

Early Stage Cap Table Management

Best Practices and Traps to Avoid



Check out [Kranz.Consulting](https://www.kranzconsulting.com) to learn more about what we can do for you!

^k

Cap Table Management Agenda

Hosted by Dan Marotto, CFO

- » The Basics of Cap Table Management
- » True Stories
- » Likely Investments
- » Best Practices
- » Q&A





Cap Table Management Fundamentals

- » Cap Table:
Source of Investment Truth
- » 409A valuations
- » Early exercise & 83(b) elections
- » What can alter the cap table
- » Management best practices



Cap Table—Source of Investment Truth



The Cap Table Should Be the Single Source of **Investment Truth** That Impacts Multiple Areas of Your Organization



1

Business Risk

Necessary for accurate financial reporting and communication to investors.



2

Financial Risk

Needed for an appropriate understanding of available options for future grants.



3

Cap Table Solution

An easy to use visual of a business' ownership structure and controlled environment —who owns what, investment type, vesting and level of investment.



Capitalization Table

A complete and accurate Cap Table is critical to your organization and investors - **inputs and compliance matter.**



Ledger of Company Ownership



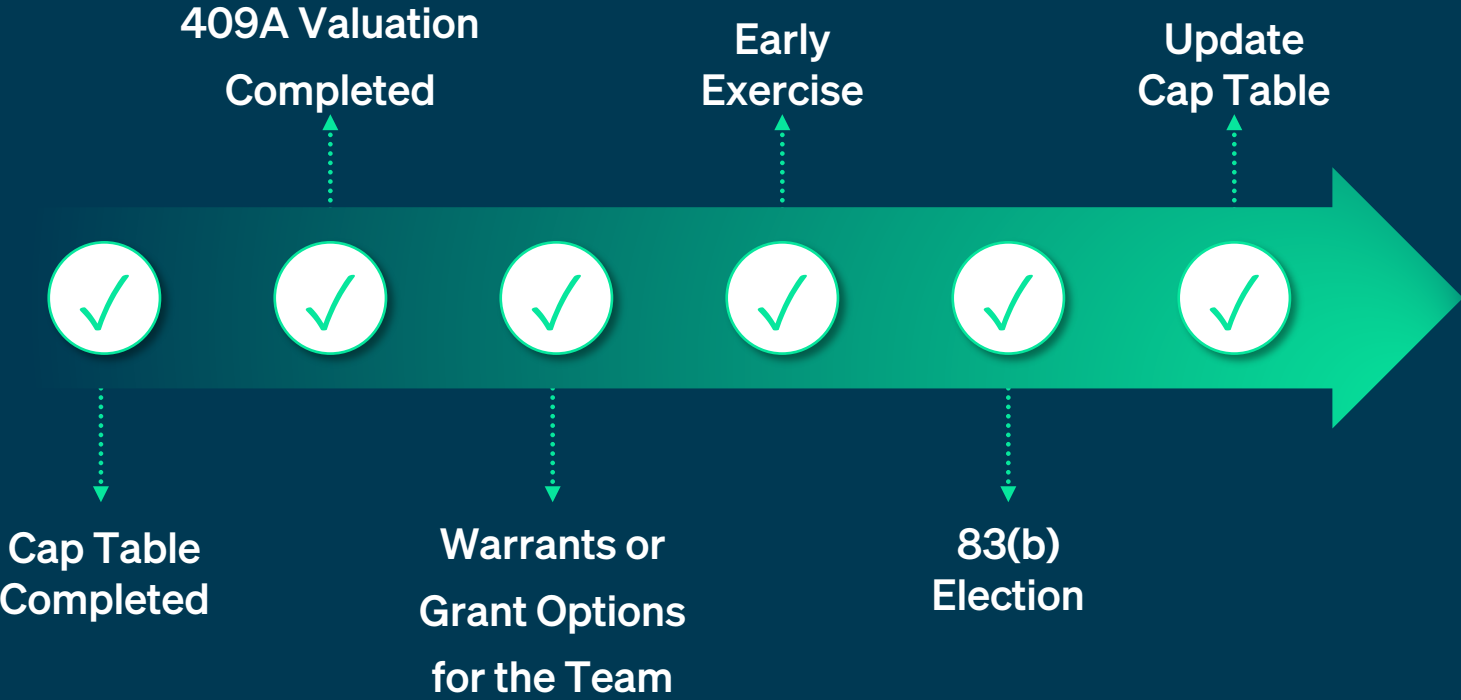
Grants, Options, Warrants Outstanding & Available



Single Source of Truth



Employee Deferred Compensation Plan Milestones



Employee, or startup founder, can elect to pay taxes on the total fair market value of option grants and restricted stock at time of granting.

Election applies to equity that is subject to vesting.



409A Valuation

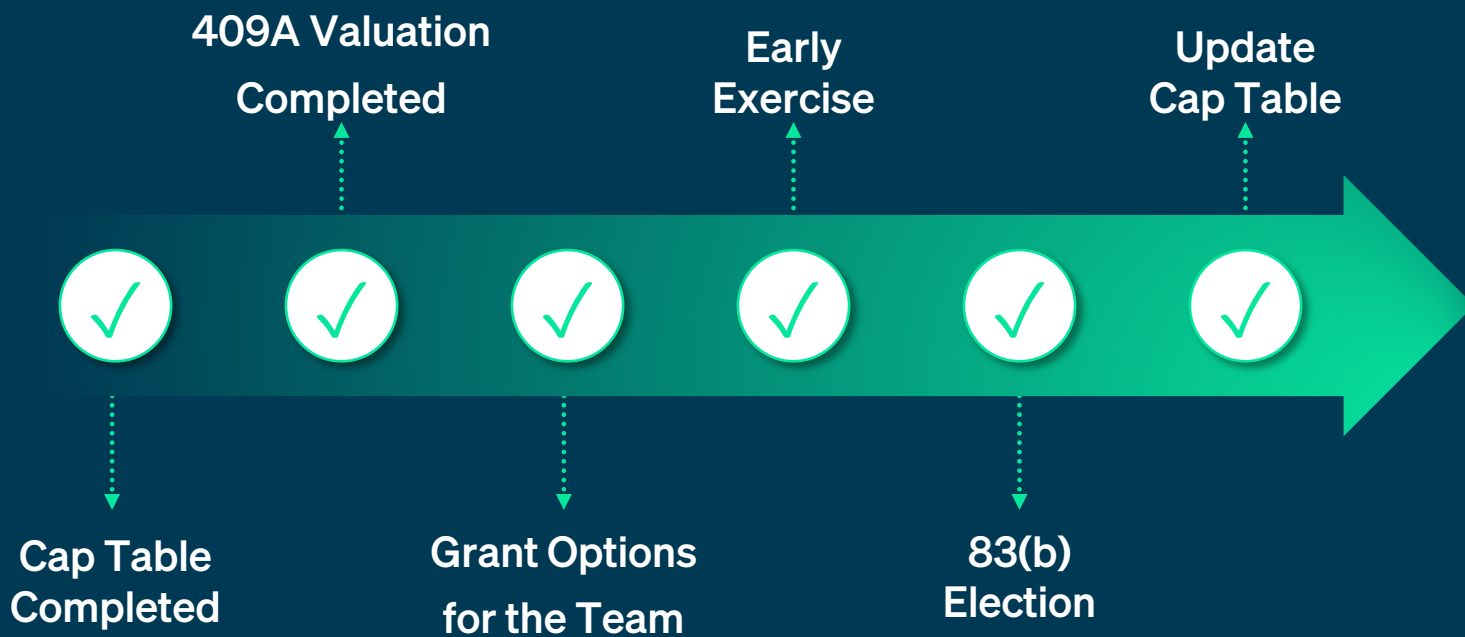


- Used to determine the fair market value of one share of your company's common stock
- Based on guidelines in the Internal Revenue Code for deferred compensation and provides Safe Harbor
- 409A reports expire! Timely completion of a 409A report is critical and note the impact of material changes – increase in shares or additional investment
- Generally, serves as a basis for input for stock-based compensation expense

Kranz has relationships with top 409A Valuation firms.
Get in touch with us today!



Early Exercise & 83(b) Election Process



Early Exercise allows employees and founders to purchase their stock options before they vest when the strike price and FMV are equal or negligible – *little to no tax at the time of exercise.*

83(b) Election allows an employee to pay taxes on their stock awards at the time that they are granted.

Critical that the administrative portion is complete – **who owns it?**



Key Takeaways and Resources



- Build out the Cap Table on a purpose-built solution – ***excel is not a sustainable path.***
- Develop and practice a standard Cap Table review process – ***address exceptions via a change control process.***
- Identify and establish working relationships with your qualified trusted advisors – ***it is inevitable that there will be issues to navigate.***



Events that Alter the Cap Table



Real life Events That We Have Experienced That Impact Your Cap Table

1

Employee separates from the business

Employee option stop vesting

2

Employee option grant administration

Two common steps - early exercises and 83(b) election

3

Recording a security conversion

Report and edit, do not double dip

4

No errors, no errors, no errors

Accurate information is the only option



What could go wrong?

- » Timely administration and management of the Cap Table is critical.
- » Consequences are real and have business and financial implications to your company.



Have a process



Get the right people



Doing the right jobs



True Story

- An employee leaves the company and has an option grant that is vesting.
- Two former employees exercised options using online portal—options vested post separation!!!
- Six months later... the company reviews the Cap Table and realizes that the former employees are exercising options that vested after their separation dates.

Consequences: Contact legal, Refile 3921 forms, restate the prior year financial statements, update the Cap Table.





True Story

- A two-step election process – the employee acts to complete an early exercise and file the 83(b) election.
- An employee executes an early exercise of their NQ Options, but did not file an 83(b) election.

Consequences: Creates a tax risk for the stockholder and the company.

Upon each vest date, if the fair value exceeds the exercise price, the company will need to report additional amount as compensation via payroll.





True Story

- Conversion does not result in double the capital – just presentation on the Cap Table.
- When onboarding a client to a new stock platform, it was noted that the company recorded convertible notes and then the associated converted preferred shares and payments for BOTH.
- Added bonus: reporting the same cash invested in both securities.

Consequences: The equity section of the balance sheet and the Cap Table are overstated and potential to negatively impact the company valuation.



**The Double Cash
Reporting Mystery**



True Story

- Bad inputs will deliver bad outputs.
- Cap Table not up to date. Outdated Cap Table used to complete the 409A valuation.
- Valuation reported to investors and used in support of next round of option grants and a fundraising cycle.

Consequences: Potentially impact the fair value of the valuation and exercise price of option grants and stock.





Summary Manage the Process

1

Update the Cap Table in a timely and accurate manner with a formal process – resolve exceptions quickly.

2

Get proper authorization and support for all changes.

3

Matching and audit principles apply, the Cap Table & equity must align.

4

When in doubt look to a trusted advisor and resolve the issue.



Common Equity Transactions

- » SAFE Agreements
- » Options
- » Restricted Stock Awards
- » Warrants



Simple Agreement for Future Equity (SAFE) Agreements

1

A balance sheet item

- SAFE agreements used to raise capital
- May be equity or a liability – what are the facts

2

Cap Table implications

- Similar to convertible security
- Provisions: early exits, change of control, dissolution
- Investor provisions: discounts, valuation caps

3

Possible fair value measurements

- Liabilities are measured at fair value each balance sheet date
- Adjustments to fair value recorded to income statement



Option Considerations

1 Service or performance based

- Very traditional for employees – vesting over a period of years
- Has a direct impact on accounting and Cap Table – when the options vest and exercised

2 Not service or performance based

- Some individuals may have been allocated significant equity without vesting schedules or performance requirements
- Include: other organizations, advisors or ‘non-capital participating’ angels

3 Accurate underlying data

- Accuracy of underlying data and inputs directly impact Stock Based Compensation expense
- Possible system limitations in Stock Base Compensation calculations depending on option terms (talk to your advisor)



Restricted Stock Awards

1

Description of RSA

Type of equity compensation grant of company stock with restrictions.

2

Share ownership

Employees will own the shares on the date they accept the grant and the defined vesting terms are satisfied.

3

Vesting

Typically, the shares will still be subject to vesting conditions – service committed and/or performance condition (company or market).



Warrants

1

Description of Warrants

A stock warrant gives holders the option to buy company stock at the exercise price until the expiration date.

Issued to consultants, banks and investors (non-employees)

2

Accounting for Warrants

Equity vs. Liabilities

Accounting implications – **what to record as an expense?**

Considerations – **Impact on covenants**

3

Valuation (FMV) Approach

Black-Scholes Model

If the warrant terms are highly variable, then engage a valuation specialist



Wrap Up



- Know your Facts and Circumstances – update accounting and Cap Table.
- Board Consent validates the Cap Table.
- Supporting documentation should match Cap Table.
- If there is an unknown, then seek an outside perspective.



Cap Table Best Practices

- » Be timely & accurate
- » Document & authorization
- » Formal Cap Table processes
- » Review & monitor
- » Trusted advisors are a resource



Conclusion

An accurate and well-structured Cap Table:

- » Instills confidence in potential investors.
- » Demonstrates that you have managed equity allocations well.
- » Shows that you've taken proactive steps to address issues.

Thank you!

Please send questions to the chat or to marketing@kranz.consulting.



Dan Marotto
CFO



Michael Barry
Emerging Growth Practice Lead



Shannon Klingelhoffer
Sr. Director of Technical Accounting



Bonnie Mott
Director, Stock Admin



Check out [Kranz.Consulting](https://www.kranz.consulting) to learn more about what we can do for you!