VENTURE FIRST

Early-Stage Valuation Experts

Why does my Company Need a Professional 409a Valuation?

Venture First supports entrepreneurs, VC Portfolios, Family Offices and Estates with a wide array of appraisal and consulting services specific to valuation of closely held enterprises. We frequently work with private companies who provide equity as compensation to employees. Using equity as a form of compensation has tax ramifications for both the Company and the employee, so it is important to be fully aware of the tax effects of various forms of equity compensation.

Internal Revenue Code 409a was codified in 2011, in response to perceived abuse of deferred compensation arrangements during the Enron and WorldCom fiascos. 409a wasn't actually intended to place burdensome compliance obligations on small, hard-to-value, cash strapped startups. Nevertheless, the statutes require that equity-based compensation must be issued at "Fair Market Value" at the time of the grant.

Whether the company offers stock options, restricted stock, profit interests or phantom stock, it is the Board's responsibility to value the underlying security at Fair Market Value. In order to determine Fair Market Value, companies most often rely on a valuation report prepared by an expert, third-party valuation provider.

"Fair Market Value" in highly speculative, emerging ventures is challenging to determine. Companies can establish "Safe Harbor" from IRS challenges to valuation matters by employing the services of a qualified, professional valuation firm. Companies should consider obtaining a valuation at each option grant. The shelf life of a valuation is the lesser of one year, or until a material event that would suggest a change valuation has occurred.

In some cases, to minimize costs, very early-stage companies elect to value their equity internally, based on rules of thumb. Alternatively, entrepreneurs may decide to issue equity compensation at a "safely high" value. For instance, we often see employee equity valued at the same price as a recent Preferred Stock. Both of these tactics are problematic. When Companies are successful and progress through development stages into viable, valuable businesses, the basis for early-equity grants will be reviewed, and if there is no credible support for the values, option contracts may need to be cancelled and reissued. Equally problematic, when equity is overvalued early in the game, and a later appraisal concludes that the correct value is significantly lower than previous grants were based upon, early option holders are left with out of the money options. Disappointing to be sure.

Although IRC 409a has only recently been defined, the IRS has been quick to enforce the regulations. As an example of the worst case scenario, The Federal Court case, Sutardja v. United States, was one of the first cases to interpret the 409a regulations, and involved a potential tax penalty in excess of $5 million. The ruling was a clear signal that the IRS is willing to aggressively pursue recovery for what it views as Code § 409a violations and that companies must be diligent in their grant award procedures in order to avoid potential 409a issues.

In addition to the benefit of getting the right strike price, an independent third party appraisal will flow into Financial Statement preparation and the determination of compensation expense associated with equity issued as compensation. The Accounting team you work with will rely on an independent valuation of equity to verify that option expensing was done correctly.

As a result, we work frequently with top tier audit firms (all of the big 4 as well as regional CPA firms) to support the valuations we perform for equity securities issued as compensation. If a valuation cannot pass audit, then prior grants will need to be reviewed, and in some cases, invalidated and reissued at the current Fair Market Value, which is typically higher than the initial issue date. Not a fun thing to go through.

Valuation of private, closely held companies is an evolving discipline involving consideration of fundamental valuation theory, as well as expert application of qualitative judgement. As a company focused specifically on early-stage companies, we are uniquely qualified to issue a well-supported opinion of value. Having served over 400 early-stage companies, we can service your valuation needs efficiently and affordably. A quality 409a valuation should not break the bank, nor should the valuation process occupy too much of an entrepreneur's time.

Contact John Shumate with Venture First at any time to discuss how we can support your valuation needs.

Contact:
John Shumate, CEO
@ john@venturefirst.com
+1.502.419.6175

Venture First
@ info@venturefirst.com
+1.502.208.2125
PO Box 7129, Louisville, KY 40257
www.venturefirst.com

About the Author

Liza Bowersox serves as Vice President for Compliance Valuation at Venture First. Her primary focus is Fair Market Value and Fair Value Opinions for tax and financial reporting purposes. She is a leading provider of independent valuation advisory and valuation education services to private companies, institutional investors, attorneys and entrepreneurs in the United States and globally. She has deep experience analyzing complex capitalization structures for the purpose of valuing common stock, preferred stock, derivatives, and equity appreciation rights. Liza has served companies with Enterprise Valuations ranging from $1-$300MM in a variety of industries. She is a member of both the American Society of Appraisers and the National Association of Certified Valuation Analysts with credentials in process for both organizations.

Prior to joining Venture First, Liza led the 409a Valuation Practice at Oxford Valuation Partners. She began her career with Arthur Andersen Business Consulting and later spent 5 years managing systems integration and technology strategy engagements with Adecco, Inc. Liza received a BA in Economics from The University of Virginia.