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Less Is Better?

MD&A Disclosures About "Cheap Stock" in IPO Transactions

by Joe DiLeo and Lisa Mitrovich, Deloitte & Touche LLP

In recent speeches, SEC commissioners and staff members have focused on the efficiency and effectiveness of disclosures in registrants' SEC filings. For example, the SEC staff has noted that it will undertake a comprehensive review that aims to make such disclosures more effective by promoting ways to reduce or eliminate those that are immaterial, redundant, or unclear. In an April 11, 2014, speech, Keith Higgins, director of the SEC's Division of Corporation Finance, indicated that the SEC staff continues to analyze whether the comment letter process (i.e., the staff's review program related to registrants' filings) has led to "unintentional outcomes" in disclosures.

Mr. Higgins observed that in performing this analysis, the staff determined that its questions to registrants about their accounting for cheap stock — i.e., equity securities issued as compensation in periods before an initial public offering (IPO) — have led to "detailed responses in the filing." He further noted that the staff has changed its practice and that the guidance in Section 9520[1] of the SEC Financial Reporting Manual (FRM), which was updated in February 2014, clarifies that the staff may ask companies "to explain the reasons for valuations that appear unusual." However, he emphasized that the SEC staff's comments are intended to help the staff determine whether a registrant's "accounting is accurate" and not to request "changes to disclosure in MD&A or elsewhere."[2]

This *Heads Up* discusses the SEC staff's rationale for updating Section 9520 and highlights recent SEC staff remarks that clarify how registrants should apply the updated guidance.

SEC Staff Observations Regarding Registrants' Past Disclosures About Share-Based Compensation

At the Practising Law Institute's "SEC Speaks in 2014" Conference (the "conference"),[3] the staff of the SEC's Division of Corporation Finance described the types of detailed disclosures in IPO registration statements that had prompted it to revise Section 9520. The staff noted that registrants have historically included:

- A table of equity instruments issued during the past 12 months.
- A description of the methods used to value the registrant's pre-IPO common stock (i.e., income approach or market approach).

[1] SEC Financial Reporting Manual Section 9520, "Share-Based Compensation in IPOs."
[2] See paragraph 9520.2 of the FRM for more information. In addition, paragraph 9520.3 notes that in evaluating share-based compensation disclosures, the SEC staff will also consider other MD&A requirements.
[3] For additional information about the conference, see Deloitte's March 20, 2014, *Heads Up*.

- Detailed disclosures about certain select assumptions used in the valuation.
- Discussion about changes in the fair value of the company's pre-IPO common stock that included each grant leading up to the IPO and resulted in repetitive disclosures.

The staff indicated that despite the volume of share-based compensation information included in IPO filings, disclosures of such information were typically incomplete because registrants did not discuss all assumptions related to their common stock valuations. Further, disclosures about registrants' pre-IPO common stock valuations were not relevant after an IPO transaction and were generally removed from registrants' periodic filings after their IPO.

Revised Share-Based Compensation Disclosure Considerations

In FRM paragraph 9520.1 as updated, the SEC staff notes that registrants undergoing an IPO typically identify share-based compensation as a critical estimate because the lack of a public market for the pre-IPO shares makes "estimating the fair value of the underlying shares . . . highly complex and subjective." As a result and as further stated in paragraph 9520.1, the staff expects registrants to disclose the following in their IPO registration statements:

a. The methods that management used to determine the fair value of the company's shares and the nature of the material assumptions involved. For example, companies using the income approach should disclose that this method involves estimating future cash flows and discounting those cash flows at an appropriate rate.

b. The extent to which the estimates are considered highly complex and subjective.

c. The estimates will not be necessary to determine the fair value of new awards once the underlying shares begin trading.

At the "SEC Speaks in 2014" Conference, the SEC staff expressed the view that streamlining share-based compensation disclosures will not only reduce the volume of disclosures but also make the disclosures more meaningful.

Editor's Note: At the conference, the SEC staff expressed the view that streamlining share-based compensation disclosures will not only reduce the volume of disclosures but also make the disclosures more meaningful. The staff indicated that by eliminating unnecessary information, registrants could reduce many of their prior disclosures "down to one paragraph."

The staff's remarks at the conference included the following insights into how registrants would be expected to apply the guidance in paragraph 9520.1 (and thereby reduce their share-based compensation disclosures):

- The staff does not expect much detail about the valuation method registrants used to determine the fair value of their pre-IPO shares. A registrant need **only** state that it used the income approach, the market approach, or a combination of both.

  Further, while registrants are expected to discuss the nature of the material assumptions they used, they would **not** be required to quantify such assumptions. For example, if a registrant used an income approach involving a discounted cash flow method, it would only need to provide a **statement** indicating that "a discount cash flow method is used and [such method] involves cash flow projections that are discounted at an appropriate rate"; no additional details would be needed.

- Registrants would have to include a **statement** indicating that the estimates in their share-based compensation valuations are "highly complex and subjective." They would not need to provide additional details about the estimates.
- Registrants would also need to include a **statement** disclosing that such "valuations and estimates will no longer be necessary once the company goes public [because] once it goes public, it will rely on the market price to determine the market value of [its] common stock."

The staff emphasized that its ultimate concern is whether registrants correctly accounted for pre-IPO share-based compensation. Accordingly, the staff will continue to ask registrants for supplemental information to support their valuations and accounting conclusions — especially when the fair value of the company's pre-IPO common stock is significantly less than the expected IPO price.[4]

[4] At the conference, the SEC staff noted that valuations that appear to be unusual may be attributable to the peer companies selected when a market approach is used. Specifically, the staff indicated that there are often inconsistencies between the peer companies used by registrants and those used by the underwriters, which result in differences in the valuations. Accordingly, the staff encouraged registrants to talk to the underwriters "early and often" to avoid such inconsistencies.

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