Corporate Venture Capital and ASU 2016-01

Best Practices for Equity Investments

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Accounting Standards Update 2016-01 has generally flown under the radar since it was released almost two years ago. However, this accounting update has the potential to significantly affect financial reporting by public and private companies with minority equity investments – including corporate entities with a portfolio of venture capital investments. This whitepaper provides an overview of the accounting standards changes as they pertain to companies with equity investments and a few best practice considerations for firms with exposure to these changes.

What Do I Need to Know?

- The new rules apply to equity investments currently reported at cost.
- Entities will be required to measure these equity investments at fair value at the end of each reporting period, with changes in fair value recognized in net income.
- Entities can elect a Measurement Alternative, which would instead require a qualitative assessment for impairment and consideration of observable price changes in identical or similar investments.
- The new rules will be effective for public companies beginning in fiscal 2018 and for private companies beginning in fiscal 2019.
- Entities should address the need for appropriate valuation policies and procedures to evaluate their equity investment reporting, monitor investments for impairment, identify observable price changes, and measure fair value when necessary.
- Mercer Capital has the experience and capabilities to help CFOs, financial managers, and corporate VC professionals measure the fair value of their investment portfolios.

What Is Accounting Standards Update 2016-01?

The Financial Accounting Standards Board published ASU 2016-01 *Financial Instruments – Overall (Subtopic 825-10)* in January 2016. The update contains new guidance on how entities should recognize, measure, and make disclosures about certain financial assets and financial liabilities. Most notably, ASU 2016-01 requires entities to account for their equity investments at fair value (with some exceptions) and recognize any changes in fair value in net income.

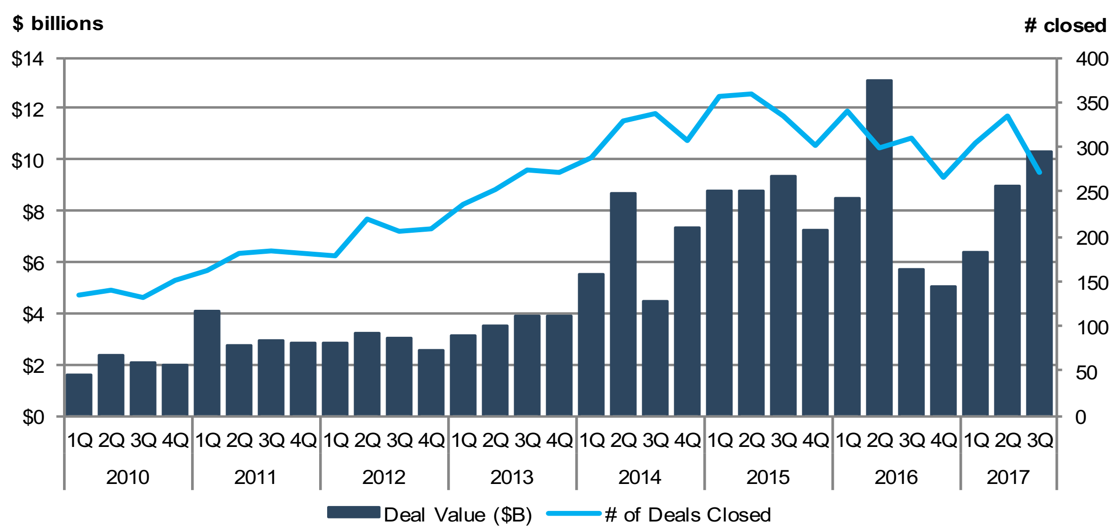
The guidance will apply to public companies for fiscal years beginning after December 15, 2017 and will allow companies to elect quarterly or event-based valuations of their investments. For private companies, the guidance is effective for fiscal years beginning on or after December 15, 2018. Public and private companies that report under GAAP need to assess the impact of this update on their financial reporting and begin developing appropriate policies and procedures for compliance.

Corporate Venture Capital Activity Is Trending Up

Corporate venture capital has increased as an investment activity for large corporations in recent years. By one count, the top ten corporate venture capital groups made over 1,600 investments between 2010 and 2016.

Intel Capital, the most active corporate venture capital investor over the past six years, made investments in 34 new companies totaling $455 million in 2016 alone.

Corporate Venture Capital Participation



Source: 3Q 2017 Pitchbook-NVCA Venture Monitor

Most Active Corporate VC Investors
2010 through 2016

	Venture Arm	# Investments
1	Intel Capital	395
2	Google Ventures	314
3	Qualcomm Ventures	189
4	Salesforce Ventures	141
5	SoftBank Capital	115

	Venture Arm	# Investments
6	Caixa Capital Risc	109
7	GE Ventures	95
8	Comcast Ventures	95
9	Cisco Investments	94
10	Samsung Venture Investment	93

With corporate venture capital activity on the rise, a keen eye is being turned to public company reporting of equity holdings. Valuations of VC-backed startups have grown rapidly in recent years, making many early venture investments worth well in excess of original cost. For example, Google Ventures (GV) invested in Airbnb in late 2010 at a valuation of $71.8 million. In March 2017, less than seven years later, AirBnB completed a $448 million financing round at a reported valuation of $29.3 billion, an increase in post-money value of more than 400x since the 2010 investment.[1]

Yet, many corporate balance sheets carry minority investments at cost – the value originally paid for the interest. Current U.S. GAAP does not require disclosure of the gains (and occasional losses) attributable to minority investments held at cost. While the incumbent accounting methodologies provide some information about deterioration in investment value, large valuation increases remain largely hidden from view. Unlike an asset for which replacement cost similar to the original outlay may be a reasonable estimate of worth, the value of investments in fledgling investee startups can change dramatically as these companies develop into successful businesses. With startups remaining private longer in the absence of exit events like IPOs, rising valuations of the underlying companies can begin to diverge significantly from the cost basis of early investments.

Current Methods of Accounting for Equity Investments

Under current GAAP, unconsolidated equity investments are accounted for using either the cost or equity method. Investments with a readily determinable fair value (such as a share of public company stock) will be carried at fair value.

Cost Method: Investments in non-marketable equity securities under a 20% ownership threshold or lacking control over the business historically have been accounted for using the amount paid for the investment. Investments carried at cost include adjustments for impairments that result from triggering events such as a sale or IPO, which affect other comprehensive income rather than affecting the income statement directly. Income from the investment – such as dividends – is included on the income statement. These minority investments are the primary focus of the new ASU 2016-01 guidance.

Equity Method: When one company holds more than 20% of another company's shares (and is deemed to have significant influence), the investment has historically been accounted for using the equity method. These investments are recorded at cost at the time of acquisition. Equity method investments subsequently recognize the pro rata share of net income from the investment as an increase to the value of the asset and an increase to net income. Dividends received reduce the investment asset. Investments reported under the equity method are – strictly speaking – presented at neither cost nor fair value.

Fair Value: Investments carried at fair value are measured at each reporting date. The gain or loss that would be received from selling an investment at a given point in time impacts the reported value of the asset. Both realized (resulting from sale of the asset) and unrealized gains or losses are recorded as increases or reductions to net income. Interest and dividend income are similarly reported through the income statement.

How to Account for Equity Investments under the New Rules

ASU 2016-01 seeks to provide more transparency and relevance to financial statement users, as well as decrease the complexity of equity investment impairment testing for financial statement preparers. The guidance applies to all equity investments that are not consolidated with the investor or accounted for under the equity method.[2] That is, investments that represent less than 20% ownership or for which the owner lacks influence over investee operations. While the update has applications to both financial assets and financial liabilities, in this whitepaper we focus on the former, specifically minority equity interests.[3] The update divides these investments into securities with readily determinable fair values and those without readily determinable fair values.

Equity Investments with a Readily Determinable Fair Value

ASC 820 defines fair value as, "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." The FASB ASC Master Glossary sets forth a few conditions for an equity security to have a readily determinable fair value.

- The fair value of an equity security is readily determinable if sales prices or bid-and-ask quotations are currently available on a securities exchange registered with the U.S. Securities and Exchange Commission (SEC) or in the over-the-counter market, provided that those prices or quotations are publicly reported by the National Association of Securities Dealers Automated Quotations systems or by OTC Markets Group Inc. Restricted stock meets that definition if the restriction terminates within one year.

- The fair value of an equity security traded only in a foreign market is determinable if that foreign market is of a breadth and scope comparable to one of the U.S. markets referenced above.

- The fair value of an equity security that is an investment in a mutual fund or in a structure similar to a mutual fund (that is, a limited partnership or a venture capital entity) is readily determinable if the fair value per share (unit) is determined and published and is the basis for current transactions.

For assets that have a readily determinable fair value, ASU 2016-01 mandates reporting investments at fair value with a cumulative-effect adjustment on the entity's balance sheet in the first fiscal year of adoption. This adjustment may increase volatility of reported income or expenses, both at the time of adoption and on an on-going basis, for firms that have previously reported these investments at cost.

Equity Investments Without a Readily Determinable Fair Value

For equity investments without a readily determinable fair value, entities can choose to apply a new Measurement Alternative. "An entity may elect to measure an equity security without a readily determinable fair value [and that does not qualify for the ASC 820 practical expedient][4] at its cost minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer."[5] Elections to measure a security using this guidance may be made on an investment-by-investment basis. However, once an entity elects to measure an equity security using the Measurement Alternative, it should be applied consistently unless the alternative is no longer permitted.

Observable price changes mean those resulting from orderly transactions, including those that are known or can reasonably be known at the date of measurement. However, it is important to note that the transactions must involve identical or similar investments from the same issuer. Determining the similarity of a new security issuance to one held by the reporting company should take into consideration the specific rights and obligations of the issuance, such as voting rights, distribution rights and preferences, and conversion features. ASU 2016-01 notes that "the entity should make a reasonable effort [that is, without expending undue cost and effort] to identify any observable transactions that it may not be readily aware of. The entity need not conduct an exhaustive search for all observable price changes."[6] Relevant transactions must occur on or before the measurement date and must be known or reasonably knowable.

Determining Impairment

While simplifying the process of determining changes (both upward and downward) to the reported value of equity investments, the Measurement Alternative does not eliminate the need to test for impairment. However, it does allow for the use of a single-step qualitative assessment at each reporting period. Qualitative indications of impairment include, but are not limited to, the following.[7]

- A significant deterioration in the earnings performance, credit rating, asset quality, or business prospects of the investee.

- A significant adverse change in the regulatory, economic, or technological environment of the investee.

Do subsequent funding rounds by startups represent transactions in "similar investment of the same issuer"?

Since venture-backed startups tend to involve complex capital structures, the question of what constitutes similar investments is particularly pertinent. Startup cap structures that include plain-vanilla common shares (and options on common), and several series of varying liquidation preferences, participation features, and convertibility based on differing ratchet provisions are common. Should a subsequent funding round in which a startup issues preferred shares with a different set of rights and preferences inform changes in the fair value of the (earlier-vintage) shares owned by a reporting entity? Our reading of the guidance suggests the answer is in the affirmative. Reporting entities are not required to expend undue effort in identifying transactions, so they do not need to track all ownership transfers involving every distinct share class. This is reasonable as it would be quite difficult to obtain information on secondary transactions between private parties. However, readily available information – particularly subsequent primary funding rounds by the investee companies – should be taken into consideration. Any observed pricing information would then have to be adjusted to determine fair value of the reporting entity's ownership interests.[8]

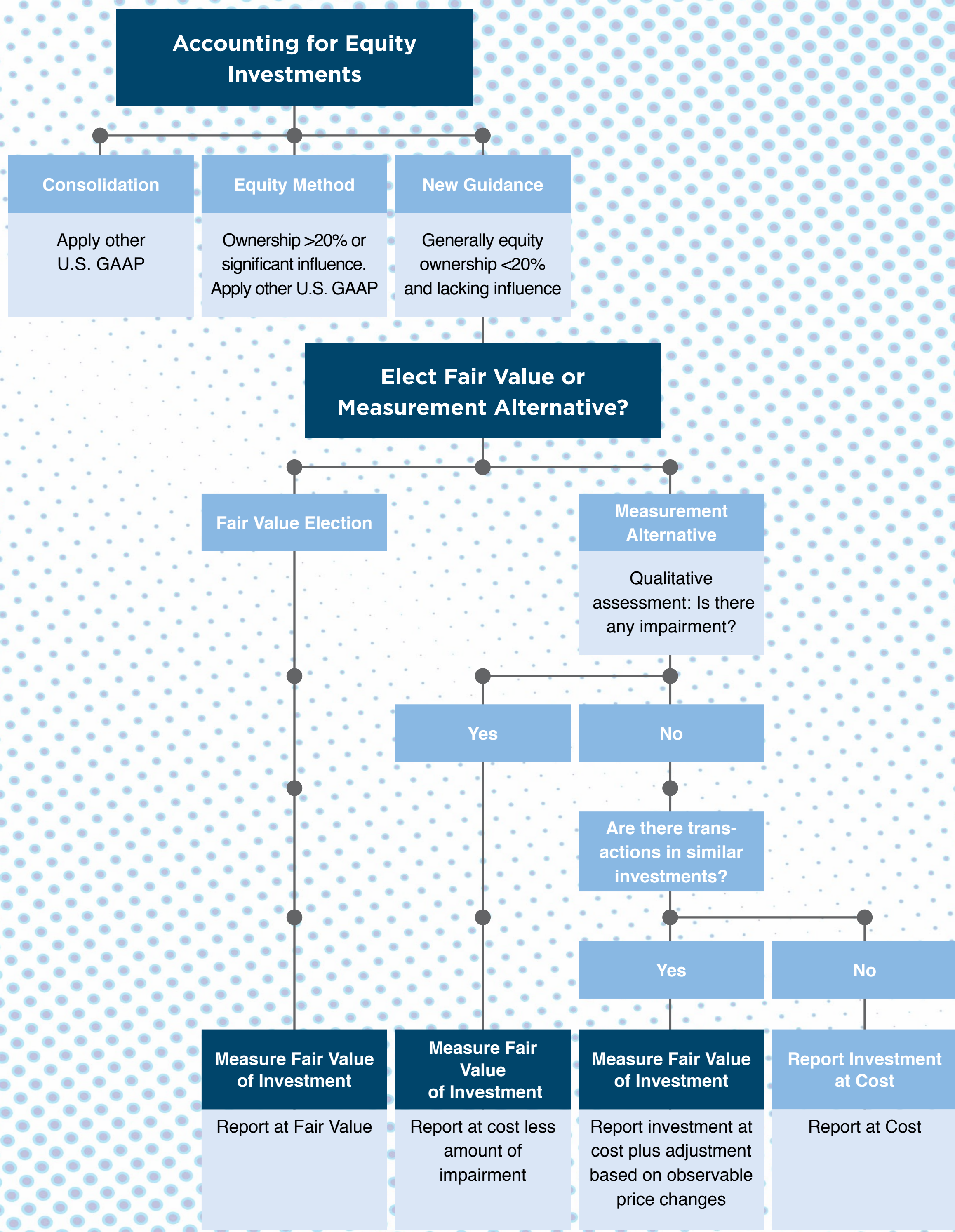
- A significant adverse change in the general market condition of either the geographical area or the industry in which the investee operates.
- A bona fide offer to purchase, an offer by the investee to sell, or a completed auction process for the same or similar investment for an amount less than the carrying amount of that investment.
- Factors that raise significant concerns about the investee's ability to continue as a going concern, such as negative cash flows from operations, working capital deficiencies, or noncompliance with statutory capital requirements or debt covenants.

If a qualitative impairment is identified, the reporting entity should estimate the fair value of the investment and recognize an impairment loss equal to the difference between the carrying amount of the investment and its fair value.

Disclosure Requirements

ASU 2016-01 includes requirements to increase not only the quantitative information provided to financial statement users, but also the qualitative details behind the numerical changes as well. As detailed in ASC 321-10-50-3,

How to Report Corporate Venture Capital Investments Under ASU 2016-01



“[a]n entity that applies the guidance in paragraph 321-10-35-2 for equity securities without readily determinable fair values shall disclose all of the following:

- The carrying amount of investments without readily determinable fair values
- The amount of impairments and downward adjustments, if any, both annual and cumulative
- The amount of upwards adjustments, if any, both annual and cumulative
- As of the date of the most recent statement of financial position, additional information (in narrative form) that is sufficient to permit financial statement users to understand the quantitative disclosures and the information that the entity considered in reaching the carrying amounts and upward or downward adjustments resulting from observable price changes.”

Will adopting the Measurement Alternative to Fair Value result in lower earnings/EPS volatility?

At first blush, it would seem that electing the Measurement Alternative would result in lower volatility for earnings and EPS. After all, if there are (1) no impairments and (2) no observable price changes for similar investments, then the investment would continue to be reported at cost. Assuming no changes over successive quarters, the cost measurement would stay the same. However, most investments in early-stage companies are made in the hope of outsized returns. After all, venture capital as an asset class is high risk, high reward. When an observable price change (like a new funding round) takes place, the increase in value can be dramatic and lead to a large fluctuation in Other Income/Expense, which directly impacts reported earnings and EPS. This might be welcome in an otherwise weak quarter, but like all episodic events, it makes comparison difficult on a quarter/quarter or year/year basis.

And on the flipside, an impairment or a down-round event can have the same dramatic effect going the other way.

The argument for taking the fair value approach (and eschewing the Measurement Alternative) is that the fair value measurement would be closer to the true market value of the investment (fair value is an exit-value concept). So when a new funding round occurs or other price changes in similar instruments are considered, the increase or decrease in value from the last reporting date would be more modest – hence, a more muted impact on quarterly or annual earnings/EPS. The potential for lower ongoing volatility from the fair value election might also make for easier estimation of forward earnings/EPS guidance under the new standard.

ASU 2016-01 Impact on Corporate Venture Capital Investment Reporting

Although the intended result of ASU 2016-01 is to increase the scope of decision-useful information reported on corporate balance sheets, it also has the potential to complicate reporting for entities with investments in venture-backed startups. Re-measuring fair value of ownership interests in companies that have become significantly more valuable since the reporting entity's initial investment could result in higher volatility of reported income (from non-core business sources). Beginning in their quarterly 2017 filings, a few major corporate investors – including Google, Salesforce, and Cisco – acknowledged an increase in income and expense volatility is expected as a result of this transition.

Evaluating the Impact of ASU 2016-01

Top Corporate VCs	Excerpts from 9/30/17 10-Q
Intel Capital	"…Management has elected to apply the measurement alternative to non-marketable equity securities."
Google Ventures	"We expect to elect the measurement alternative"
	"We anticipate that the adoption of ASU 2016-01 will increase the volatility of our other income (expense), net, as a result of the remeasurement of our equity securities upon the occurrence of observable price changes and impairments."
Qualcomm Ventures	"The Company…is in the process of determining the effects the adoption will have on its consolidated financial statements."
Salesforce Ventures	"The Company plans to elect the measurement alternative. The Company…expects the adoption of ASU 2016-01 will impact its strategic investments portfolio. The Company is currently evaluating the impact to its consolidated financial statements and expects it could have a material impact, including additional volatility to other income (expense) within the Company's statements of operations, in future periods."
Comcast Ventures	"We are currently in the process of determining the impact that the updated accounting guidance will have on our cost method investments."
Cisco Ventures	"While Cisco is currently evaluating the impact of this accounting standard update on its Consolidated Financial Statements, Cisco expects that this accounting standard update will increase the variability of other income (loss), net."
Microsoft Ventures	"We are currently evaluating the impact of this standard on our consolidated financial statements, including accounting policies, processes, and systems."
Pfizer Venture Fund	"We expect the adoption of this new accounting standard may increase the volatility of our income in future periods, due to changes in the fair value of equity investments."

How to Value a Venture Capital Investment

The valuation of ownership interests in a venture-backed startup company involves evaluating changes in the prospects of the company and the industry in which it operates, probabilities of various exit scenarios, as well as the capital structure. The following outlines our process when providing periodic fair value marks for venture capital investments in pre-public companies for financial and corporate investors.

Examine the Most Recent Financing Round Economics

The transaction underlying the initiation of an investment position can provide three critical pieces of information from a valuation perspective:

- Size of the aggregate investment and per share price.
- Rights and protections accorded to the newest round of securities.
- Usually, but not always, an indication of the underlying enterprise value from the investor's perspective.

Deal terms commonly reported in the press focus on the size of the aggregate investment and per share price. The term "valuation" is usually a headline-shorthand for implied post-money value that effectively assumes all equity securities in the company's capital structure have identical rights and protections. While easily computed, this approach glosses over the fact that for pre-public companies, securities with differing rights and protections should and do command different prices.

The option pricing method (OPM) is an alternative that explicitly models the rights of each equity class and makes generalized assumptions about the future trajectory of the company to deduce values for the various securities. Valuation specialists can also use the probability-weighted expected return method (PWERM) to evaluate potential proceeds from, and the likelihood of, several exit scenarios for a company. Total proceeds from each scenario would then be allocated to the various classes of equity based on their relative rights. The use of PWERM is particularly viable if there is sufficient visibility into the future exit prospects for the company.

The economics of the most recent financing round helps calibrate inputs used in both the OPM and PWERM.

- Under the OPM, a backsolve procedure provides indications of total equity and enterprise value based on the pricing and terms of the most recent financing round. The indicated enterprise value and a set of future cash flow projections, taken together, imply a rate of return (discount rate) that may be reasonable for the company. Multiples implied by the indicated enterprise value, juxtaposed with information from publicly traded companies or related transactions, can yield valuation-useful inferences.
- Under the PWERM, in addition to informing discount rates and providing comparisons with market multiples, the most recent financing round can inform the relative likelihood of the various exit scenarios.

How to Value a Venture Capital Investment

01

Examine Most Recent Financing Round Economics

"Simple" Pre- and Post- Money

OPM Backsolve

→ **Calibrate Valuation Methods to Implied EV**

↓

DCF

PWERM

Market Multiples

Transaction Multiples

02

Adjust Valuation Inputs to Measurement Date

Company Performance Relative to Most Recent Round

↓

Financial Results

Forecast Changes

Interest from Potential Acquirers

Market Conditions Relative to Most Recent Round

↓

Public Multiples

IPOs

Transactions

General VC Performance & Investment Activity

03

Measure Fair Value

Valuation of Subject Interest at Measurement Date

↓

OPM

PWERM

04

Reconciliation and Tests of Reasonableness

When available, indications of enterprise value from the investor's perspectives can further inform the inputs used in the various valuation methods. In addition to these quantitative inputs, discussions and documentation around the recent financing round can provide critical qualitative information, as well.

Adjust Valuation Inputs to Measurement Date

Between a funding round and subsequent measurement dates, the performance of the investee company and changes in market conditions can provide context for any adjustments that may be warranted for the valuation inputs. Deterioration in actual financial performance may warrant revisiting the set of projected cash flows, while improvements in market multiples for similar companies may suggest better pricing may be available at exit. Interest from potential acquirers (or withdrawal of prior interest) and general IPO trends can inform inputs related to the relative likelihood of the various exit scenarios.

Measure Fair Value

Measuring fair value of the subject security entails using the OPM and PWERM, as appropriate and viable, in conjunction with valuation inputs that are relevant at the measurement date.

Reconciliation and Tests of Reasonableness

A sanity check to scrutinize fair value outputs is an important element of our measurement process. Specifically as it relates to venture capital investments in pre-public companies, such a check would reconcile a fair value indication at the current measurement date with a mark from the prior period in light of both changes in the subject company, and changes in market conditions.

ASU 2016-01 Best Practices

The shift to fair value basis for measuring and reporting equity investments could prove challenging for many entities because these investments do not have readily determinable fair value. In addition, application of the new standard could result in increased volatility in net income and EPS, even when using the measurement alternative.

The valuation challenges associated with the new guidance are not unique, however. For the valuation of minority investments in venture-backed and other closely-held nonpublic entities, broadly recognized valuation best practices include:

- Valuation policies and procedures that establish methodologies for various classes of investments, specify personnel to be involved in the valuation process, address potential conflicts of interest, and provide for appropriate disclosure.
- A governance mechanism (valuation committee) that is reasonably independent from the direct influence of portfolio managers and investment personnel.
- Qualified valuation professionals, including internal or external specialists as appropriate, who contribute to the implementation of the valuation policies and procedures.

As corporate entities with VC investments begin to adopt ASU 2016-01, a well-executed valuation framework that includes appropriate valuation policies and procedures, an adequate governance mechanism, and an able team of valuation personnel could be invaluable. While external valuation expertise is not a substitute for a sound valuation framework, incorporating such expertise can improve the fair value measurement process and outcomes.

Mercer Capital provides a comprehensive suite of valuation services to assist corporations, boards of directors, portfolio managers, financial managers, and others with their financial reporting requirements. Our services include independent determinations of value for select investments or periodic reviews of management-prepared valuations. Please give us a call to discuss your valuation needs in confidence. For more discussion on fair value, corporate venture capital, and related topics, visit Mercer Capital's Financial Reporting Blog.

End Notes

1. VC Experts
2. The guidance does not apply to entities in industries that already account for substantially all investments at fair value, such as broker-dealers, post-retirement benefit plans, and investment companies.
3. For a primer on the application of ASU 2016-01 to financial institutions, view our whitepaper *ASU 2016-01: Recognition and Measurement of Financial Assets and Liabilities* at http://mer.cr/2Ch9Sx2.
4. The ASC 820 practical expedient allows reporting entities to measure certain investments at their net asset value (NAV) per share if (1) the investment doesn't have a readily determinable fair value and (2) the investee is an investment company within the scope of ASC 946, Financial Services-Investment Companies.
5. ASC 321-10-35-2
6. ASC 321-10-55-8
7. ASC 321-10-35-3
8. ASC 321-10-55-8 through 321-10-55-9

Should a reporting entity opt for Fair Value over the Measurement Alternative?

Speaking as a valuation service-provider, the only reasonable answer to this question is, "Of course!"

In all seriousness, reporting entities' concerns regarding the choice probably relate to two aspects: (i) earnings/EPS volatility and (ii) complexity and cost. We discussed the issue of earnings/EPS volatility in an earlier section. The allure of adopting the Measurement Alternative rests on the assumption that "assuming nothing significant has occurred in the interim," investor entities should be able to continue reporting the investments at cost. The guidance in ASU 2016-01, however, makes the practice less straightforward than before. First, at a minimum the reporting entities have to document their determination of no significant changes using a qualitative impairment test for each investment at each reporting period. Second, if there are significant changes – whether an impairment event that results in a write-down or favorable observable transactions that give rise to write-ups – the reporting entity will need to measure the fair value of the investment in addition to undertaking the qualitative impairment assessment. To us, this seems like duplication of effort in a sizable number of cases.

Opting for regular fair value measurement by a third party can also be good portfolio management practice for corporate venture investors. Many corporate VC professionals may wear multiple hats within their organizations. While this can mean that these individuals bring technical and subject matter expertise to the table, the financial minutiae of the investment process may not receive all the attention that they deserve. Third-party validation could be enormously helpful for investment personnel operating within corporate structures.

An aside on cost. We are accustomed to pricing our services on a per-name (per-investment) basis, with modest variations depending on measurement frequency and volume of names. As principals, however, corporate VCs (or regular VCs, for that matter) can – we would argue, should -- view the expense associated with fair value measurement as part of the administrative costs of assembling, monitoring, and pruning or otherwise maintaining an investment portfolio. If the corporate entity had invested in the startups as a limited partner in a traditional VC fund, it would have to pay out both management fees (say, 2% of investments) and incentive fees (say, 20% carry). For investments made by an in-house team, (a portion of) the 2% management fees could reasonably be applied to administrative costs. So, for perspective, on an annual basis how many basis points of invested capital would a corporate VC end up spending on valuation fees? Probably not much.

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In an environment of increasingly complex fair value reporting standards and burgeoning regulatory scrutiny, Mercer Capital helps clients resolve financial reporting valuation issues successfully.

Mercer Capital has the capability to serve the full range of fair value valuation needs, providing valuation opinions that satisfy the scrutiny of auditors, the SEC, and other regulatory bodies.

We also have broad experience with fair value issues related to public and private companies, financial institutions, private equity firms, start-up enterprises, and other closely held businesses. National audit firms consistently refer financial reporting valuation assignments to Mercer Capital.

Our professionals are nationally recognized as leaders in the valuation industry, and hold the most rigorous credentialing designations including the CEIV, CFA, ASA, and CPA, among others, which are representative of the highest standards in the valuation and accounting industries. Mercer Capital has the institutional capability to tackle even the most uncommon or complex fair value issues. We understand the sensitivity of financial reporting timing needs and meet your deadline on time, every time.

For more information about Mercer Capital, visit www.mercercapital.com.

Travis W. Harms, CFA, CPA/ABV
901.322.9760
harmst@mercercapital.com

Lucas Parris, CFA, ASA-BV/IA
901.322.9784
parrisl@mercercapital.com

Sujan Rajbhandary, CFA
901.322.9784
sujanr@mercercapital.com

Samantha L. Albert
901.322.9702
alberts@mercercapital.com

Megan Richards
901.322.9767
richardsm@mercercapital.com

MERCER CAPITAL

Memphis
5100 Poplar Avenue, Suite 2600
Memphis, Tennessee 38137
901.685.2120

Dallas
12201 Merit Drive, Suite 480
Dallas, Texas 75251
214.468.8400

Nashville
102 Woodmont Blvd., Suite 231
Nashville, Tennessee 37205
615.345.0350

www.mercercapital.com