Audit Tips from the Big 4 Auditors

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The inception of ASC Topic 820 brought greater ambiguity to the question of what is acceptable or material and will clear audit scrutiny. With the introduction of Qval in 2014, this ambiguity subsided significantly as the investment community adopted the solution as the go-to tool to value their portfolios using accepted calculations.

The audit process is complex and evolving, and we work continuously with Big 4 audit firms to identify critical areas that require additional support to ensure a smoother audit review.

This year, to ease the workload of audit season, we reached out to our Big 4 colleagues and asked these three questions:

- What are the areas of anticipated focus in the 2017-2018 audit?
- What are the top auditor suggestions for a smoother year-end?
- What triggers a valuation being passed to the technical services teams for additional testing?

We'll be sharing their responses in a three-part article series, with today's article focusing on the first question.

So, let's see what the Big 4 auditors anticipate as focus areas for 2017 audit season:

→ Significant investments

This is fairly straightforward. Companies that are making a 'significant' portion of your portfolio should be given special attention. While the Big 4 auditors did not give any number for the threshold, it is safe to assume any companies that make more than 10% of the fund will be given extra attention by your auditors.

→ Unicorns

No surprise here! If you are fortunate enough to have a unicorn as part of your portfolio, you can certainly expect them to be under scrutiny. Auditors are also in a unique position to know what other venture and private equity firms are doing to value these investments. Even though they are supposed to review each investment from an individual investor's perspective, it is difficult keeps those observations in a vacuum.

→ Lifecycle of the company

When reviewing a company, auditors do their homework and first understand the industry and the facts and circumstances around the company. Based on their understanding of the company, the stage of its development, or its lifecycle, they develop certain expectations of the methodology or assumptions for its valuation. If the valuation presented to them departs from those expectations, you can assume that they will closely examine your reasons for deviating from the norm.

Financings to rely on

As they say, beauty is in the eye of the beholder. Similarly, a company is worth whatever someone is willing to pay for it. A portfolio company valuation becomes relatively simple when there is a prior financing round to benchmark to, irrespective of using a backsolve or post money to value. In 2016, there were fewer venture capital financings to rely on, reducing reliability on the prior round as benchmark of value. However, in 2017, there has been good investment activity. As a result, in most cases, auditors are expecting some reliance in the last round, or a 'trend and bend' of the last round with a market approach, or a combination of the above.

Market impact

This one is not as clear-cut as the above points, but it's one worth paying attention to. It is easy to form a bullish or bearish opinion of the company based on its performance or investor outlook. However, what if the market or the company's industry is trending to the contrary? While you may believe your portfolio company is unique enough to buck the trend, it would be prudent to take a pragmatic perspective that considers all aspects of a company. That means examining both internal and external factors as well as the historic, current and future outlook.

M&A Exits vs IPOs

IPO markets are soft relative to M&A. If, historically, the portfolio company's expected exit is an IPO, the prevailing market conditions may affect that expectation. For such companies, the Big 4 suggest considering or weighing in some probability of an M&A exit in order to account for the current market scenario.

Fluctuations in value

Auditors like patterns. Or, rather, they dislike peaks and valleys. If, for the last two to three years, a portfolio company has been marked up, and this year, due to internal or external factors, the value differs, that will stand out. In such cases, it's best to find a balance between historically aggressive valuations and the recent flat or down rounds. Identify these companies as outliers and have a preemptive conversation with the audit team. Chances are, if you are experiencing this issue, so are their other clients, and they may be able to make recommendations that will not raise any red flags in audit or with GP review.

The biggest learning after speaking with the Big 4 senior audit partners was that firms should start planning early and consider a valuation from an auditor's perspective. If you can wear an auditor's hat, then you can anticipate their areas of focus, including those identified above.

Stay tuned for the next two articles in which we will share auditor suggestions for a smoother year-end and the triggers that can send a valuation to the technical services teams for additional testing.

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