



AICPA guide, covering valuation of privately held shares stands out in relation to other valuation literature. It covers certain technical valuation topics as well as softer or business aspects of valuation. The technical content includes application of the option pricing model, related allocation techniques, relations between assets and equity volatility, many helpful examples. Business content includes stages of enterprise development, their impact on fair value estimates, discussing of market participant expectations, evaluating relevance of secondary transaction. The guide is geared toward valuations performed for financial reporting purposes, generally, more complex valuations.

The AICPA guide became probably the single most popular source of reference among valuation professionals. It is no surprise that AICPA prepared the updated version to the initial guide published in 2013.

The guide is hard to read. Mostly due to frequent cross-references, use of more formal language and, at times, difficult-to-reperform numerical examples. We hope readers will find our summary of key updates in the draft guide helpful. The key updates are as follows:

- expect to see the so-called common-stock equivalent (CSE) allocation method, which ignores contractual liquidation preferences and assumes one per share price across all equity classes where, the per share price is from the most recent share issuance transaction;
- CSE method is likely to be used in combination with other allocation methods, including option pricing model;
- use of CSE will generally result in higher valuations of less senior shares, e.g. common stock;
- expect to see the implied credit spread, representing an internal rate of return on the present value of the liquidation preference less the risk-free rate. Calculated credit spread is compared against market participants expectations as part of valuation reasonableness check.
- expect to see more reliance on secondary transactions, i.e., trading of existing securities as opposed to a primary transaction in which the issuer itself sells new securities. Higher extent of reliance on secondary transactions should be supported by detailed analysis to determine their applicability in fair value estimates.



- the updated guide makes an emphasis on using the fair value of debt as opposed to book value or repayment value when determining fair value of equity;
- the updated guide places more emphasis on calibration and consistency checks applied as part of the valuation process.

Area	Description	Ref.
Use of common-stock equivalent allocation method, weighting	<i>Allocation Methods- General</i> Many capital structures have multiple classes of outstanding shares, e.g. common stock, series A preferred, series B preferred, etc. Relevant terms specify the order of distribution and the threshold (or hurdle) triggering capital distribution in relation to each class. The distribution in question can be liquidating or in the normal course of business e.g. in form of dividends. For example, in a two-class equity structure of common and preferred shares, preferred shares are entitled to dividend distributions before common shares. Common shares are entitled to distribution only when and if preferred shares are paid 120% of their initial price, i.e., 20% of return. A standard valuation approach is to first determine total equity value, i.e., fair value of all classes of equity. A valuation specialist then allocates the total value to individual equity classes. A common approach uses option pricing model (OPM). Ownership of each class of equity is analogized to a stock option with the exercise price that equals respective distribution preference or threshold. Other relevant inputs include estimate volatility of an equity class, term, i.e., expected time until exit or other distribution, risk-free rate, etc. in the above example, preferred shares will be assigned the exercise price of zero, common shares- 1.2 of the cost of preferred shares. Black-Scholes formula is used to determine the value of each share class. <i>Backsolve method</i> Total equity value, i.e., fair value of all classes of equity can be determined using a backsolve method. As part of the method, price of the most recent financing round is used as current fair value for the stock issued in this round. Total equity value is calculated to make sure that it equals the sum of fair value of individual stock classes, using the Black-Scholes formula accompanied by a trial-and-error method. Backsolve method is conceptually and practically similar to the use of OPM allocation method.	Par. 6.38-



The updated guide introduces another allocation method referred to as common-stock equivalent (CSE). The common stock equivalent (CSE) method values each class of equity on an as-converted basis, considering the number of common stock equivalents represented by each class. CSE assumes one per share price across all equity classes.	Par. 6.20
The existing and updated guides include discussion of other methods- a scenario-based method and current value method (CVM).	
The updated guide includes a hybrid method based on weighted OPM and CSE. Generally, only one allocation method is used.	Par. 6.54(c)
<i>Common-stock equivalent (CSE) allocation</i> CSE method ignores contractual liquidation preferences and assumes one per share price across all equity classes. The per share price used is from the most recent share issuance transaction. The method appears to be consistent with investor's assumptions where the issuance price is determined by dividing total estimated equity value by all shares outstanding. For example, let's say an investor performed necessary due diligence and valuation procedures and determined that estimated fair value of investee's business is \$ 1,000 K. Total amount of shares issued and outstanding at the valuation date was 1,000 or \$ 1,000 per share. The investor would be willing to buy 100 newly issued shares in exchange for total proceeds \$ 100 K. Issuance of new shares at fair market value increases total equity value by the same amount, i.e., \$ 100 K and does not change the per share value. In other words, the new issuance at fair value does not dilute economic interest; it dilutes voting interest.	
Note that CSE method is simplistic in nature and has limited applicability. Limitations primarily arise from assigning the same fixed price to all classes of shares regardless of specific rights and preferences. This assumption is justifiable under either of the following conditions: a) the business will perform poorly and each class of share will get zero distributions b) the business will be highly successful so that actual distributions will significantly exceed liquidation preferences, thus rendering the preferences less important c) investors will exit the business on as-if converted basis, e.g., due to conversion requirements before the IPO or any other reason.	Par. 6.58-6.59



	Given limitations of CSE, the updated guide views it as largely used together with OPM as part of calibration procedures. The updated guide illustrates use of CSE method by applying 40% weight to prices determined using OPM and 60% to prices determined using CSE, i.e., by following a hybrid method. Use of CSE method will likely result in higher valuations of less senior shares, e.g. common stock. The sequence of equity rounds is as such that investors in the most recent raise are given more preferential treatment than investors in the prior rounds. This results in higher issuance price. Since the valuation method assigns the most recent issuance price across the board, this results in higher overall prices. This will not hold true if the recent raise was more junior as compared to prior equity raises. Note that since common shares do not have preferences similar to preferred stock, ignoring the preferences makes estimated fair value of commons shares in line with preferred.	
Implied spread in the liquidation preference	The updated guide introduces implied yield on the investment in preferred stock, i.e., stock with a liquidation preference. The yield or return is calculated by taking the value allocated to the liquidation preference and dividing it by the future payoff for the liquidation preference. Let's say Series C preferred stock has a liquidation preference whereby distributions to less senior investors will only occur after Series C receives \$15,000,000 of the distribution. Using OPM, the valuation allocated to the liquidation preference was \$6,135,000. Expected term to liquidity is 10 years. The return on investment in the liquidation preference is calculated as follows: $(1 + \text{implied yield})^{\text{term}} = \frac{\text{Future Payoff for Liquidation Preference}}{\text{Value Allocated to Liquidation Preference}} \text{ or } (1 + \text{implied yield})^{10} = \frac{15,000,000}{6,135,000}$ Implied yield equals 9.4%. With the risk-free rate of 1.7%, we can calculate the credit spread as approximately 7.7% or 9.4% less 1.7%. Note that \$ 6,135,000 is not the total estimated fair value of Series C but rather value specifically allocated to the liquidation preference or debt-like portion of Series C. Value of the liquidation preference can be rationalized as	Par. 6.57



	total value of Series C less value associated with distributions to Series C, if any, occurring after Series C preference is satisfied. The implied credit spread represents an internal rate of return on the present value of the liquidation preference less the risk-free rate. The return is compared to market participants' required rate of return for a similar debt-like preferred stock. In other words, the implied credit spread is used a reasonableness check of estimated fair value of the liquidation preference. The model is calibrated further if the implied credit spread is notably different from the market participant's return. The updated guide suggests the use of CSE along with OPM, i.e., a hybrid allocation method as part of calibration. Future payoff for liquidation preference is the same under OPM and CSE. In other words, use of the hybrid method does not change this variable. CSE assumes the valuation allocation to liquidation preference is zero. Therefore, use of the hybrid approach would result in lower value allocated to liquidation preference as compared to OPM. This would also result in higher implied yield and credit spread. Note that future payoff for liquidation preference is set as a number that at least equals the issuance price for the security in question. For example, Series C was issued for \$ 15,000,000, Series C investors would need to receive at least this amount before other investors will. From this perspective, an argument can be made the implied yield shown return on total investment and not just on the liquidation preference. In other words, variable Future Payoff for Liquidation Preference carry characteristics of total investments and not just the investment in the liquidation preference. Such characteristic increases the implied yield and the credit spread. Based on the above consideration, there are limits on applicability of the credit spread reasonableness test. Another check suggested by the updated guide is to calculate the percentage of liquidation preference to total estimated fair value of preference stock and see if the percentage is consistent with market participant expectations.	Par. 6.59, 6.60 6.49(a)
Use of secondary transactions	A secondary transaction is any trading of existing securities as opposed to a primary transaction in which the issuer itself sells new securities. Traditionally, professional valuation literature has been cautious about using secondary transactions to estimate fair value. This is mostly because the company usually has little information about them unlike primary issuances where the company is directly involved. US GAAP specifically requires to place less weight on the transactions where a reporting entity does not have sufficient information to conclude whether the transactions are orderly (ASC 820-10-35-54J(c)).	Par. 8.66



	According to the updated guide, “the increase in observable transactions (secondary transactions)... over the period since the publication of 2023 edition, indicating that it would likely be appropriate to place more weight on these transactions”. The updated guide provides detailed factors to be considered to determine the extent of reliance on secondary transactions. Use of secondary transactions depends primarily on information access, level of due diligence, economic motivations, expertise of the parties, and market conditions (see par. 8.40-.49). The original guide provided less detailed guidance on the use of secondary transactions. Overall, we expect to see more reliance on secondary transactions. Higher extent of reliance on these transactions should be supported by detailed analysis to determine their applicability in fair value estimates.	Par. .04
Fair value of debt	The updated guide makes an emphasis on using the fair value of debt, as opposed to book value or repayment value when determining fair value of equity. Specifically, fair value of equity is calculated by subtracting fair value of debt from the enterprise value. The requirement to estimate fair value of debt is not new, so the updated guide acts as a reminder. The primary method used to estimate fair value of debt is the income method. This is based on discounting the expected cash flows to the debt holder through the assumed liquidity date using an appropriate market yield, which incorporates a credit spread. Market information can be used to estimate fair value of traded debt. The amended guide focuses on determining debtor’s credit spread using synthetic credit rating. A synthetic credit rating is a quantitative analysis that compares selected financial ratios for the subject company to relevant public companies with rated debt, using these metrics to estimate the rating for the subject company. Additional adjustments may be made based on qualitative considerations. The adjustments will reflect any security interest involved, the level of seniority, etc. The updated guide repeatedly emphasize that the fair value of debt determined to estimate the fair value of equity (FV of equity = Enterprise Value – FV of debt) may be different from the fair value of stand-alone debt. This is because the market participants transacting in the equity are different than the debt investors trading in debt. As an example, due to existing or future anticipated economic conditions, equity participants may expect to repay debt sooner than debt participants expect.	4.12 4.16-4.19 4.27



Calibration	The updated guide places more emphasis on calibration and consistency checks applied as part of the valuation process. Examples include: - Calibrating estimated fair value of the various classes of equity to the most recent preferred stock financing or secondary transactions. As noted above, OPM, a scenario-based or hybrid (including the use of CSE) methods can be used. - Use of alternative valuation methods, e.g., DCF or income method when the recent transaction is not orderly. Use of the backsolve method based on the OPM framework may not be enough; - Use of implied credit spread on the preferred stock liquidation preferences when the recent transaction and OPM pricing approach was used to infer the estimated fair value of individual equity classes; - Using DCF or recent transaction to determine enterprise value and then calculating implied revenue multiples and comparing such multiples to market information; - Enterprise value was determined using market multiples and then the multiples are calibrated to other observable transactions using historical, projected or pro forma multiples to account for signification differences between the guideline public company and the subject enterprise The word “calibrated” is mentioned 111 times in the updated guide versus 1 time in the original guide. Overall, we expect valuations performed with more inputs and more calibration, including the use of more than one valuation method.	6.32 6.44 6.57 6.67 Q&A 10.22
Other	The amended guide includes more information on the use of valuation approaches, i.e., market, income and asset approaches. Regarding the market method, the guide includes dedicated, expanded sections on calculating multiples, selecting which multiples to use, normalizing data, adjusting guideline multiples for comparability, handling outliers, and weighting.	Chapter 3: Overview of Valuation Approaches



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