



U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INVESTMENT
SUITE 6300
WASHINGTON, DC 20416

Date: February 15, 2013

To: Licensed Small Business Investment Companies

From: John Wilmeth, Chief--Data Management Staff
Carol Fendler, Director, Licensing & Program Standards

Subject: Year-end Financial Reporting Requirements

Under §107.630 of the SBA regulations, each Small Business Investment Company (SBIC) Licensee must file an Annual Financial Report, SBA Form 468, within three months from the close of its fiscal year. For example, if your fiscal year end is December 31, 2012, you must file Form 468 no later than March 31, 2013.

In accordance with §107.504(a), you must prepare Form 468 electronically using the Windows electronic reporting software provided by SBA. **SBICs must use the most recent version of the electronic reporting software available for their form of organization (limited partnership or corporation), as discussed in Section 3 of this memo.**

This memo provides information concerning the Form 468 software and guidance on SBIC audit and financial reporting issues. Please review this material and provide your independent public accountant with a copy of this memorandum.

Section 1: Form 468 Revisions and Requirements to File Supplemental Information

In 2011, SBA received approval from the Office of Management and Budget (“OMB”) to collect additional financial information on SBIC portfolio companies. Last year, SBA gave SBICs the option to provide this “Schedule 8” information in a number of different formats. This year, SBA is collecting “Schedule 8” information in a standard Excel spreadsheet. SBA is distributing the Excel spreadsheet together with this letter;

Section 2: IT Project Update

SBA is developing a new Web-based reporting system (new system) for SBICs that will replace the current Access-based reporting software. The first phase of the new system, which includes SBA Forms 1031 and 468, has been completed and numerous iterations of internal user acceptance testing (UAT) performed. More details on the new system will be provided under a separate memorandum.

Section 3: Which Version of the Software Should I Use?

SBICs that are organized as limited partnerships or limited liability companies must use partnership version 3.6 of the electronic reporting software. **SBICs that are organized as corporations** must use corporate version 2.1 of the electronic reporting software. The software for partnerships and corporations is available at <http://archive.sba.gov/aboutsba/sbaprograms/inv/extra/>. These are the same versions that SBICs were instructed to use last year.

Partnership version 3.6 and corporate version 2.1 will both work on PCs running Microsoft Windows 7, Windows Vista, and Windows XP operating systems.

If you are unable to download the electronic reporting software, you may request a copy on CD-ROM by sending an email to the Office of Investment's mailbox at sbic@sba.gov. Please type "Request for SBIC Reporting Software" in the subject line of your email and include in the body of the email your complete mailing address and whether you are requesting the partnership or the corporate software. If you would like SBA to send the software by Federal Express, please provide your FedEx account number.

If you are upgrading an existing installation of the software with a version other than 2.1 or 3.6, do not uninstall the current copy of the electronic reporting software until after you have installed the new version of the software and imported your existing data into the new version. Not following this sequence could result in the loss of your reporting data.

Section 4: Filing Requirements—SBA Form 468

1. A complete filing of Form 468 consists of the data files created by the electronic reporting software and the supplementary Excel file; two printed sets of the schedules generated by the software (including signed management certifications, one of which must have original signatures) and the supplementary Excel spreadsheet; two copies of the Operating Plan Update narrative (for Licensees with outstanding SBA leverage or commitments), the Independent Auditor's Report, and the Notes to Financial Statements.
2. Send the paper copies of the Form 468 to the following address: U.S. Small Business Administration, Office of Investment, Attention: Antoinette Shingler, 409 3rd Street SW, Suite 6300, Washington, DC 20416.
3. Transmit the Form 468 data files created by the electronic reporting package to the Office of Investment on a CD or diskette, or by electronic mail. If you send the Form 468 data files via email attachment, please state in the subject line of the email the name of the SBIC Licensee and whether the Form 468 is an annual, quarterly, or

economic impact filing. The Office of Investment's electronic mailbox address is sbic@sba.gov. Note that Form 468 files attached to an email should have a file extension of *.sba. (SBA Form 1031 files have a file extension of *.dbf.) In addition, if you have the ability to create Adobe Acrobat (PDF) files, the Investment Division would appreciate receiving a copy of the entire Form 468 in PDF format along with the Form 468 email attachments. However, sending the Form 468 in PDF format is not a reporting requirement.

4. LATE FILING PENALTY: Under Section 315(a) of the Small Business Investment Act of 1958, as amended ("Act"), SBA may impose a late filing penalty of \$100 per day for every day the report is late.

5. When extenuating circumstances make it impractical to file the report within the prescribed time, you may request additional time. Please be advised, however, that a request for an extension must be justified and approval is not routine. The request must be in writing and be addressed to your area chief or assigned financial analyst in the Office of SBIC Operations. We must receive your request before the filing due date (see § 107.670 of the regulations). You may send extension requests by letter, fax or electronic mail, which is preferred. The Office of Investment's fax number is (202) 205-6959. Upon receipt of your request, SBA may exempt you from the civil penalty provision of section 315(a) of the Act, in such manner and under such conditions as SBA determines.

6. Form 468 includes an unaudited schedule called "Economic Data for Portfolio Concerns" (page 21 in version 3.6 or page 22 in version 2.1) which asks for information about the revenues, employees and tax payments of companies in your portfolio. If you need extra time to obtain the information needed for this schedule, you may file Form 468 without it and submit it separately when it is completed. Attach a cover letter to your hard copy filing of Form 468 stating that the Economic Data schedule will be filed separately. You may take up to two months beyond your filing deadline to submit the schedule (see §107.630(a) and (e) of the regulations). You do not need to request a formal extension as long as you file the remainder of Form 468 on time. When you have completed the Economic Data schedule, send your Form 468 data files to SBA a second time via electronic mail, CD or diskette. Also send two paper copies of the schedule to the following address: U.S. Small Business Administration, Office of Investment, Attention: Antoinette Shingler, 409 3rd Street SW, Suite 6300, Washington, DC 20416. **Note: The information provided in the Economic Data schedule is crucial to efforts by SBA and the SBIC industry to maintain support for the SBIC program. SBA closely monitors compliance with this reporting requirement.**

7. Industry information shown on Form 468 Schedule of Loans and Investments (page 11 in version 3.6 or page 12 in version 2.1) must be reported using 2007 NAICS Codes. You can find the NAICS Code for a given industry on the web at <http://www.census.gov/eos/www/naics/index.html>. Enter an industry description and

click on the button titled NAICS Search on the left side of the page to find the NAICS Code for a given industry.

8. Mature funds that are no longer making new investments are reminded to comply with §107.590(c) which requires the submission of a wind-up plan to your assigned SBA financial analyst.

Section 5: Valuation Reporting

1. Along with the paper copies of your SBA Form 468, you are required to submit the valuation reports you prepare internally to support the valuations shown on Form 468 for each portfolio company. There is no SBA-mandated format for these reports.

Section 6: Conduct of the Annual Audit

1. **Confirmations:** For Licensees with SBA leverage, the SBA's independent auditors require that SBA confirm a Licensee's outstanding balance. To expedite this request, mail your outstanding balance confirmation to the following address:

U.S. Small Business Administration
Denver Finance Center
Attn: Mia McCutcheon
Denver, CO 80259

Please include the SBIC license number on your request and provide a stamped envelope for return of the original signed copy of the confirmation. **The Denver Finance office cannot accept faxed or emailed confirmation requests.**

Please note that the Denver office can confirm a Licensee's outstanding Participating Securities balance, but is not in a position to confirm the accumulated Prioritized Payments. SBA recommends that all SBICs with Participating Securities leverage complete the Prioritized Payment section of the Participating Securities Distribution Worksheet for this purpose.

2. **Auditing Standards.** Audits are to be performed in accordance with Generally Accepted Auditing Standards (GAAS). It is not necessary to follow government auditing standards.

3. **Auditor's Opinion.** The financial statements contained in the Annual Report, SBA Form 468, are the subject of the independent public accountant's opinion and must be referred to specifically in the opinion. SBA recognizes that various Generally Accepted Accounting Principles (GAAP) changes in recent years have resulted in several significant differences between SBA Form 468 and GAAP financial statements (including, but not limited to, the treatment of unrealized gain/loss, presentation of financial highlights, valuation of certain loans and investments, treatment of Participating Securities, prioritized payments and SBA profit

participation). As a result, the financial statement presentation on Form 468, based on SBA's "Accounting Standards and Financial Reporting Requirements for SBICs" and this memo, may be considered an Other Comprehensive Basis of Accounting (OCBOA). Auditors may elect to provide SBA with an OCBOA opinion rather than a GAAP opinion, with the auditor's report stating that the financial statements have been prepared in accordance with accounting practices prescribed or permitted by the U.S. Small Business Administration. SBA has no objection to this practice provided there is an appropriate footnote description stating such differences.

4. Special Reporting Requirement for SBICs. The annual audit of an SBIC must include "a statement by the independent certified public accountant" that a Licensee's valuations were prepared in conformity with its SBA-approved valuation policy. This provision is included in section 310(d) of the Small Business Investment Act of 1958, as amended, and §107.503(e)(2) of the SBA regulations. SBA has determined that this legal requirement can be satisfied through the use of the following explanatory paragraph in the auditor's report on the Form 468 financial statements: "As discussed in Note [number], the investment securities included in the financial statements have been valued by the [board of directors, or general partner(s)] using valuation criteria applicable to the licensee. These criteria were established in accordance with section 310(d)(2) of the Small Business Investment Act of 1958, as amended." The referenced section 310(d)(2) states that each valuation submitted by an SBIC must be prepared in accordance with valuation criteria that (1) shall be "established or approved" by SBA, and (2) "include appropriate safeguards to ensure that the noncash assets of a licensee are not overvalued." For further information, please see section IV, paragraph B, of "Accounting Standards and Financial Reporting Requirements for SBICs". Please note that this requirement applies only to reports on SBA Form 468 and not to reports on any other financial statements that an SBIC may prepare.

Section 7: Accounting Matters – General

1. Reporting Valuations on SBA Form 468. The FASB has issued **FAS 157** (now codified as ASC Topic 820), "Fair Value Measurements", which provides a framework for measuring fair value under GAAP. SBA has not adopted FAS 157 for reporting valuations on SBA Form 468, and Licensees are not required to include FAS 157 valuation disclosures in the footnotes to their SBA Form 468 financial statements. SBICs should continue to determine and report portfolio valuations in accordance with SBA's "Valuation Guidelines for Small Business Investment Companies" and SBIC Technote 12, "Guidelines Concerning Valuation Issues". Please review Attachment 2 to this letter which addresses questions SBA has received about how to interpret the guidance in Technote 12 concerning liquidation preferences.

2. Financial Highlights. SBA does not require "Financial Highlights" of the type described in AICPA Statement of Position 95-2 (ASC Topic 946).

3. **Organization Costs.** In accordance with AICPA Statement of Position 98-5(ASC Topic 720), organization costs of an SBIC are to be expensed as they are incurred. This accounting treatment applies only to organization costs, not to SBA leverage fees or partnership syndication costs.

4. **Investments in Flow-through Entities.** The Statement of Operations Realized (page 4P or 4C of Form 468) includes a line for “Income (Loss) from Investments in Partnerships/Flow-through Entities” (line 3). Investors in such entities typically use the equity method of accounting, under which the cost basis of the investment is adjusted at the end of each accounting period to recognize the investor's allocated share of earnings or losses, and the amount of the adjustment is included in the net income of the investor. However, SBA has determined that this method is not appropriate for SBICs.

Under SBA’s guidelines, instead of using the equity method, Licensees with portfolio investments in flow-through entities must report these investments at their fair value in the Statement of Financial Position, with the difference between cost and value reflected as unrealized appreciation or depreciation. Any income or loss allocated to the Licensee may, if appropriate, be a factor in the Licensee's estimate of the investment's fair value, but such allocations are not recognized as income or loss in the Statement of Operations Realized. Furthermore, the Licensee's cost basis is not adjusted to reflect such allocations. Licensees are to recognize income or loss when realized upon disposition or liquidation of all or part of their ownership interest. Income is also recognized when the Licensee receives a cash dividend or other distribution from the investee (unless the distribution represents a return of capital, which does not result in the recognition of income, but is treated as a reduction of the Licensee's cost basis).

5. **Consolidation of Portfolio Companies.** For most SBICs, the reporting entity is the SBIC only (for exceptions, see section V, paragraph C, of “Accounting Standards and Financial Reporting Requirements for SBICs”). Portfolio companies should not be consolidated.

6. **“Blocker” Corporations.** Under §107.720(b)(3), an SBIC can receive SBA approval to form one or more wholly-owned corporations through which it provides financing to small businesses organized as LLCs, limited partnerships, or other flow-through entities, in order to avoid causing tax-exempt investors in the SBIC to incur unrelated business taxable income (UBTI). Under these circumstances, the SBIC should report its investment on page 11 (version 3.6) or page 12 (version 2.1) of Form 468 under the name of the eligible small business that is the ultimate recipient of the financing. In a comment field, the SBIC must indicate the name of the blocker corporation through which it holds the investment.

Section 8: Accounting Matters – Participating Securities SBICs

1. **Classification of Participating Securities under FAS 150.** The FASB has issued **FAS 150** (ASC Topic 480), “Accounting for Certain Financial Instruments with

Characteristics of Both Liabilities and Equity.” SBA’s view is that this Statement requires the outstanding principal balance of Participating Securities to be reported as a liability. SBA Form 468 classifies outstanding Participating Securities as a liability to conform to this requirement.

2. Treatment of Prioritized Payments and Leverage Fees. FAS 150 also affected the accounting treatment of prioritized payments and leverage fees related to the Participating Securities. **“Earned” Prioritized Payments, Charges and Adjustments**, which an SBIC is obligated to pay to SBA based on its profits, are reported as interest expense in the Statement of Operations Realized (line 11a). Any amount that is “Earned” but unpaid as of 12/31/10 will be reported on line 33b of the Statement of Financial Position. This presentation requires an adjustment to net income in the Participating Securities Distribution Worksheet; see Section 7 of this memo. **“Accumulated” Prioritized Payments**”, which an SBIC is not obligated to pay, should not be accrued because of their contingent nature but must be disclosed in a footnote to the financial statements. Consistent with the characterization of participating securities as a liability, leverage fees from 2005 and later years that are associated with these instruments must be treated as deferred financing costs, not as syndication costs. SBA encourages, but does not require reclassification of leverage fees paid in 2004 and earlier years. The summary of significant accounting policies accompanying the financial statements should clearly describe the accounting treatment of leverage fees, including any differences in the treatment of fees paid before and after December 31, 2004.

3. Prioritized Payments and Profit Participation Not Subject to FAS 133. SBA is aware that some SBIC accounting practitioners have considered whether the prioritized payment and/or profit participation features of the Participating Securities may be subject to the requirements of **FAS 133** (ASC Topic 815), “Accounting for Derivative Instruments and Hedging Activities.” If applicable, FAS 133 would require SBICs to report prioritized payments and profit participation potentially due to SBA as liabilities measured at estimated fair value. For the purpose of reporting to SBA on Form 468, SBICs should not treat potential SBA prioritized payments or profit participation as a derivative instrument per FAS 133. Prioritized Payments are to be presented in accordance with Section 6, item 2 of this memo. Any actual profit participation that has been calculated as of December 31, 2012 and is payable to SBA as a required annual distribution by the May 1, 2013 payment date are to be shown in the Statement of Financial Position on line 33c.

4. Tax Identification Number. If you have issued Participating Securities and are preparing a K-1 for SBA, the SBA’s tax identification number for such purpose is 53-0215587.

Section 9: Participating Securities Distribution Worksheet

1. Required Submission of Distribution Worksheet. If you have issued Participating Securities, complete and submit the Participating Securities Distribution

Worksheet in addition to your SBA Form 468. You must use the worksheet to do the calculations required by §§107.1510 through 107.1560 at the end of each fiscal year, beginning with the first year in which you issued Participating Securities. Even if you have no profits as of the end of a particular year and will not be making any distributions, you must go through the applicable sections of the worksheet, such as the computation of Accumulated Prioritized Payments and Adjustments. Specifically, you are required to complete the following sections:

- The preliminary information at the very beginning of the worksheet (lines 1 through 5)
- Section I: Earmarked Profit (Loss)
- Section II: Liquidity
- Section III: Prioritized Payments
- Section IV: Profit Participation (Parts IV-1 and IV-2 only)

2. **Requirements for SBICs Making a Required or Optional Distribution.** If the Participating Securities Distribution Worksheet indicates you must make a required year-end distribution, or if you wish to make an optional distribution, please telephone or email both your assigned SBA financial analyst and Marilyn Kapila (202-205-7504, marilyn.kapila@sba.gov) as soon as possible. SBIC program regulations require that you notify SBA (i.e., submit a completed distribution worksheet and any necessary supporting documentation) at least **10 business days** prior to any distribution. Required year-end distributions for Calendar Year 2012 must be made no later than May 1, 2013. Also, be aware that Participating Security redemption payments made after November 1, 2012 were applied on the February 1, 2013 payment date. Redemption payments made after February 1, 2013 will be applied on the May 1, 2013 payment date.

3. **Requirements for SBICs Not Making a Distribution.** If the distribution worksheet shows that no distribution is required and you do not plan to make an optional distribution, submit your worksheet in hard copy only to: U.S. Small Business Administration, Office of Investment, Attention: Marilyn Kapila, 409 3rd Street SW, Suite 6300, Washington, DC 20416.

4. **Downloading the software.** The distribution worksheet can be downloaded from <http://archive.sba.gov/aboutsba/sbaprograms/inv/extra/>. Scroll down to the Participating Securities Distribution Worksheet Software section and click on the download button. **Please note that the current version of the software is Version 3.0. You must use this version if you have leverage drawn against a commitment issued by SBA on or after October 1, 2001.** Older versions do not allow you to correctly enter the annual charge on such leverage. Also, if you have previously used older versions of the worksheet and now must switch to Version 3.0, you must enter all your current information in a new (blank) copy of Version 3.0 (you can open a previous worksheet in 3.0 and edit it, but it will still be in its original version, not in 3.0). **[The distribution worksheet can be installed on PCs running all Microsoft**

operating systems with the exception of Windows Vista and Windows 7 64-bit version.]

5. Calculation of “Earmarked Profit”. If you had Earned Prioritized Payments, Charges and/or Adjustments during 2012 (i.e., prioritized payments that you were obligated to pay to SBA based on your profits), the SBA requires these amounts to be reported on Form 468 as interest expense in the Statement of Operations Realized, in accordance with FAS 150 (see Section 6, item 2 of this memo). For the purpose of completing section I-3 of the Participating Securities Distribution Worksheet, this interest expense must be added back to year-to-date net income on line 1 to calculate Earmarked Profit correctly and avoid double-counting.

6. Calculation of “Excess Management Expense”. In the calculation of Excess Management Expense (section I-2 of the Participating Securities Distribution Worksheet), on line 5 you must enter the gross management fee computed under your approved management fee formula, before any offsets for fee income earned by Associates. If you report your management fee expense net of offsets on Form 468, include a reconciliation of the gross and net management fee figures with your distribution worksheet submission. Note: If you have previously made one or more distributions based on distribution worksheets in which Excess Management Expense was calculated using a net management fee, you will not be required to restate those worksheets.

Section 10: Other Available Information

1. The following accounting-related documents are available on the SBIC program web site at <http://archive.sba.gov/aboutsba/sbaprograms/inv/forsbic/index.html> under the heading “Standards and Guidelines”: (1) Accounting Standards for SBICs; (2) Chart of Accounts for SBICs; (3) Valuation Guidelines for SBICs. These items were published in August 1999 as appendices to SBA SOP 10 06, “Oversight and Regulation of Small Business Investment Companies.” In addition, SBIC Technote 12, “Guidelines Concerning Valuation Issues”, issued August 2007, is available at http://archive.sba.gov/idc/groups/public/documents/sba_program_office/inv_sbic_tech_notes12.pdf. We encourage you to download and review these materials.

2. If you have any questions concerning SBIC accounting, financial reporting, or participating securities distributions, contact Marilyn Kapila at (202) 205-7504 or marilyn.kapila@sba.gov or Carol Fendler at (202) 205-7559 or carol.fendler@sba.gov.

3. For questions concerning electronic reporting, contact Ed Watkins at (202) 205-7071 or edward.watkins@sba.gov.

4. For questions concerning Form 468 filing confirmations, contact Antoinette Shingler at (202) 205-6517 or antoinette.shingler@sba.gov.

5. For other matters, including valuation reporting, contact your area chief or analyst.

Attachment 1

Form 468 Schedule 8 Instructions

1. Introduction

These instructions will help SBICs complete Schedule 8, the Excel spreadsheet supplementing SBA's Access-based Form 468 software. Schedule 8 provides SBA with a snapshot of each portfolio company, including general and financial information. SBA does NOT require this information to be audited. This schedule will help SBA manage program risk, evaluate portfolio performance, and facilitate processing SBIC requests promptly.

Until further notice, SBICs will continue to use both the Access-based Form 468 software and the Excel Schedule 8 supplement. SBICs must continue to use the Access-based software to complete the Economic Data for Portfolio Concerns. The Schedule of Participations and Joint Financings (Schedule 5) may be omitted.

The Economic Data for Portfolio Concerns will continue to be due no later than the last day of the 5th month following the end of the annual reporting period.

2. Schedule 8 Exemptions

SBA recognizes that financial risk plays a key role in the materiality of this information. Therefore, the following SBICs will not be required to complete Schedule 8, unless specifically instructed to do so by SBA:

- SBICs with no outstanding SBA leverage, no SBA leverage commitments, and not seeking SBA leverage commitments within the next twelve months.
- SBICs licensed prior to 1994 unless specifically requested by SBA. (New leverage commitment requests may prompt SBA to make such a request.)

In addition, for SBICs that are not in one of the above categories, SBA will not require completion of Schedule 8 for the following investments:

- Loans secured by a taxi medallion.
- If the portfolio company is public and the SBIC only holds debt or common stock.

On a case by case basis, SBA may grant exemptions from Schedule 8 reporting requirements for some or all of an SBIC's investments. SBA will consider materiality and financial risk in determining whether to grant such an exemption.

3. General Portfolio Company Information (Columns A through I)

General Portfolio Company Information on Schedule 8 includes: Portfolio Company Name; Employer ID; Business Description; Overline; Current Stage; Exchange (if public); Stock Symbol (if public); Previous Business Name (if any); and Other Comments.

4. **Portfolio Company Financial Information (Columns J through X)**

The required portfolio company financial information is shown in the table below. Complete all columns for each investment, except for columns that do not apply to a particular investment type (for example, as shown in the table, “Interest Charges” must be provided only for debt investments).

Data Element	Description	Investment Type
As of Date	Provide the ending date for the period of financial information you are providing. For example: If you are providing information for the twelve months ended 12/31/2012, enter “12/31/2012” in this column.	All
Revenues	Self-explanatory.	All
Gross Profit	Revenues minus cost of goods sold	All
EBITDA	Earnings Before Interest, Tax, Depreciation and Amortization	All
Interest Charges	Identify the interest expenses paid on all debt, both short term and long term, by the portfolio company	Debt
Net Income	Self explanatory	All
Cash flow from Operations	Self explanatory	All
Cash Balance	Self explanatory	All
Current assets	Self explanatory	All
Fixed assets	Self explanatory	As requested
Total assets	Self explanatory	All
Current liabilities	Include any short-term debt reported as a current liability.	All
Long Term Debt	Long term funded debt plus any convertible debt issued by the small concern unless and until converted to equity.	All
Total Liabilities	Self explanatory	All
Enterprise Value	Common and Preferred Equity Market Value + Debt – Cash. Please note that if you have performed GAAP valuations, enterprise values should reflect these values. Otherwise provide the value used in determining your valuations as reported to SBA on Form 468.	Equity*
* Includes debt that has been converted to equity and any warrants held above cost.		

5. **Waterfall/Capitalization Table**

For equity investments (including debt that has been converted to equity and warrants held above cost), SBICs must provide a capitalization table in the SBIC’s format as an Excel file which reflects the current capital structure for the portfolio company and all relevant information (e.g. liquidation preferences) needed to help SBA evaluate the SBIC’s position in the company. The table MUST be in Excel, not in PDF.

Once submitted, the SBIC will not need to resubmit the waterfall/capitalization table information unless the information changes. SBICs should submit any change to the waterfall with the next Schedule 8 filing.

Attachment 2

Valuations When an SBIC Has Liquidation Preferences

The Form 468 Schedule of Loans and Investments requires an SBIC to list and value separately each security of a portfolio company that it holds.

Many equity securities have a liquidation preference associated with the order and amount the security is entitled to receive when distributions are made.

SBA's model valuation policy does not allow for unrealized appreciation above cost based on liquidation preferences, even if it is allowed for GAAP purposes. SBIC TechNote #12 provides the following supplemental guidance on how SBICs may take into account the downside protection that a preference provides:

- If the SBIC's investment provides for liquidation preferences, the SBIC's valuation should take into account the downside protection afforded by the preferences, up to the cost of the investment, in the event that the value of the underlying company deteriorates. When considering the protective impact of its own preferences, the SBIC must also consider the potential unfavorable impact of preferences held by other investors.

It is not uncommon for new rounds of funding to include liquidation preferences used to preserve the total investment that a fund has in the portfolio company. SBA has been asked how the valuation of multiple securities should be reported on the SBA Form 468 if the most senior security has a liquidation preference that recovers the cost, or part of the cost, of all of the outstanding securities. Specifically, applying the above guidance from SBIC TechNote #12, can all or part of the cost of the junior securities be protected to the extent that the senior security has a liquidation preference that is expected to return the cost of both the senior and junior securities?

SBA's response to this question is yes, as illustrated in the following examples, subject to the documentation requirements listed at the end of this attachment.

Example #1:

The investor syndicate has one or more investors who are not able or willing to put more money into a company. The syndicate puts a liquidation preference on the new round of funding to penalize the syndicate members who are not participating in the newest round.

	Price Per Share	Total round Size	Post-Money Enterprise Value	Seniority	Liquidation Preference X	Liquidation Preference \$
Series A	\$ 1.00	2,500,000	4,000,000	2	1	2,500,000
Series B	\$ 1.00	2,000,000	6,000,000	1	3	6,000,000
		\$ 4,500,000				
Liquidation Value						
Enterprise value		6,000,000				
Series B		6,000,000				
Series A		-				
Total value	\$	6,000,000				

In this case, assuming the \$6M enterprise value can be supported, the fund will get more than cost basis of its total investment in the portfolio company, based on the liquidation preference on the Series B, but nothing would go specifically to the Series A. Because the SBIC's total cost basis is protected by the Series B preference, the SBIC would show both the Series A investment and the Series B investment at cost on the Form 468 Schedule of Loans and Investments.

Example #2

The investor syndicate has one or more investors who are not able or willing to put more money into a company. The syndicate puts a liquidation preference on the new round of funding to penalize the syndicate members who are not participating in the newest round. The newest round was also done at a lower pre-money enterprise value.

	Price Per Share	Total round Size	Post-Money Enterprise Value	Seniority	Liquidation Preference X	Liquidation Preference \$
Series A	\$ 1.00	2,500,000	4,000,000	2	1	2,500,000
Series B	\$ 1.00	2,000,000	4,000,000	1	3	6,000,000
Total		\$ 4,500,000				
Liquidation Value						
Enterprise value		4,000,000				
Series B		4,000,000				
Series A		-				
Total value	\$	4,000,000				

In this case, assuming the \$4M enterprise can be supported, the fund will get all its cost in Series B (\$2.0M) and some of its cost basis from Series A (\$2.0M of the \$2.5M) based on the liquidation preference on the Series B, but nothing would go specifically to the Series A. Because the SBIC's Series A cost basis is partially protected by the Series B preference, the SBIC would show both the Series A investment at \$2.0M (written down from cost of \$2.5M) and the Series B investment at its cost of \$2.0M on the Form 468 Schedule of Loans and Investments.

SBA believes that reporting in accordance with these examples will allow an SBIC to appropriately represent the total value of its position in a company, not to exceed cost, in accordance with SBA valuation guidelines.

Documentation Requirements

1. For any security that is reported on Form 468 at a value that depends on the estimated value of a liquidation preference, the SBIC must note the basis for the valuation in the comments section. The comment must describe the preference and indicate the specific security that has the preference.
2. Upon request, an SBIC must provide documentation satisfactory to SBA of its calculation of the enterprise value on which the value of a liquidation preference is based. The calculation of enterprise value must take into account any down round that has taken place, whether or not outside investors were involved. If SBA is not satisfied that the enterprise value is reasonable and appropriately supported, we can require adjustment of the value based on an independent third party valuation, either by a contractor of our choosing or a valuation firm engaged by the SBIC and acceptable to SBA. Licensees are strongly cautioned that merely holding a preference does not provide downside protection if the value of the portfolio company is insufficient to cover the preference.