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The 3 keys to surprise-free valuation audits

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Surprises are great on birthdays; terrible in year-end audit situations. If you're not in line with audit expectations or up to speed with valuation best practices, you're playing a high-stakes game that could end up in year-end write-downs or – worse yet – losing face with your partners and LPs.

It's easy to fall behind in today's fast-changing world of valuation methods. Practically every year, the audit community revises something about the foundation or framework of valuation practices. To help you and your finance team navigate the murky waters of today's complex reporting requirements, this guide takes a close look at the way Topic 820 (formerly FAS 157) financial accounting standards are currently being applied. As you will see, there are three things you need to be paying close attention to right now to avoid a valuation nightmare.

#1 Post money is now widely ignored

Historically, post money has been the dominant approach for valuating portfolio company investments. In fact, it's still the most commonly used approach in deal-making and associated activities. But since the application of Topic 820, the audit community has begun to ignore this method completely. The main reason auditors want a better way of establishing the overall valuation of investor holdings is that these calculations are often used to arrive at the value of *individual* share class holdings.

When equity investors view the *overall* valuation in terms of post money, this does not account for the terms and preferences of individual classes of stock. This is a problem because it doesn't make sense to equate the highest preferred stock values with common stock values. This would be acceptable if a company were performing extremely well and all investors were able to convert their shares at the same time. But even in the best case scenario, not all stock classes are guaranteed conversion at the time of the exit.

While it's true that prices in a post-money calculation are considered arm's length between a willing buyer and seller, it's more advisable to only assign that exit price to the current round of preferred stockholders. This number then becomes the first data point for determining the valuation of the remainder of the stock classes.

This approach is very much in line with the 409A requirements of underlying portfolio companies, which need to assess stock classes as they relate to financing terms and conditions (in accordance with prescribed methodologies) *before* determining the current value of stock options for tax reporting. Although 409A methodologies vary, they all start with the underlying premise that preferred classes of stock carry a higher value based on preferences and seniority.

Based on all of the above, it's essential to emphasize to your investing partners that post-money values should not be reflected in the carrying value of the investment.

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#2 Know your deal terms – inside and out

There are many key provisions that go into a venture term sheet besides price per share, post money and total amount raised. Understanding key terms and their impact on your valuation model is critical – including why the terms were agreed upon in the first place.

When defending your valuation position and approach to your audit team, know how the deal was negotiated and what the investing partner's main motivation was for investing. This will help your internal finance team determine if a round is arm's length and a good data point for the valuation work. It will also make the auditors more comfortable with the way you carry value. This applies to both primary and secondary transactions. For example, when a secondary transaction occurs where founders are selling their shares to obtain liquidity, this may need to be ignored for valuation purposes as it is not a true indication of company value.

Digging deeper into deal terms

In today's valuation world, deal terms are almost as important as the overall post money or issue price. To align with model-based valuation approaches under the Topic 820 framework, make sure you know your key terms and conditions as well as their impact on liquidation payouts and valuation models. There are many consistent terms across deals, but sometimes these vary from investment to investment. Not identifying these terms on in-house valuations can lead to inaccurate valuations on interim financial statements and year-end write-downs. In the worst case, deals may fall apart because of a disagreement on the terms investing partners and portfolio companies spent months negotiating.

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Pari pasu versus ranked preference

The seniority or ranked preference of preferred securities can greatly affect payouts when the exit price is below a level where all stock converts to common. This is one of the primary reasons why auditors now insist that post money valuations aren't justified.

When a preference is *pari passu*, the classes of preferred stock are paid out together, with each class returning their liquidation amounts simultaneously. If Series A and Series B are *pari passu*, for example, they will be paid together. If proceeds are not enough for each to return its entire liquidation preference, Series A and Series B investors will share the proceeds owed to them pro rata.

This differs from a ranked preference in which Series B would typically be senior to Series A and therefore return its entire preference amount prior to the Series A receiving any proceeds. When performing valuations, these preferences have to be considered as they alter the value of the enterprise along with its underlying preferred securities as illustrated below. Here are two scenarios that illustrate this point.

Scenario 1: When preferred securities are allocated *pari passu*, the distribution to the common is $10,070,615.

Seniority	Series Name	Seniority Description
1	Preferred Series A	1 - Highest Seniority and Pari Passu
1	Preferred Series B	1 - Highest Seniority and Pari Passu
1	Preferred Series C	1 - Highest Seniority and Pari Passu

US Dollars Ownership Class	Total Aggregate Value	Total Shares Outstanding	Original Issue Price	Fair Value Per Share	Variance
Common Stock	$10,070,615	3,010,555	$0.00	$3.35	
Preferred Series A	$7,742,581	2,000,000	$2.00	$3.87	93.56%
Preferred Series B	$4,721,239	944,845	$4.50	$5.00	11.04%
Preferred Series C	**$4,237,500**	**750,000**	**$5.65**	**$5.65**	**0%**
2010 Stock Option Plan @ $0.01	$1,619,757	485,116	$0.01	$3.34	33289.07%
2011 Stock Option Plan @ $0.05	$1,607,785	485,116	$0.05	$3.31	6528.46%
2012 Stock Option Plan @ $0.25	$1,549,004	485,116	$0.25	$3.19	1177.22%
Preferred Series C Convertible Debt - 1/1/2014 @ $5.65	$82,404	16,880	$5.65	$4.88	-13.6%
Non-Convertible Promissory Note - 1/1/2013	$2,703,766	2,240,658	$1.00	$1.21	20.67%
Preferred Series B Warrants @ $4.50	$79,432	55,155	$4.50	$1.44	-68%
Total	**$34,414,084**	**10,473,441**			

Scenario 2: Everything is the same as Scenario 1 except that Series C has been given seniority relative to Series A and B. This not only drops the value of common stock to $7,312,804, but it also results in a significantly lower enterprise value.

Seniority	Series Name	Seniority Description
1	Preferred Series C	1 - Highest Seniority
2	Preferred Series A	2 - Lowest Seniority and Pari Passu
2	Preferred Series B	2 - Lowest Seniority and Pari Passu

US Dollars Ownership Class	Total Aggregate Value	Total Shares Outstanding	Original Issue Price	Fair Value Per Share	Variance
Common Stock	$7,312,804	3,010,555	$0.00	$2.43	
Preferred Series C	**$4,237,500**	**750,000**	**$5.65**	**$5.65**	**0%**
Preferred Series A	$5,725,456	2,000,000	$2.00	$2.86	43.14%
Preferred Series B	$3,632,565	944,845	$4.50	$3.84	-14.56%
2010 Stock Option Plan @ $0.01	$1,175,807	485,116	$0.01	$2.42	24137.65%
2011 Stock Option Plan @ $0.05	$1,165,588	485,116	$0.05	$2.40	4705.4%
2012 Stock Option Plan @ $0.25	$1,115,625	485,116	$0.25	$2.30	819.88%
Preferred Series C Convertible Debt - 1/1/2014 @ $5.65	$54,870	16,880	$5.65	$3.25	-42.47%
Non-Convertible Promissory Note - 1/1/2013	$2,691,375	2,240,658	$1.00	$1.20	20.12%
Preferred Series B Warrants @ $4.50	$50,112	55,155	$4.50	$0.91	-79.81%
Total	**$27,161,701**	**10,473,441**			

Liquidation preferences

It's imperative to pay attention to negotiated payout preferences when making valuations. Given the risk of investing capital into early-stage companies, venture investors typically negotiate the right to have their investments return prior and in preference to other investors and option holders. These preferences commonly are associated with a multiple (e.g., 1x means one times the original issue price).

For the majority of portfolio companies, classes of preferred stock carry a 1x liquidation preference. This means, in the event of a merger, acquisition or liquidation of the company, the holders of the preferred stock are entitled to receive a payout equal to the original issue price of the security.

In certain circumstances, the purchasers of preferred securities may negotiate a higher multiple for the liquidation preference. With a higher multiple (most commonly 2x or 3x), the preferred class of stock would be paid that multiple of the original issue price for every share held (in an attempt to lock in a positive return, despite a range of negative outcomes). These favorable preferences increase the intrinsic value of the preferred security while being punitive to the valuation of other share classes.

Scenario 3: In this example, all of the deal terms are the same as in Scenario 2 except that Series C now receives a liquidation preference of 2x its original issue price. As you can see, the enterprise value drops rather significantly.

Preferred Series C

Authorized Shares:	1,082,979
Closed Date:	1/1/2014
Price Per Share:	$5.65
Seniority:	1 - Highest Seniority
Conversion Price:	$5.65
Conversion Ratio:	1 share of common for each share of preferred
Liquidation Preference:	
Liquidation Multiple:	2X
Begins:	Starts as of month 1 after issuance
Expiration:	Non-Expiring

US Dollars Ownership Class	Total Aggregate Value	Total Shares Outstanding	Original Issue Price	Fair Value Per Share	Variance
Common Stock	$1,256,200	3,010,555	$0.00	$0.42	
Preferred Series C	**$4,237,500**	**750,000**	**$5.65**	**$5.65**	**0%**
Preferred Series A	$1,247,302	2,000,000	$2.00	$0.62	-68.82%
Preferred Series B	$965,767	944,845	$4.50	$1.02	-77.29%
2010 Stock Option Plan @ $0.01	$201,743	485,116	$0.01	$0.42	4058.66%
2011 Stock Option Plan @ $0.05	$199,045	485,116	$0.05	$0.41	720.61%
2012 Stock Option Plan @ $0.25	$186,051	485,116	$0.25	$0.38	53.41%
Preferred Series C Convertible Debt - 1/1/2014 @ $5.65	$6,675	16,880	$5.65	$0.40	-93%
Non-Convertible Promissory Note - 1/1/2013	$2,533,012	2,240,658	$1.00	$1.13	13.05%
Preferred Series B Warrants @ $4.50	$5,264	55,155	$4.50	$0.10	-97.88%
Total	**$10,838,560**	**10,473,441**			

Comparing Scenarios 1, 2 and 3

This summary of Scenarios 1, 2 and 3 shows how dramatically the enterprise value of a firm can drop as deal terms are altered.

Comparing Scenario's - Graphic 1

Series	Post $ CSE	Pari Passu	Ranked Preference	2x Liquidation Multiple
Common	$5.65	$3.35	$2.43	$0.42
Series A	$5.65	$3.87	$2.86	$0.62
Series B	$5.65	$5.00	$3.84	$1.02
Series C	$5.65	$5.65	$5.65	$5.65
Entity Value	**$59,175,000**	**$34,414,000**	**$27,162,000**	**$10,839,000**

These effects become immediately apparent when you run valuation models that factor in multiples according to liquidation preferences. This is why an option pricing model (OPM) may render a value significantly lower than a post money or market approach. It is possible to argue that preferences will 'disappear' on exit or a future round of financing if the exit valuation or the next round is significant enough, but this tactic is seldom effective and ignores the negotiated terms.

What is participating preferred stock?
'Participating Preferred' is an investor-favorable term, which both limits the downside and enhances the upside of the investment. It's also one more reason why share classes need to be considered carefully when valuing a company. When this method is used, investors may receive the benefit of preferred stock to be paid first, as well as the right to share in payouts with common holders.

The amount of sharing in common stock can be either 'capped' (most commonly at 2x or 3x the securities original issue price) or 'uncapped.' When the participation is uncapped, the preferred security is not incentivized to convert to common stock since it achieves the best of both worlds – receiving its full preference in seniority to common shareholders and receiving its full pro rata as if it converted to common.

As with multiples applied to liquidation preferences, share classes without the 'preferred' label are significantly impacted by an OPM valuation, along with the company's overall equity or enterprise value.

> ***"...share classes need to be considered carefully when valuing a company."***

#3 Corroborative approaches make a stronger valuation case
To give your valuation output added strength and acceptance, it's important to compare your primary method of valuation to a second corroborative approach. While technically it is acceptable (per Topic 820 requirements) to rely on only one reliable approach that's reasonably applied, it is far preferable to have a second method of valuation as well.

If a company has normalized revenues, when back-solving to a recent round, the value derived should be supported by a market or income approach, whichever is more applicable. When disparity between approaches is greater than commonly acceptable, conduct a subjective analysis to determine which approach to rely on. Use appropriate reasoning based upon deal terms and the facts and circumstances around the investment.

Disparities are prevalent when companies have preferred share classes that offer more beneficial terms than usual. This happens, for example, when many shares are offered with 2x or 3x payout preferences, or when shares have a significant step-up in value due to secondary transactions.

As you become better acquainted with how to handle valuation audits, be sure to keep all stakeholders in the loop – your investment firm (especially investing partners and the back-office finance team), portfolio company, auditors, valuation consultants and limited partners.

How Shareholder InSite can help

Shareholder InSite makes a sophisticated software platform called Qval that helps you reap the rewards of your investments, without any of the valuation stress. Qval is a web-based solution you can run on your computer, tablet or smartphone. It makes it easy to produce accurate and comprehensive portfolio company valuations using the most advanced methodologies. Instantly!

Many of the world's most respected venture and private equity firms rely on Qval every day. Qval provides a standard, repeatable, flexible approach to reporting the value of your investments. With it, you can:

- Produce accurate, audit-ready 820 valuations
- Take corroborative approaches in which you compare post money with other valuation methodologies (like the market approach or option pricing model)
- Track cap tables and make hypothetical projections
- Generate fast, accurate term-sheet analyses and waterfall distribution scenarios

To learn more about Qval or schedule a personalized demo, please contact the Shareholder InSite sales team at sales@shareholderinsite.com or (615) 873-4567, ext. 3.

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