

THE COST OF COMPLIANCE FOR 409A/123R VALUATION: The higher costs of getting it wrong

Private companies must now meet a substantially higher standard in the valuation of their shares for both tax and financial reporting purposes, with the passage of IRS Section 409A and SFAS 123R. Even at the earlier stages, venture-backed companies are being encouraged, if not instructed by their investors, to obtain third-party valuations to support their positions. Corporate boards, recognizing potentially increased liability, are also pressing for outside valuations. Meanwhile, investors are pushing their portfolio companies to reduce burn rates and to conserve cash due to the poor prospects for the exit markets and a slowing economy. Compliance expenses are a natural place for CFOs to look to cut costs, and outside valuations are often viewed as a necessary evil by both companies and investors. However, understanding the true requirements for compliance with 409A and 123R may make CFOs think twice about sacrificing quality at the altar of lower cost.

What Drives the Review Process?

For early stage companies¹ 123R may be the source of scrutiny more than 409A. While many early stage companies do not have audited financial statements, as they grow this will become a requirement. Early stage company CFOs should be planning for this time, and one way to do that is to make sure that the valuations

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they have are of sufficient quality. An early stage, venture-backed company's primary concern related to 123R is its auditor's acceptance of the valuation in support of its audit. Depending on the number of options granted in a particular period, the numbers are often immaterial from an audit standpoint. Understanding your audit materiality threshold and the impact of your share valuation and option grants will provide useful insight into the degree of scrutiny your auditor will undertake. Large option grants that are material to the financial statements will tend to encourage your auditors to involve their valuation professionals in reviewing the valuation. By involving their valuation professionals, the audit team brings expertise to the table that they often lack, while also managing their risk. The valuation professional's role is to provide expert support for the audit position and in this role, they become a member of the audit team. The issue here, from the company's standpoint is twofold:

¹ For purposes of this article, early stage companies are defined as those **currently expected to be** at least three years away from a likely initial public offering.

cost of the review and the quality standard to which the report will be held.

Valuation teams at the Big Four firms review literally thousands of appraisal reports each year — but they don't see them all. Audit teams are not required to bring in valuation professionals on their engagements. Most firms encourage (and some would say strongly encourage) this approach although audit teams that believe they have sufficient expertise to review the valuations may choose not to bring in their valuation people. While this sounds like it a good thing — potentially reducing review fees and streamlining the process — there are risks. Valuation professionals are used to working in a world of estimates, subjective assessments and professional judgment. Auditors have a bias to a clear documentation trail and minimizing subjectivity. That star Senior Associate on your audit engagement may find himself on unaccustomedly soft ground when looking at a valuation, leading to a never ending cycle of questions and requests for supporting information as he attempts to purge out the subjectivity. Having an experienced valuation professional assisting often minimizes these efforts as they understand the level of subjectivity that is typical and can focus in on key elements driving the valuation.

Elements of a Quality Appraisal

Quality is a concept that everyone understands, but to be useful needs to be defined within the specific situation. When talking about a valuation, quality results from a combination of documentation, analytical rigor, reasoned judgment and an overarching understanding of the company, its stage, and its position within the industry.

One of the most common shortcomings of a valuation is a failure of the valuation firm to appropriately understand the factors that influence value for that particular industry. Selecting a valuation firm with

deep credentials in the industry can greatly enhance the quality of a valuation. Alternatively, a lack of this industry knowledge can lead to a valuation result that is simply wrong. One clue that the valuation firm lacks the appropriate industry knowledge is that its discussion tends to be generic, seeming as if it could apply to almost any industry. A valuation based on deep industry knowledge will note key value drivers and how they impact the company.

Almost all valuation firms have generic models that they use for performing elements of the valuation exercise. The comprehensiveness of these models is another indication of quality. The more information the valuation professional has to look at, the more likely they will draw a more reasoned and supportable conclusion. That said, be on the lookout for “canned” models. Companies have been trying for years to develop software to perform valuations. None of it works. There is simply too much judgment and complexity in a valuation to allow it to be programmed into software.

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Valuation is more art than science. The valuation professional needs to look at multiple indications to triangulate on a value conclusion. Valuations supported by a single methodology are, by their very nature, risky. One ill-conceived assumption, and the answer will be incorrect. Valuations derived from multiple approaches and methodologies provide a test of each individual methodology. Highly divergent answers from different methodologies may be a sign of an internal inconsistency.

Audit reviewers will be looking for support for assumptions and inputs. A quality valuation provides these in the valuation itself, eliminating the need for multiple requests on the part of the audit review team for supporting documentation. Two fairly reliable indications of a lower quality valuation are “thin” reports, i.e. little narrative supporting the assumptions and conclusions and resistance on the part of the valuation firm to provide supporting analyses to the audit teams.

Lastly, the answer needs to make sense. Valuation professionals producing quality reports “take a step back” and ask themselves “given everything that I know, does this answer make sense?” Poor quality valuations tend to be simply the ‘number that came out of the model,’ without the appropriate review and sanity check.

When considering a valuation firm, ask for a redacted report that is representative of the work it would provide you for a similar scope and fee. Don’t get the ‘sample report’ as it may not be representative of either scope or fee.

Total Cost of Compliance

Audit valuation reviews can range from an informal reading of the report, which is meant to flag items that the audit team may want to pursue, to a full expert consultation, where the valuation team will provide audit support documentation of the review process and conclusion. These efforts can vary materially in both time and cost. A clear understanding of the impact of the valuation on financial statements may allow a company to guide the audit team to the level of review that is actually necessary, reducing both time and cost.

When considering hiring a valuation firm a number of factors come into play, some of which relate to quality and risk, but all of which have an impact of total cost. But what is “total cost?” The total cost is made up of four elements: the opinion, the audit review cost, the

management time required and the deferred cost of IRS review.

Opinion costs range from as little as \$3,000 to more than \$30,000, depending on the stage of the company (later stage equals more money), where the company is relative to a potential exit, the complexity of the capital structure (if you have a Series O, expect to pay more), and any complicating factors that may exist. Obtaining a quality opinion should be first and foremost on your mind. Those \$3,000 opinions are often referred to by valuation reviewers and auditors who’ve been through the pain of reviewing of them, as “drive by valuations.” Valuations are like most things — you tend to get what you pay for. Ask yourself, “how can one firm do a valuation for half the cost of another?” Either someone is eliminating elements of the valuation process, and by doing so negatively impacting the quality of the opinion, or they have seriously and incorrectly scoped the effort required. Both of these scenarios may lead to issues with the valuation. Your best strategy is to ask around. Talk to auditors — they see more valuations than anyone. If your investors or attorneys provide referrals, make sure it not a cost driven referral.

We’ve discussed audit review costs by alluding to additional time that could be required. Valuation reviews can cost upwards of \$40,000, if an appraisal is poorly prepared and the company drives the auditor to work through the process of getting it up to the level of quality required. This is a painful process for all involved, and might have been avoided either through hiring a more appropriate valuation firm at the outset, or by taking the valuation reviewers advice to simply discard the inadequate valuation and get a new one. Valuation reviewers are looking for ways to get a valuation to be sufficient. If your auditor’s valuation folks are telling you the valuation “cannot be relied upon,” it’s generally beyond hope, and your best move is to ask the auditor for names of reputable firms and start over with one of them.

Unfortunately, the cost of management time only becomes apparent when the review begins. A protracted review process, resulting from a low quality opinion, can be a huge time sink for management. Your CFO has better things to do than act as the referee between the auditor and the valuation firm. Here's a tip that will save you time and facilitate the review process: Get off the call. The most productive review calls occur between the auditor's valuation people and the valuation firm, without the auditor or the client on the phone. Only having the valuation professionals on the phone allows for detailed technical discussions that would require considerable explanation, and allows both parties to speak frankly, without the pressure to defend their work in front of their client or audit brethren.

The cost of an IRS review remains to be seen (see below); however, based on the number of tax court cases every year, and the fact that until only recently most valuations were for tax purposes, it is likely to be significant. It's worth remembering that it is real dollars of the company, or its employees, that are at stake in IRS reviews, so the IRS is highly motivated in this time of budget shortfalls.

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Why You Should Care: It's Expensive to Get it Wrong

A common lament of early stage CFOs is, "But I'm four years away from any kind of exit and don't even have auditors, so I just need to get this done as cheaply as

possible." This perspective, ignoring quality, presents several risk factors that could ultimately turn out to be both costly ... and potentially career limiting.

The first risk factor is that everything goes better than planned. Fast forward two years. Your company has blown through its development milestones and the sector has become the new cleantech. The investment bankers are swarming, telling you they can get you public now and at a great valuation. Everyone is excited as the S-1 is being put together. That is until your new auditor, Big4 Audits LLP, finds your stock valuations done by Cheapest Valuations LLC. These are now supporting the S-1, which means they are going to get detailed scrutiny by both the auditor and, very likely, the SEC. The valuations are poor quality, incurring substantial hours in audit review, and ultimately have to be redone, costing you both time and money. At this juncture you're looking at top end valuation firms that are highly experienced in valuations of the quality required to withstand SEC scrutiny and you are paying fast track prices. Likely cost: in excess of \$30,000 per valuation date that needs to be redone. Even once they clear the auditors, the SEC may dig in, asking more and more detailed questions as this is a hot topic for its reviewers. Worst case scenario, while all this is going on there's a market shock and "the window" slams shut. Suddenly that \$5,000 you saved isn't looking like frugality, it's looking like bad business judgment.

The second risk factor is new auditors. Some investors require Big Four or superregional audit firms. Raising that Series B round brought you the capital you need, great investors to boost your public image and help with their contacts and industry knowledge ... and a new auditor. Valuations are high on the list of things a new auditor is looking for. While not as dire as the situation above, you can expect Big4 Audits LLP to have its valuation team do a detailed review at this point, since it is looking for risk issues. Listening to the principal at Cheapest Valuations LLC wither under the

questioning of the Managing Director at Big4 would have been entertaining, if it weren't your valuation they were shredding, — unsupported assumptions by ill conceived methodology. That MD bills out at more than \$600 per hour and he has a team behind him that is actively working to resolve your valuation issues, one billable hour at a time. As easy as it is to blame the auditor, they are doing exactly what you hired them for, and ultimately they are providing you a valuable service in helping you to avoid the first risk scenario. A quality appraisal, while still subject to the review process, generates fewer questions, is supported by documentation for the underlying assumptions that can be provided to the audit reviewer and rarely escalates into a battle of egos.

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The last risk factor is the IRS. Admittedly, the IRS has essentially ignored 409A up to this point. Sorry, the free ride is over. At this moment the IRS is training a small army of valuation engineers to begin reviewing 409A valuations in 2009. The obvious first candidates will be the big, splashy IPO darlings who have taken cheap stock charges. They have admitted to the world that they “got it wrong” on the stock valuations, and the IRS will be happy to take those admissions and squeeze as many dollars as possible out of them. “Fine, skin'em for all I care. I'm a little private company.” Yes, but think about who is next. Once the IRS runs out of those obvious targets, one reasonable next choice would be companies getting valuations from firms that are doing bargain basement priced opinions. It stands to reason that these will be less well performed and

supported, so the chances of being able to prove gross inadequacy and pierce the safe harbor is the best. It might take the IRS three to four years to get to your firm, but by then you are larger, more successful, there's more money at stake and hindsight doesn't help to support your position. Yes, Virginia, the IRS does have hindsight on its side. Also, if the IRS is able to pierce the safe harbor, the valuation firm can also be held financially liable. What do you think the chances are that Cheapest Valuations LLC, a small, valuation-only shop that only entered the business when this whole 409A/123R opportunity popped up, is still around to help you defend your valuation if a couple of its opinions on the big, splashy IPO companies have blown up?

In addition to the hard dollar costs and lost time, these risk factors may also have a more insidious and negative side effect, particularly when 409A is the issue. Since it is likely that the major option holders are senior management, problems around valuations start to create a rift between management and the board of directors. If it's shown that a company underpriced its options, there are real dollar impacts to the holders. A CEO who is suddenly liable for a sizable amount of additional tax, plus a 20 percent penalty and future taxes every time a new slice of those options vest, is going to be looking to the Board of Directors to “fix” the problem. Litigation between the option holders and the company may only be one step away. The last thing an early stage company needs is this type of internal strife. It distracts everyone from their primary purpose of building the company.

The Bottom Line

The SEC, the FASB and the IRS have all increased both the requirements, and the non-compliance risks around stock valuations, largely due to their roles as primary inputs into the option pricing and valuation process. Recognizing a market opportunity, there has been a rush for firms to enter the 409A/123R valuation arena.

The quality of the reports and underlying analyses vary greatly, as does the cost. Looking at these valuations as a low risk compliance exercise, and focusing on getting the opinion done for the lowest possible cost ignores the need for quality and its impact on the total cost of compliance. Failing to take into account the additional costs of review, and the potential costs of a position that proves unsupportable can expose the company and its optionees to considerable risk. Company CFOs need to recognize that the valuations they are purchasing are not a commodity. Quality matters. While price may not be inextricably linked to quality, it does provide some useful guidance on what you are getting. Caveat emptor!

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Walling previously led valuation consulting at PricewaterhouseCoopers LLP's Valuation Group in San Jose, where he focused on complex security and derivative valuation projects as well as tax and financial reporting valuations. Walling has more than 14 years of experience in the field and previously held leadership positions with valuation services groups at both Coopers & Lybrand and Arthur Andersen. Walling has also worked for several technology companies such as Appiant, Inc. and Quartz Inc. and he was co-founder and CFO of ClearPath Technologies. He holds a master's degree in business administration in finance/investments from Santa Clara University and is a Chartered Financial Analyst.

ABOUT SVB ANALYTICS

SVB Analytics offers valuation and corporate equity administration services to SVB Financial Group's core constituencies of private, venture capital-backed companies and venture capital firms. SVB Analytics' services offerings include fair market IRC409A/FAS123R valuations and corporate equity tracking and administrative services. SVB Analytics is a member of global financial services firm SVB Financial Group, with Silicon Valley Bank, SVB Capital, SVB Global and SVB Private Client Services, which serve the unique needs of technology, life sciences and private equity firms.

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