	Calibration provides evidence supporting unobservable inputs for the selected valuation as of the transaction date; and allows the user to reconcile the inputs selected in subsequent measurement periods with initially observable data for debt and equity investments.	Debt calibration overview: [10.10 – 10.12] Equity calibration overview: [10.13 - 10.25]
Relevance of calibration as time passes	Calibration is most relevant when the measurement date is close to the transaction date. Calibration is less relevant when there has been a significant change in the circumstances that generally warrants a change in the valuation methodology.	[10.26 – 10.27]
DLOM / DLOC	Since the initial transaction price is executed with consideration of the level of ownership (control or minority) and knowledge of the illiquidity is also considered, a discount for lack of control (DLOC) and a discount for lack of marketability (DLOM) are generally *not applicable* at subsequent measurement dates.	[10.28 – 10.30] See Chapter 9 for further detailed discussion on DLOM / DLOC

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Chapter 8 – Valuation of Equity Interests in Complex Capital Structures

- Key Takeaways:
  - Valuation / allocation methods are formally defined
  - No single method is superior (¶ 8.15)
  - Challenges with complexity does not justify using rules of thumb (¶ 8.16)
- Current Value Method:
  - Sole reliance on the CVM should be limited two circumstances (¶ 8.58):
    1) A liquidity event is imminent, or
    2) The fund has seniority over the other classes <u>and</u> effective control over the timing of an exit

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Chapter 8 – Valuation of Equity Interests in Complex Capital Structures

- Scenario-Based Methods (¶ 8.20 - 8.36)

Method	Description	Applicability
• Simplified Scenario Analysis	• Fully-diluted or post-money value	• High likelihood for conversion (e.g. IPO) and value of liquidation preferences are negligible
• Relative Value Scenario Analysis	• Multi-scenario model calibrated to most recent round using post-money value	• Value to liquidation preferences in downside scenarios is likely
• Full Scenario Analysis	• Probability-weighted present value of future investment returns (aka PWERM)	• Time to liquidity is short and range of outcomes easier to predict

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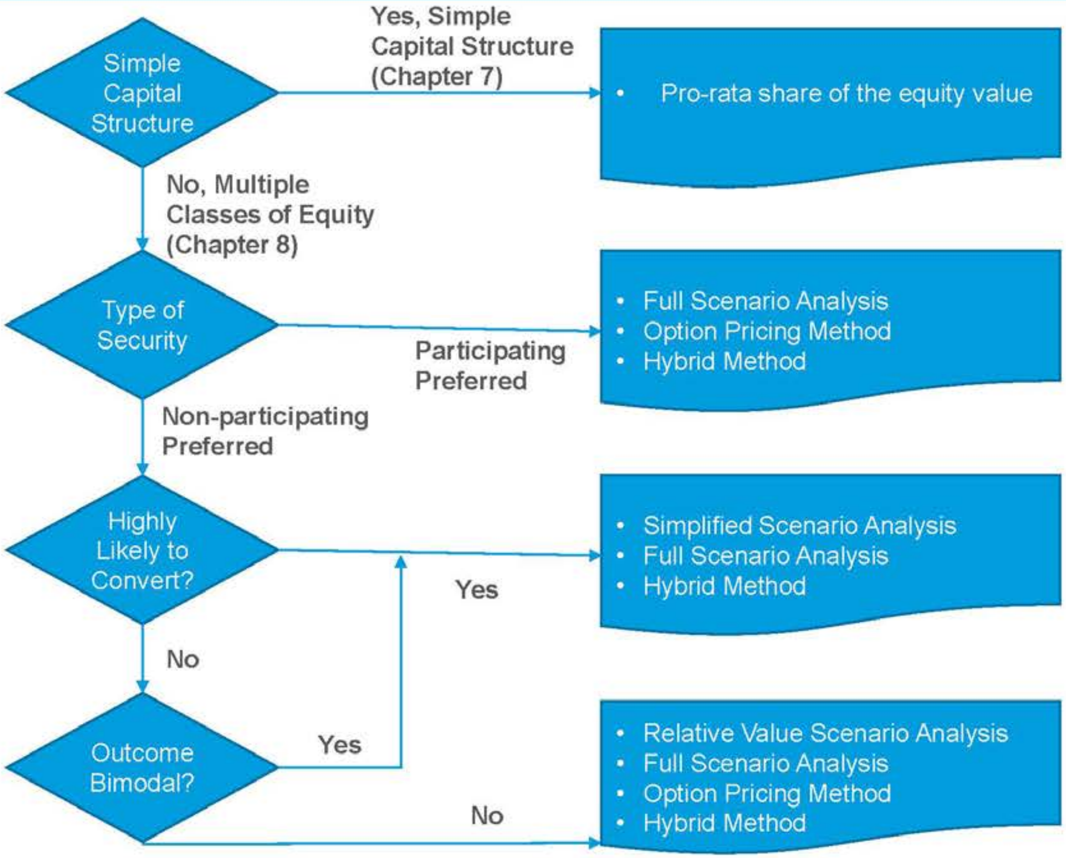
Chapter 8 – Valuation of Equity Interests in Complex Capital Structures

- Option Pricing Method:
  - For participating preferred with unlimited upside it may be appropriate to consider an IPO scenario assuming forced conversion (¶ 8.50)
  - Generally, if the distribution of outcomes are bimodal, a scenario-based or hybrid method may be more appropriate
- Hybrid Methods:
  - Several alternatives classified as hybrid methods, but generally include weighting a scenario-based method and the OPM
  - In all cases, important to reconcile probability-weighted present value of preferred stock to most recent transaction (¶ 8.65)

Chapter 8 – Valuation of Equity Interests in Complex Capital Structures

Flowchart 8.67



Changes to Revenue Recognition Rules

5-Step model

Identify the contract with the customer	Contract with the customer is similar to legacy GAAP. Arrangements negotiated as a package must be combined.
Identify the performance obligations in the contract	Performance obligations are similar to deliverables, but they must be both capable of being distinct and distinct within the context of the contract.
Determine the transaction price	Transaction price includes variable consideration, i.e. usage based fees, milestone payments, refunds, concessions, discounts, etc.
Allocate the transaction price	Transaction price is allocated to each item based on its relative stand alone selling price (SSP). Discounts are allocated proportionately to all items.
Recognize revenue	Revenue is recognized at a point in time (i.e. delivery) or over time (as services are provided) based on certain criteria.

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Key changes: Industry hot points

Level of impact		
Low	**Medium**	**Significant**
ALL	**CONSUMER PRODUCTS INDUSTRIAL PRODUCTS MANUFACTURING**	**SOFTWARE & TECHNOLOGY, ENGINEERING & CONSTRUCTION, ENTERTAINMENT & MEDIA, AEROSPACE & DEFENSE, AUTOMOTIVE, COMMUNICATIONS, PHARMA & LIFE SCIENCES**
• Focus on transfer of "control" instead of risks and rewards of ownership. • Collectibility assessment is more complex, and may result in delayed revenue recognition • Updated contract modification and combination guidance. • Limited method of allocation (SSP basis). • Financing components applied to both deferred and advance payments. • Enhanced disclosures • Updated consignment guidance (focus on control)	• Variable consideration requires management judgment and use of estimates. All refunds, returns, discounts, rebates, penalties, and others will require further analysis. • Accounting for return/refund/exchange rights will change. Entities will need to implement new valuation requirements around return assets. • Recognition of revenue over time or at a point in time depends on whether one or more of three specific criteria are met, which will be subject to judgment and legal enforceability. • Certain warranties represent separate performance obligations. • Updated bill-and-hold guidance (less onerous)	• Elimination of ALL industry-specific guidance. • Use of the residual method only permitted when pricing is highly variable or uncertain • Performance obligation is both capable of being distinct and distinct within the context of the contract. • Most software license revenue recognized up-front. • Licenses are evaluated to determine whether they include a right to use (point-in-time) or a right to access (over time) IP. • Cannot presume that arrangements accounted for under the percentage-of-completion method under current guidance will continue to be recognized over time. • Royalties will require new estimation techniques. • Costs to obtain or fulfill a customer contract must be capitalized in certain circumstances.

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Impacts to M&A Transactions and Valuation

- **Changes to allocation and timing of revenue**
  - Recurring vs. non-recurring revenue
  - Multiple element transactions impacted
- **EBITDA changes** will occur due to:
  - Changes in timing of revenue recognition
  - Cost capitalization requirements
- **Valuation multiples** and trends will change
- **Impacts to debt covenants** due to EBITDA changes and additional assets and liabilities
- **Public company acquisitions** of private companies in 2018 will require targets to be compliant within the quarter
- **Technology changes** may be required
  - 2 sets of books needed for some period based on adoption method
  - Technology changes require additional modules or integration with ERP systems

New Lease Accounting Standards

Financial statements impact: lessee

Balance Sheet

Right-of-use (ROU) asset:

- Lease ROU assets can be presented separately or together with other assets
- If not presented separately, disclose the line item where they are presented and the amount of lease ROU assets
- Finance lease ROU assets are prohibited from being presented in the same line item as operating lease ROU assets

Lease liability:

- Lease liabilities can be presented separately or together with other liabilities
- If not presented separately, disclose the line item where they are presented and the amount of lease liabilities
- Finance lease liabilities are prohibited from being presented in the same line item as operating lease liabilities

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Financial statements impact: lessee (cont.)

Income statement

No significant change from current GAAP

Finance lease:

- Lease-related interest expense and amortization presented in a manner consistent with how an entity presents interest expense and depreciation/amortization of similar assets

Operating lease:

- Lease expense included in income from continuing operations

Statement of cash flows

Finance lease:

- Principal payments within financing activities
- Interest payments in accordance with ASC 230, Statement of Cash Flows

Operating lease:

- All payments within operating activities, except those payments made to bring an asset to the condition and location intended for its use are investing activities

Both lease types:

- Lease payments for short-term leases and variable lease payments (not included in lease liability) are within operating activities
- Supplemental non-cash disclosure for new leases

Financial metrics

- The transition to the new standard could have additional financial statement implications that will require consideration and evaluation.
- Financial metrics, key performance indicators and capital structure impacts:
  - Key impacts relate to financial position (balance sheet)
    - Return on assets, debt-to-equity ratios and liquidity
  - Debt covenants, interest coverage ratios and EBITDA/EBIT levels
    - Potential changes to interest expense on finance leases due to changes in discount rate under ASC 842
    - Potential impairment charges due to increase in long-lived assets (right-of-use asset)
  - Recognition of foreign currency remeasurement gains and losses related to lease liabilities that are denominated in a currency that is different from the Company’s functional currency