Game Changers? Financial Reporting Updates and Late-breaking News

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AGENDA

- FASB – Proposed Changes to ASC 718
- SEC Comment Letter Trends – Stock Compensation
- Regulatory Update
- Private Equity Stock Compensation – Trends and Accounting
- Pre-IPO Considerations – Accounting and Valuation Of Equity Awards
FASB – Proposed Changes to ASC 718

- Minimum statutory withholding requirements
- Current guidance requires liability classification when more than the statutory minimum is withheld. Applying this requirement can be complex.
- FASB staff identified three alternative exceptions which would not result, by itself, in an award being classified as a liability:
  - Alternative A: An award partially or fully cash settled for tax withholding purposes.
  - Alternative B: An award partially cash settled for tax withholding purposes in which the amount withheld is reasonably consistent with the minimum tax withholding requirements.
  - Alternative C: An award partially cash settled for tax withholding purposes in which the amount withheld is the maximum marginal

Translation & Concerns

- Given the complexity of determining “minimum statutory withholding”...
- At least the determination might be simplified

Concerns:
- Avoiding liability treatment is a convincing argument that withholding should not be increased
  - In direct conflict with IRS Information Letter 2012-0063 (Increased Withholding on Supplemental Payments)
- Further divergence from IFRS 2
  - Withholding shares for taxes = liability treatment
FASB – Proposed Changes to ASC 718

- Accounting for forfeitures
  - The staff noted that estimating forfeitures can be complex and costly. The staff identified the following alternatives to improve GAAP in this area:
    - Alternative A: Entities are required to account for forfeitures as they occur.
    - Alternative B: Entities make an accounting policy election to either estimate forfeitures or account for forfeitures as they occur.

Translation & Concerns

- No more estimating forfeiture rates!
- No more applying forfeiture rates!
- Back to the halcyon days of 123, pre 123R!
  - True up as forfeitures occur!

- Concerns:
  - Years of my life wasted...
FASB – Proposed Changes to ASC 718

- Accounting for income taxes upon vesting or settlement of awards
  - The Board agreed to replace the current guidance which allocates tax effects between equity and income tax expense. The FASB staff presented the following two alternatives to the board:
    - Alternative A: Recognize all excess tax benefits and all tax deficiencies within the income statement, and remove the requirement to not recognize an excess tax benefit until it is realized.
    - Alternative B: Recognize all excess tax benefits and all tax deficiencies within additional paid-in capital, and remove the requirement to not recognize an excess tax benefit until it is realized.

Recap & Translation

- APIC – increases and decreases would impact
  - Tax Expense OR
  - APIC (but not APIC pool) – Balance sheet account
- APIC pool eliminated
- Impact on DTA balance - None

- Concerns
  - Greater income statement volatility if all transactions go straight to P&L?
  - Another reason to grant RSUs instead of options, since you can at LEAST predict timing of transactions
FASB – Proposed Changes to ASC 718

- The Board directed the staff to further research:
  - practical expedients for private companies with respect to intrinsic value, expected term and formula value plans
  - impact of certain features such as repurchase features on the classification of awards as liability or equity
- The Board added a separate project to its agenda to address potential improvements to accounting for share-based payments to nonemployees including:
  - the scope of the nonemployee guidance
  - accounting for awards with unresolved performance conditions

More Information

2013 SEC Comment Letter Trends: Stock Compensation

- Based on comment letters published by the SEC staff between January 1, 2013 and September 15, 2013 related to stock compensation.
- Assist management teams in identifying and understanding the SEC staff’s current focus areas related to stock compensation.

SEC Comment Letter Trends: Employee Compensation

11% of Comments in Filing Section
- MD&A
- Financial Statement
- Exhibit

62% of Comments by Form
- S-4
- 10-K
- 10 K
- F-1
- 20-F
Management’s Discussion and Analysis

- MD&A was top area for comment in the 2013 comment letters analyzed
- Emphasizes importance SEC staff places on MD&A and quality and transparency of this narrative

![Diagram showing % of Comments by MD&A Topics]

Critical accounting policies and significant judgments and estimates

- 95 comments received regarding MD&A
- 89% of MD&A comments related to critical accounting policies and significant judgments and estimates
- Sample 2013 comments:
  - Please provide a discussion of each significant factor contributing to the difference between the fair value as of the date of each grant and the estimated IPO price range. Please reconcile and explain the differences between the mid-point of your estimated offering price range and the fair values included in your analysis.
  - Please identify any third-party specialists who have provided valuations for consideration in determining the fair value of your common stock. Identify for which transactions the valuation reports were utilized. Describe the approach or basis underlying these valuations. Indicate whether these valuations corroborated the fair value as determined by your arm’s length transactions.
SEC Comments by Category

% of Comments by Category

Disclosure: 50%
Valuation: 41%
Accounting: 9%

SEC Comments by Category

% of Comments by Category

Disclosure: 10%
Valuation: 14%
Accounting: 9%

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Disclosure

- 50 comments (50%) related to disclosure and 29% of disclosure comments related to IPOs

- Many IPO-related disclosure comments focused on explaining differences between most recent valuation of stock and IPO price
  - Area of focus by SEC staff in IPOs – referred to as “cheap stock”

- AICPA Accounting and Valuation Guide Valuation of Privately-Held-Company Equity Securities Issued as Compensation (May 2013)
  - Provides best practice guidance for valuing privately-held company equity securities
  - No authoritative status but SEC staff expects companies to make disclosures that guide recommends for pre-IPO periods

Disclosure

- Sample comments
  - Disclose why the IPO price increased in comparison to the May 20xx valuations. Describe the significant reasons and assumptions that account for the increase.
  - Please include additional disclosures to explain the increase in fair value from the March 31, 20xx valuation of $x.xx to the estimated IPO price of $xx.xx.
  - Once pricing information is available, please revise to provide a specific discussion of each significant factor contributing to any significant difference between the estimated fair value of your stock and the estimated IPO price (or pricing range) for the xx months prior to the contemplated IPO. Please also disclose the aggregate intrinsic value of all outstanding options based on the midpoint of the estimated IPO price range.
Disclosure, cont’d

- Theme noted in disclosure comments related to use of peer companies in valuation of stock awards.
- Sample comments:
  - Please expand your discussion under “Common Stock Value” to disclose the significant factors and assumptions used in determining fair value. For example, for the market value approach disclose the factors used in determining the comparables and tell us on a supplemental basis the names of the public companies used and why you consider them to be most similar.
  - Please tell us the names of the peer companies that you consider similar to you and why you consider these companies similar to you.
  - Translation: Google? Really?

Accounting recognition

- Only 11 comments (9%) related to accounting recognition
- Not many comment related to some of the more complex areas
- Sample comments:
  - We note that your Board of Directors approved the issuance of stock options and restricted stock during your first quarter 20xx. We note no recognition of share-based payment expense for the quarter ended March 31, 20xx in your financial statements. Please explain to us your accounting treatment for these stock-based payments awards. Your response should include the general terms and conditions of each arrangement, number of shares or options issued, the period over which the options and restricted stock vest, and explain why no stock compensation expense was recognized during the quarter ended March 31, 20xx.
  - Please tell us how you have concluded your employee stock purchase plan is noncompensatory. Cite all relevant accounting literature within your response.
Accounting recognition

- Some were broad in nature and other comments related to specific area such as repurchase provisions
  - Excerpt from sample repurchase comment:
    - Please explain your consideration of the repurchase feature as a forfeiture provision and how this feature may impact the grant date fair value. In this regard, we refer to you ASC 718-10-30-10 which indicates that any feature that continues after the requisite service period has been completed would be considered in determining the grant date fair value but would not necessarily impact the timing of recognition.

Industry Analysis

% of Comments by Industry

- Technology: 45%
- Pharmaceutical & Life Sciences: 32%
- Industrial Products: 7%
- Retail & Consumer: 5%
- Automotive: 3%
- Banking & Capital Markets: 1%
- Asset Management: 1%
- Entertainment, Media & Communications: 5%
Regulatory update

FAF Post-Implementation Review

- Financial Accounting Foundation (FASB oversight body)
- Review of FAS 123(R)
- Purpose
  - Is standard achieving intended objectives?
  - Implementation issues, ongoing costs/benefits, practice issues
  - Recommendations for improvement
- Final report issued August 2014
- Overall – positive report. But more difficult for private companies
- Primary issues
  - accounting for APIC pools (public and nonpublic)
  - liability versus equity classification (public and nonpublic)
  - minimum tax withholdings (public)
  - estimated expected forfeitures (nonpublic)
  - measuring share-based payment transactions (nonpublic)
FASB Private Company Council

- Standards on goodwill, interest rate swaps, variable interest entities
- Pre-agenda research on stock compensation
- Staff performing outreach
- Key concerns, implementation and practice issues, etc.
  - Valuation requirements
  - Formula-based arrangements
  - Considerations for entities that intend to go public
  - SEC requires “unwinding” of PCC GAAP

PCAOB Emphasis on Accounting Risks Of Incentive Plans

- Proposed PCAOB rules

- Auditors should perform procedures to obtain an understanding of financial relationships and transactions with executive officers

- Should be designed to identify risks of material misstatement and should include, but not be limited to:
  1. Reading the employment and compensation contracts between the company and its executive officers and
  2. Reading the proxy statements and other relevant company filings with the SEC and other regulatory agencies that relate to the company's financial relationships with executive officers
Post-Vesting Performance Awards

- EITF’s recent consensus – post-vesting performance conditions
  - ASU 2014-12 finalized
  - Effective 2016 for most companies
  - Early adoption permitted

- Addresses performance target not tied to vesting
  - Example – Stock option exercisable upon IPO. 3 year required service period
  - Example – Retirement eligible award, value based on 4 yr EBITDA

- Follow performance condition model
  - That is, assess probability
  - Do not incorporate into fair value

Private Equity Stock Compensation – Trends and Accounting


- In the 2013 survey, PwC collected and analyzed data on the equity compensation plans of 17 US-based private equity firms used at 30 portfolio companies acquired between January 1, 2010 and December 31, 2012
Participant Demographics

Awards inherently tied to the equity growth of the company (options, equity interests) - remain primary vehicle for financial sponsors

Continue to rely on “nil cost, upside only” equity awards
Profits Interests

- Common in pass-through entities (partnerships, LLC’s, etc.)
- Favorable tax treatment ($0 day-one value)
- SEC Staff speech – careful analysis required for accounting
  - More akin to equity or profit-sharing bonus?
- If equity, follow ASC 718
- If profit sharing, follow ASC 710

Vesting Conditions

- Funds continue to tie vesting to performance, granting 50-75% of awards with performance vesting conditions
- Of companies with performance-based vesting criteria, 65% used exit-based performance metrics such as:
  - Multiple of invested capital
  - Internal rate or return or
  - Combination of both

Choosing the right performance metric is critical to aligning the incentives of management and the financial sponsor.
Accounting for PE Awards

- Many awards include vesting provisions tied to “liquidity event”
  - IPO or change in control
  - Performance condition

- Awards often also include market conditions
  - IRR, MOIC, etc.
  - Impact on grant date fair value

- In practice, not probable until event occurs
  - No expense prior to liquidity event
  - Recognize expense upon liquidity event, regardless of whether market condition achieved

Key Plan Terms

<table>
<thead>
<tr>
<th>Call right provisions</th>
<th>Fair market value</th>
<th>Lower of cost &amp; FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Termination by the company for cause</td>
<td>8%</td>
<td>92%</td>
</tr>
<tr>
<td>Termination by the company without cause</td>
<td>100%</td>
<td>0%</td>
</tr>
<tr>
<td>Voluntary termination by the executive without good reason</td>
<td>57%</td>
<td>43%</td>
</tr>
<tr>
<td>Voluntary termination by the executive with good reason</td>
<td>100%</td>
<td>0%</td>
</tr>
</tbody>
</table>

- Financial sponsors and management are focused on repurchase provisions of awards and valuation methodology
  - Company call rights
  - Bad leaver provisions
  - Anti-dilution provisions
PE Stock Compensation Considerations

- Repurchase provisions
  - Put/call features on employee termination
  - Potential for liability classification
  - Share must be held for reasonable period (six months)
  - Repurchase provision may act as forfeiture provision
    - For example – award fully vested day 1
    - Company call right on employee termination
    - Prior to year 3 – lower of FMV or exercise price (cost)
  - Substantive service period = 3 years. Spread expense over that period.

Tender Offers

Offers to repurchase stock options from employees

- Settlement of an equity instrument
  - If repurchase price is at or below the fair value, the amount paid is charged to equity
  - If repurchase price is above fair value, the excess is compensation cost

- Modification that allows the employee to cash settle the option at a future price
  - Change to a liability award with additional compensation charge for any increase in fair value of the option since the grant date
Antidilution Provisions & Equity Restructurings

- Companies with “adjustment discretion” can encounter significant and often, unanticipated accounting charges.
- Example: Management receives 1 million options with strike price of $10. Two years later, stock price is $20 and company issues an extraordinary dividend of $5. The plan document does not require adjustment for equity restructuring. However, Company adjusts exercise price to maintain intrinsic value of awards.

<table>
<thead>
<tr>
<th></th>
<th>Immediately before modification</th>
<th>Immediately after modification</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market price of stock*</td>
<td>$15.00</td>
<td>$15.00</td>
</tr>
<tr>
<td>Exercise price</td>
<td>$10.00</td>
<td>$5.00</td>
</tr>
<tr>
<td>Fair-value per option</td>
<td>$7.84</td>
<td>$10.73</td>
</tr>
<tr>
<td># of options</td>
<td>1,000,000</td>
<td>1,000,000</td>
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<tr>
<td>Total comp cost</td>
<td>$7,800,000</td>
<td>$10,700,000</td>
</tr>
<tr>
<td>Est. incremental compensation charge</td>
<td>$2,900,000</td>
<td></td>
</tr>
</tbody>
</table>

* Although the market price is $20 prior to the dividend, the market price is assumed to be $10 before the modification.

Pre-IPO Stock Compensation Considerations
Pre-IPO Stock Compensation Considerations

- Many awards include vesting provisions tied to "liquidity event"
  - IPO or change in control
  - Common in private equity
- Performance condition
- In practice, not probable until event occurs
  - No expense prior to liquidity event
- Awards often also include market conditions
  - IRR, MOIC, etc.
  - Impact on grant date fair value

Pre-IPO Stock Compensation Considerations

- Many awards are modified in contemplation of an IPO
- If not probable of vesting, then Type III or Type IV modification and therefore, new measurement date
Escrowed Share Arrangements

- In connection with an IPO or other capital-raising transaction shareholders (founders or other management) may place shares in escrow to be released back only if service or performance criteria are met.
  - Presumed compensatory ASC 718-10-S99
  - Equivalent to a reverse stock split – company recognizes compensation cost (fair value at grant over requisite service period)
  - Presumption can be overcome if not contingent on employment
  - Reflect in f/s even if company is not party to arrangement (i.e., between shareholder and new investor)
  - Economically similar transactions are accounted for the same (i.e., forfeited or repurchased at nominal value upon failure to meet service or performance condition)

Transition from Nonpublic to Public Company

- Upon filing initial prospectus (S-1) the company is considered public under ASC 718
- Measurement of Awards classified as Equity
- All new stock awards must be measured at fair value
- Previously issued awards measured at calculated-value can continue to use that method unless award is modified, repurchased or cancelled
Transition from Nonpublic to Public Company

- Measurement of Awards classified as Liability
  - Need to measure all awards at fair value as of the date the company is considered public
  - If awards were previously measured at intrinsic-value or calculated-value, need to change to fair value

Example: Change measurement of awards classified as liability from intrinsic value to fair value
- Vested liability award with intrinsic value $10
- March 1, 201X Co files S-1 and intrinsic value $13 and fair value $15
- Recognize compensation cost of $3 between January 1 and March 1 under intrinsic-value method and recognize $2 of additional compensation cost for the change from intrinsic to fair value on March 1.
- Re-measure award at fair value at end of quarter and record compensation cost for subsequent changes in fair value.
Additional Disclosure for Public Companies

- SAB Topic 14 requirements
  - MD&A shall include specific changes in accounting policy required under ASC 718 in subsequent periods and the likely future effects
- ASC 718 disclosure requirements do not differ for public vs nonpublic entities

Additional Disclosure Considerations

- In addition to the requirements of ASC 718, disclosures about risks and uncertainties might be required due to the use of estimates and judgments in the valuation of privately issued equity securities
- The AICPA recommends that financial statements included in an IPO include the following for the 12 months prior to the financial statement date:
  - Grant dates, number of equity instruments granted, exercise price and other key terms, fair value of common stock at grant date, and intrinsic value of each equity instrument granted
Valuation Concepts - Other Considerations

- A valuation that is prepared contemporaneously with the valuation date is recommended and will not be biased by hindsight.
- There may be events which affect the value of the company after the valuation date. If these events were known or knowable as of the valuation date, they should be considered.
- Valuations should provide a single best estimate rather than a range of values.
Cheap Stock Issues

- SEC challenged registrants that issued stock or granted stock or warrants with exercise prices at a price significantly below the public offering price shortly before going public.

- Example: nonpublic company grants at-the-money stock option six months before IPO under ASC 718
  - IPO price is $10 higher than options exercise price
  - No discrete event to increase fair value of stock during six months
  - SEC staff may presume this was a cheap-stock grant
  - Company may have to rerun option pricing model and record “cheap-stock” charge for larger fair value of in-the-money option rather than at-the-money option

- No preconceived range of acceptable discounts – facts and circumstances evaluation
Cheap Stock Issues

Items affecting the SEC’s decision on whether to challenge the compensation recorded (or lack thereof) will include:

- Transactions with third parties for cash near time of the grant to the employee, and the size and nature of such transactions.
- Appraisals by reputable valuation experts independent of the IPO that were prepared at or near the grant date.
- Changes in business indicating a change in value of the business, such as new contracts or sources of revenues, more profitable operation, etc.
- The length of time between grant and IPO.
- Adequate contemporaneous documentation to supports the valuation Transfer restrictions.

Cheap Stock Analysis

A cheap stock analysis should generally include the following for each equity-related issuance within the latest fiscal year and interim period through the date of the IPO:

1. the date the security was issued and to whom,
2. the deemed fair value of the security, with objective and reliable evidence of how the company determined the value of such security, and
3. a timeline of events leading up to the filing of the IPO,

This analysis should specify the reasons for any difference between the fair value at the transaction date and the estimated IPO price range.
Valuation Concepts—AICPA Cheap Stock Guide

- In 2013 the AICPA issued an updated Accounting and Valuation Guide Valuation of Privately-Held Company Equity Securities Issued as Compensation
  - Provides nonauthoritative valuation guidance and illustrations for preparers, auditors, and valuation specialists
  - Key changes is a focus on transactions in the company’s securities and consideration of private or secondary market transactions in those securities when determining their fair values.
  - Illustrates techniques used to determine the fair value of a company and the methods used to allocate the company’s fair value to the components of its capital structure.

Valuation Concepts—Company Valuation

- Equity awards issued as compensation from privately-held companies will require a company valuation
- Best practice is to perform a valuation explicitly for the purpose needed
- For this purpose, a company will often be valued on a minority basis as equity compensation awards are typically minority shares
  - This may be different from the value of the total company in exchange if, for example, potential acquirers were able to recognize synergies in a business combination.
Valuation Concepts—Valuation Techniques

- The valuation techniques used to value a privately-held company and its securities can be classified into 3 groups.
  - Market approaches
  - Income approaches
  - Asset approaches
- All 3 should be considered along with facts and circumstances to determine which approach is most appropriate
- Multiple approaches can be used and compared

Valuation Concepts—Valuation techniques

- A market approach considers prices and other information obtained from market transactions of similar assets, liabilities or entities.
- An income approach converts estimates of future cash flows into a single current amount.
- An asset approach looks at the value of the company as the value of its underlying assets and liabilities.
- Management should engage a valuation specialist to assist in estimating the value of the securities if management does not have the expertise.
Valuation Concepts—Information Availability

- Information that is available to determine the fair value of the company will change depending on the stage of development.
- Companies that are near IPO are more likely to have reliable information such as realistic income forecasts.
- As the company matures and approaches an IPO, it may also begin to receive estimates of an IPO price. These should be considered.
- When a company nears IPO, the income and market approaches can generally be reliably performed.