Stock Compensation and the IPO Process— Insights from SEC Comment Letters

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Traditional exit strategies for many high-growth private companies are either strategic acquisitions or an initial public offering (IPO). A variety of company, industry, and market-specific factors will determine the form of liquidity event. Private companies targeting a liquidity event through an IPO face certain challenges as a result of the process of getting a Form S-1 Registration Statement approved by the U.S. Securities and Exchange Commission (SEC). The SEC raises questions on proposed filings through the "Comment Letter" process. IPO "windows" may open and close quickly. Given this, the ability to satisfactorily respond to SEC comments can impact the ability to obtain targeted pricing and timing for an IPO.

SEC Comment Letters on Form S-1 submissions cover a variety of areas. SEC comments on employee stock compensation are one of the more frequent areas of comment. Many private firms incentivize management and key employees through the grant of employee stock options to purchase common stock. For private companies without listed stock, these stock option grants typically require an appraisal of the fair value of the common stock. "Cheap stock" comments explore the relationship of the targeted IPO price with the estimated fair values of a firm's common stock in the years prior to the IPO. The SEC is concerned about the reliability of stock value estimates and the impact on reported earnings of a company prior to an IPO.

SEC cheap stock-related comments cover a variety of areas. Comment Letters and registrant responses are posted to the SEC website and are available to the public. Prior Comment Letters provide insights on SEC areas of concern. A few selected comments include:[1]

1. Reconcile prior valuation to the IPO mid-point of estimated price range.
2. Explain any factors leading to an increase in the value of the common stock.
3. Reconcile any fair value estimates with preliminary pricing discussions with underwriters.
4. Advise on consistency of any stock valuations for employee stock compensation purposes with valuations prepared for goodwill impairment (ASC 350) purposes.
5. Provide the basis for relying or not relying on any prior transactions in the stock of the company.
6. Disclose factors for determining comparables, provide the names of public companies, and why comparable.
7. Disclose multiples used in valuation.
8. Disclose methodology used to determine any volatility estimates.
9. Disclose discount for lack of marketability and discuss evidence that supports the estimate.

Studies of SEC filings and Comment Letters indicate that the number of rounds of Comment Letters ranged from two to nine, with an average number of rounds of four. More importantly, the duration of time until a registration statement was approved ranged from two to eighteen months, with an average duration of five months. The quality of prior valuations and the disclosure and quality of responses influence the number of rounds of comments and the duration of the Comment Letter process and the timing of SEC approval of an S-1 filing.

One leading international law firm prepared a list of best practices pertaining to employee stock compensation matters for firms planning an IPO. These best practices require the teaming of management and independent valuation consultants. Several best practices include:[2]

1. Obtain a contemporaneous independent valuation that follows the guidance of the AICPA "Cheap Stock" guide.
2. Pre-emptively address cheap stock issues by including robust disclosure in the IPO registration statement on the process and substance

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of the valuation and changes in the equity value and ultimate IPO price.

3. Be ready to provide SEC staff a detailed analysis regarding key elements in earlier stock valuations.

Given the move to a variety of fair value estimates as a part of developing a variety of accounting estimates, the SEC has dedicated staff with deep experience in fair value determinations. For the auditors of firms that are already public, the Public Company Accounting Oversight Board has increased its scrutiny of fair value estimates. This increased scrutiny recognizes the challenges associated with fair value estimates given the significant informed judgment that is typically a part of the valuation process.

1 https://www.sec.gov/answers/commentletters.htm

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