Cabrillo Advisors, LLC
A Primer on 409A

The following is a primer on Internal Revenue Code 409A prepared by Cabrillo Advisors, LLC. Cabrillo's IRC409A valuation work has been performed for portfolio companies of leading venture capital firms nationwide across a broad range of industries and has been vetted with numerous auditors, including most regional and national or Big4 firms.

IRC 409A Background

In October 2004 the IRS issued a new regulation, Internal Revenue Code §409A ("IRC409A" or "409A"), as a part of the American Jobs Creation Act of 2004 in response to perceived abusive compensation practices and stock option pricing practices (i.e. issuing stock options below fair market value). The enactment applies to all forms of deferred compensation including stock options and other forms of equity based compensation. Non-compliance could result in severe tax penalties for compensation recipients.

The IRS requires that private companies establish that their stock options are not being issued "in-the-money" or with an exercise price below "fair market value". This can be accomplished by performing a business valuation to determine the fair market value of the subject business.

Becoming 409A Compliant

Valuations can be performed by an individual inside the company or an outside party. The only stipulation is that the appraiser has at least 5 years of experience in business valuation, financial accounting, or a related field. It is often the recommendation of a company's advisors to elect having an outside party perform the valuation analysis given that the work will likely be less scrutinized and given the severe implications of basing equity grants off of an incorrect valuation.

Valuation Approach

The American Institute of Certified Public Accountants (AICPA) has issued a practice aid which provides guidance on the appropriate methodologies for valuing companies in different phases of development. In order for a valuation to be deemed acceptable, it must consider numerous internal and external factors related to the business, as follows:

- **Internal factors.** Internal factors include milestones achieved, management experience and track record, workforce skill, existence of intellectual property, advantageous relationships with suppliers/customers, and financial performance.

- **External factors.** External factors that impact the analysis include state of the industry/economy, competitive landscape, industry attractiveness, barriers to entry, etc.

Step 1: Business Enterprise Value

The first step in a 409A analysis is to determine a Business Enterprise Value. The three generally accepted approaches for determining enterprise value are:

- **Market Approach.** Determined based on a review of the valuations of publically traded companies as well as published valuations for recent private transactions in with business models similar to the company being valued.

- **Income Approach.** Determined based on the present value of anticipated future cash flows, commonly referred to as Discounted Cash Flows.

- **Asset Approach.** Determined based on the value of both tangible and intangible assets.

Typically two or more of the approaches will be weighted to determine a blended value. It should be noted that in businesses which are not asset intensive (i.e. software, business services) the asset approach will rarely be considered.

Other factors considered include control premiums and discounts for lack of marketability.

Step 2: Allocation of Value

For companies with multiple classes of equity, such as preferred stock or convertible debt, the Business Enterprise Value needs to be allocated to the differing classes of stock. The AICPA suggest three potential methodologies for this analysis, as follows:

- **Option Pricing Method (Black Scholes).** In the option pricing method, each class of equity is treated as a call options on the business enterprise value, with exercise prices based on the liquidation preferences of each class of stock.

- **Probability Weighted Expected Return Method (PWERM).** The value of the common stock is estimated based upon an analysis of the common stock value considering various potential scenarios. Although the future outcomes considered in any given valuation will vary based upon the facts and circumstances, common scenarios include an IPO, merger or sale, dissolution, or continuous operation as a viable private enterprise.

- **The Current-Value Method.** The current-value method of allocation is based on first determining enterprise value then allocating that value to the various series of preferred stock based on their liquidation preferences or conversion values, whichever would be greater. Its use is appropriate only in two limited circumstances, including (1) an imminent acquisition or dissolution, or (2) circumstances where no significant common equity value has been created.

Selection of the appropriate methodologies from the three described above will be based on facts and circumstances specific to the entity being valued. It is common practice to apply a weighting to two or more of the methodologies and develop a blended value to apply to the deferred compensation.

Once completed, a valuation conducted for 409A compliance must be refreshed every 12 months or sooner if there is a material change in the business or the implied market value of the common stock (i.e. Additional round of financing, loss of a major customer, etc.).

Implications of Non-Compliance

The tax penalties stemming from non-compliance can be severe and are enforced on the recipient of the deferred compensation or equity compensation. On a combined basis, federal and state taxes with penalties can reach upwards of 80%.

On the federal level, penalties include taxation on the value of the compensation at ordinary income tax rates in addition to an excise tax equal to 20% of the compensation. Taxes are also imposed on the state level, and in California, consist of a 9.4% individual tax rate plus a 20% state excise tax.

In addition to monetary costs, failure to be 409A compliant can impede an institutional financing or exit transaction as investors/buyers are now requiring compliance prior to completing a deal.

About Cabrillo Advisors

Cabrillo Advisors is a full service business valuation firm providing valuation services for public and private clients performed by valuation experts in accordance with AICPA, GAAP, and USPAP standards. Please allow us to serve you on your valuation requirements.

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