

Technical Line

Reminders about 'cheap stock' issues for companies going public in IPOs and SPAC mergers

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What you need to know

- ▶ Private companies need to consider the valuation of share-based payments if they are planning to go public through an initial public offering or a merger with a special purpose acquisition company.
- ▶ The SEC staff continues to challenge the valuation of share-based payment awards granted in the period before an entity enters the public markets.
- ▶ The AICPA Accounting and Valuation Guide, Valuation of Privately-Held-Company Equity Securities Issued as Compensation, provides a framework and describes best practices for valuing private company securities.
- ▶ Companies should disclose the methods they used to determine the fair value of the shares underlying share-based payment awards and the nature of significant assumptions involved.

Overview

One of the key accounting and auditing issues for a company that is planning an initial public offering (IPO) or a merger transaction with a special purpose acquisition company (SPAC) is the valuation of equity securities, including stock options, issued as compensation under Accounting Standards Codification (ASC) 718¹ while the company is privately held. A key financial reporting concern is often referred to as "cheap stock," which is when the value of the underlying stock at the grant date is significantly less than the estimated IPO price or the fair value implied by the SPAC merger transaction.

The Securities and Exchange Commission (SEC) staff generally believes that the publicly traded price of a company at the time of its IPO or its implied fair value in a SPAC merger transaction provides the best indication of fair value as of the transaction date, and there should be a rational correlation between the value of the awards issued before the transaction and the estimated IPO price (or range) or the implied fair value of the SPAC merger. The SEC staff often challenges the valuation of share-based payment awards issued in the period before an IPO that is significantly lower than the estimated IPO price. Recently, the staff also has been challenging the valuation of share-based payment awards issued before a SPAC merger transaction that is significantly lower than the fair value implied by the transaction.

Key considerations

Valuation of share-based payments

When a company grants share-based payment awards, management needs to support its judgments and estimates about the fair value of the company's securities and should retain documentation about such estimates, preferably contemporaneous documentation.

The SEC staff expects companies that plan to enter the public markets to apply the valuation guidance in the American Institute of Certified Public Accountants (AICPA) Accounting and Valuation Guide, Valuation of Privately-Held-Company Equity Securities Issued as Compensation (the Guide), when valuing share-based payments (and other equity instruments) they grant in the period before the transaction.

The Guide includes a framework for valuation specialists, preparers of financial statements and independent auditors for estimating and auditing the fair value of share-based payments issued by nonpublic entities. While the Guide is non-authoritative, it includes what the AICPA staff and the AICPA's Equity Securities Task Force view as best practices. The Guide also includes an overview of the valuation process for the share-based payments of a nonpublic entity, including the factors to be considered and various approaches for determining fair value.

How we see it

An entity's compliance with the Guide will not prevent it from getting SEC staff questions about the valuation of share-based payment awards issued in the period before entering the public markets. The staff may challenge both the appropriateness of the valuation methodology considering the circumstances and the underlying assumptions used to value share-based payment awards granted in the period before the entity enters the public market. However, the Guide includes a framework that, when appropriately applied, should yield a credible valuation that the SEC staff likely would not object to.

The Guide recommends that nonpublic entities obtain contemporaneous valuations from independent valuation specialists to determine the fair value of securities issued as compensation. The Guide asserts that such a valuation is more objective and provides more persuasive evidence of fair value than a retrospective valuation or a valuation that is performed by a related party (e.g., a director, officer, investor, employee, the investment firm underwriting an IPO).

While a nonpublic entity's equity shares are not actively traded, observable market prices for them may be available. For example, entities may sell their shares around the same time that they grant share-based payments. Employees and former employees may also sell shares to investors directly or through secondary markets. When these transactions occur, an entity should carefully evaluate whether the sales prices represent the fair value of the shares. However, in most cases, observable market prices for shares of nonpublic entities are not

available. As a result, the fair value of shares must be determined by reference to the fair value of the underlying business determined using a market approach (e.g., a market-multiple analysis, backsolve method) or an income approach (e.g., a discounted-cash-flow analysis). We would expect the fair value measurement of the entity's equity value to be consistent with the principles of ASC 820.² The Guide also includes a framework for evaluating observed transactions in a nonpublic entity's shares (including secondary market transactions).

The Guide also discusses the IPO process and its effects on enterprise value, specifically how the IPO often significantly reduces the entity's cost of capital. An entity's cost of capital inversely affects enterprise value (i.e., a lower cost of capital increases the fair value of the enterprise and the fair value of its shares). Accordingly, the fair value of a newly public entity, including an entity that goes public by merging with a SPAC, would generally be higher than its value immediately before the IPO or merger. Other factors that affect valuation include the entity's stage of development, whether significant milestones have been reached (e.g., regulatory approval, execution of contracts with customers, positive cash flows), the presence of other classes of equity, and the probability of the IPO or SPAC merger occurring.

All relevant evidence, both positive and negative, should be considered in estimating the fair value of a nonpublic entity and its shares, and the valuation methodology and the nature of the underlying assumptions should be clearly documented. Ultimately, the entity, not the valuation specialist, is responsible for the reasonableness of the fair value estimate used to record the cost of share-based payments in its financial statements.

The SEC staff expects companies to apply the Guide when valuing share-based payments issued in the period before the anticipated transaction.

How we see it

The SEC staff frequently asks companies about how they determined the fair value of the shares underlying share-based payment awards, including the probability of the IPO or SPAC merger occurring that was used in the valuation.

Companies should be prepared to discuss in detail the drivers for the change in the estimated fair value of the underlying shares between each measurement date and the IPO or merger date considering changes in valuation assumptions and other market changes. The process of explaining these changes may delay a transaction. If the SEC staff objects to the valuation used in the calculation of compensation cost (which may also be used to value other instruments), the entity may need to restate its historical financial statements.

Disclosure considerations

The staff of the SEC Division of Corporation Finance states in its Financial Reporting Manual that entities should disclose the following information about share-based payments issued in the period before becoming a public entity:

- ▶ The methods used to determine the fair value of the entity's shares and the nature of material assumptions used in determining the fair value
- ▶ The extent to which such estimates are highly complex and subjective, and the fact that estimates won't be necessary for new awards once the shares begin trading

Based on this guidance, entities should focus on describing the methodology and judgments they use and the extent to which the estimates are complex and subjective. That is, they do not need to quantify each assumption or explain how the assumptions changed over time, although this information should be maintained in an entity's internal documentation and may need to be provided when responding to an SEC staff comment letter.

In addition, the Guide recommends that entities make extensive disclosures in registration statements regarding their determination of the fair value of share-based payment awards in both the financial statements and management's discussion and analysis. The Guide also provides examples of disclosures.

Endnotes:

¹ ASC 718, *Compensation – Stock Compensation*.

² While the measurement of share-based payment awards under ASC 718 is technically excluded from the scope of ASC 820, *Fair Value Measurement*, the Guide notes that the AICPA staff and the AICPA's Equity Securities Task Force believe that cheap stock valuations should generally be consistent with the valuations performed under ASC 820 because the fair value concepts are closely aligned.

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