



Quick Reference Guide for Valuation of Portfolio Company Investments

Highlights of the AICPA Accounting and Valuation Guide

The American Institute of CPAs (“AICPA”) issued the final guidance entitled “Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies” (“Guide”) on August 19, 2019. This Guide was developed by the AICPA Private Equity/Venture Capital Task Force, which includes members from the PE/VC industry, auditors, valuation practitioners and AICPA staff.

The Guide addresses accounting and valuation of portfolio company investments within the scope of FASB Accounting Standards Codification (ASC) 820,

Fair Value Measurement and ASC 946, *Financial Services — Investment Companies*. This is not a “how to” guide, but rather information that provides investment companies that invest in equity and debt instruments of portfolio companies with:

- ▶ Overview and understanding of the valuation process and the roles and responsibilities of the parties to the process; and,
- ▶ Best practice recommendations for complying with ASC 820 and ASC 946.

The Guide has two parts. Part I covers 14 chapters with the main body, while Part II consists of

Appendices A through C concluded by a glossary. An outline of the Guide is presented below:

Part I – AICPA Guide

1. Overview of the Private Equity and Venture Capital Industry and Its Investment Strategies
2. Fair Value and Related Concepts
3. Market Participant Assumptions
4. Determining the Unit of Account and the Assumed Transaction for Measuring the Fair Value of Investments
5. Overview of Valuation Approaches
6. Valuation of Debt Instruments
7. Valuation of Equity Interests in Simple Capital Structures
8. Valuation of Equity Interests in Complex Capital Structures
9. Control and Marketability
10. Calibration
11. Backtesting
12. Factors to Consider At or Near a Transaction Date
13. Special Topics
14. Frequently Asked Questions

Part II – Appendices

- A. Valuation Process and Documentation Considerations
- B. Valuation Reference Guide
- C. Valuation Case Studies
- D. Glossary

The Guide is intended to provide assistance to management and boards of directors of investment companies; valuation specialists; auditors; and other interested parties, such as limited partners, when evaluating the illiquid nature of their equity and debt investments and the significant subjectivity associated with determining their fair values.

In this Guide, you'll receive recommended approaches and best practices, such as how to:

- ▶ Estimate the **value of the enterprise for the purpose of valuing equity interests** reflecting assumptions that are consistent with the company's plans under current ownership, given the way in which the investors who in aggregate have control of the business would maximize value. The fund would then consider whether any additional adjustments are needed.
- ▶ Estimate the **fair value of debt** and the value of debt for the purpose of valuing equity consistent with the cash flows, the market yield, and the remaining expected term.

- ▶ For **equity investments in portfolio companies with complex capital structures**, consider alternative methodologies or apply appropriate adjustments when using the option pricing method (“OPM”) to allocate value between senior and junior preferred classes of equity.
- ▶ Estimate value by **calibrating** the selected valuation model to any recent transactions and then update these assumptions for changes between the transaction date and the measurement date.
- ▶ Perform **backtesting** to improve the fund’s valuation processes.
- ▶ Provide support that a fund’s **fair value measurement assumptions** reflect what a market participant would consider in measuring fair value. An integral part of this support is the **creation and maintenance of sufficient and appropriate documentation pertaining to valuation methodologies** employed, inputs and assumptions used and the resulting output associated with the fair value measurements.
- ▶ Document and clearly identify the basis and selection of all the significant inputs to an investment valuation. Examples of key inputs include **discount rates, profit margins, growth rates, royalty rates, and market multiples**.

Timing of Guidance Considered

The Guide includes examples involving valuation of different type of investments over different life cycles. While the Guide assists in addressing areas of diversity in practice, the Guide does not promulgate new requirements. Instead, the Guide’s goal is to describe what is required by GAAP and explain leading practices for complying with those requirements.

Relevant guidance issued through May 1, 2019, has been considered in the development of the issued Guide. However, the Guide does not include all accounting, valuation and other requirements applicable to an entity or a particular engagement. The Guide is intended to be used in conjunction with all applicable sources of relevant guidance.

In developing the Guide, all guidance issued up to and including the following was considered, but not necessarily incorporated, as determined based on applicability:

- ▶ FASB Accounting Standards Update (ASU) No. 2019-04, Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments
- ▶ AICPA’s Statement on Standards for Valuation Services No. 1, Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset (VS sec. 100)

Users of the Guide should consider guidance issued subsequent to those items listed previously to determine their effect, if any, on entities and engagements covered by the Guide. In determining the applicability of recently issued guidance, its effective date should also be considered.

Importance of Guide

The Guide is the first guidance on applying ASC 820 specifically targeted to the challenges experienced by investment companies in valuing their portfolio investments.

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