www.pwc.com

Stay informed
2014 SEC comment letter trends

Employee stock compensation

February 2015

Current developments

pwc

Message from Ken Stoler

Clients and friends:

Recent changes and ongoing uncertainties in the economic and regulatory environment continue to add to the inherent challenges in preparing high-quality annual reports. A continuing key theme emphasized by the staff of the SEC is the importance of providing information to investors that is reliable, useful, and transparent, particularly in areas of significant judgment.

The SEC staff has continued to emphasize the importance of providing comprehensive and transparent disclosures in filed reports to comply with current disclosure requirements and to reflect the business risks and conditions in today's economic environment. At the same time, the FASB has made decisions on which direction to take most convergence projects and other standard setting activities, and the SEC has continued to focus on rulemaking activities required by the Dodd-Frank Wall Street Reform and Consumer Protection Act. All of these activities are expected to significantly affect the regulatory landscape for years to come.

Disclosure, valuation, and accounting related to employee stock compensation are complex areas that continue to be a focus for the SEC staff. We have prepared this publication to assist management in identifying and understanding the SEC staff's current focus areas related to stock compensation. The information summarized within this publication is based on comment letters published by the SEC staff between September 15, 2013 and September 15, 2014 related to stock compensation. We have highlighted the more prevalent issues commented on by the SEC staff and provided relevant examples of recent comments to aid preparers in ensuring their disclosures are robust and consistent with the accounting and reporting guidance for stock compensation.

We hope you find this latest edition of our annual publication of SEC comment letter trends related to employee stock compensation to be a useful reference tool as you prepare your annual and quarterly reports and if you are in the process of preparing for an initial public offering. Please do not hesitate to reach out to your local PwC team or one of the authors of this publication with questions or if you would like to discuss in further detail.

Best Regards,

Ken Stoler
HR Accounting Advisory Leader

Table of contents

SEC developments

2014 was a busy year at the SEC. Although there were only a few changes in senior personnel (compared to 2013 when several high profile staff positions were filled and three Commissioners, including a new Chair, were appointed), one notable change was the appointment of Jim Schnurr as the SEC's Chief Accountant. Schnurr joined the SEC staff in October and will play a major role in shaping the SEC's agenda at a time when accounting, auditing, and financial reporting are key areas of focus. This focus reflects a common understanding that transparent, accurate, and reliable financial reporting forms the foundation of trust that allows our capital markets to function properly and provides the transparency and confidence investors need when making decisions.

Following through on initiatives started in 2013, 2014 saw a high level of activity in the SEC's enforcement program, with renewed attention on financial fraud, issuer disclosure, and gatekeepers. The Enforcement Division's Financial Reporting and Audit Task Force—a small group of experienced attorneys and accountants charged with developing state-of-the art tools to better identify financial fraud and incubating cases to be handled by other groups—is one example of how the SEC has increased its focus. The Task Force monitors high-risk areas, analyzes industry performance trends, reviews restatements, revisions, and class action filings as well as academic research. It is also working on the SEC's Accounting Quality Model—sometimes referred to as Robocop—which is being developed to use data analytics to assess the degree to which a company's financial reporting appears to be noticeably different from its peers. The Task Force was very busy during 2014 with even more activity expected in 2015.

The SEC staff has continued to focus on internal control over financial reporting, with more attention on how companies evaluate deficiencies relating to immaterial financial statement errors. The SEC staff signaled its intention to increase its focus in this area in late 2013, and this has led to more frequent comments and questions in 2014, with more likely to come in 2015.

Recognizing that full and fair disclosure is a central goal of the US securities laws and is critical to the fulfillment of the SEC's core mission, during 2014 the SEC launched a "Disclosure Effectiveness" initiative. Through this initiative, the SEC is looking for ways to update and modernize its disclosure system and to eliminate duplicative or overlapping requirements, while continuing to provide material information. Trying "to put better disclosure into the hands of investors," the SEC staff is taking a fresh look at the question: what information do investors need to make informed decisions? In addition to looking at the specific disclosures companies provide, the SEC staff is also looking closely at how disclosures are provided, particularly in light of advances in technology and changes in how information is consumed. For instance, the SEC staff might explore a "company file" approach through which investors would access company-specific information on the SEC's website through tabs such as "Business information," "Financial information," "Governance information," and "Executive compensation," instead of searching for that same information by combing through a reverse chronological list of filings. The SEC staff has been clear that reducing disclosure is not the objective of this important project (indeed, they have said that updating the requirements may well result in additional disclosures), but they have indicated that they believe the initiative can reduce costs and burdens on companies.

Even before any rule changes are adopted (or proposed), companies already have the ability to improve the quality and relevance of their disclosures by reducing redundancy, removing out-of-date, unnecessary information, and refining disclosures to focus on those issues which are truly applicable and material. The SEC staff has been encouraging companies to experiment with the presentation of the information in their filings with the objective of improving the transparency, quality, and relevance of their disclosures.

John A. May
SEC Services Leader

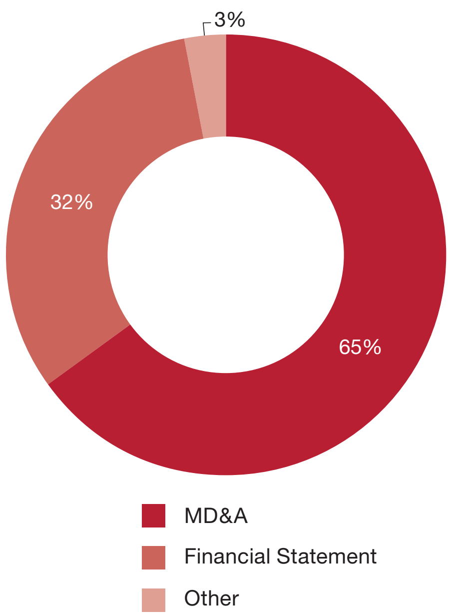
Overview

This publication includes an analysis of comments made by the SEC staff to registrants published on the SEC's website between September 15, 2013 and September 15, 2014 related to employee stock compensation. There were 223 comments related to stock compensation issued during that period, to a total of 101 companies.

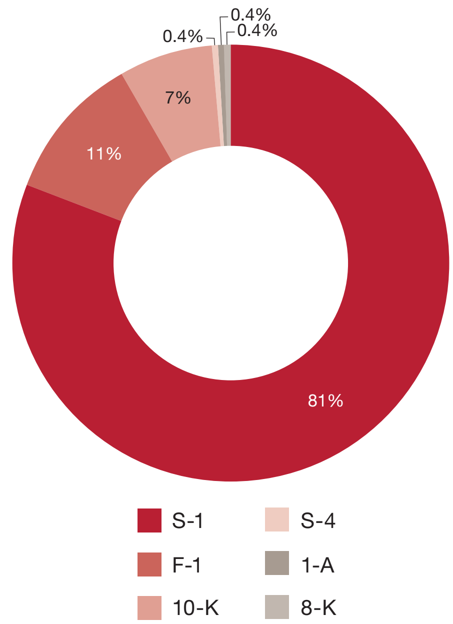
We have the following key observations and trends regarding the comment letters to these companies:

- **65%** of the total number of comments received related to Management's Discussion & Analysis of Financial Condition and Results of Operations
- **81%** of the comments received related to S-1 filings
- **52%** of the comments received related to disclosure, 30% related to valuation, and only 18% related to accounting recognition

% of Comments in Filing Section

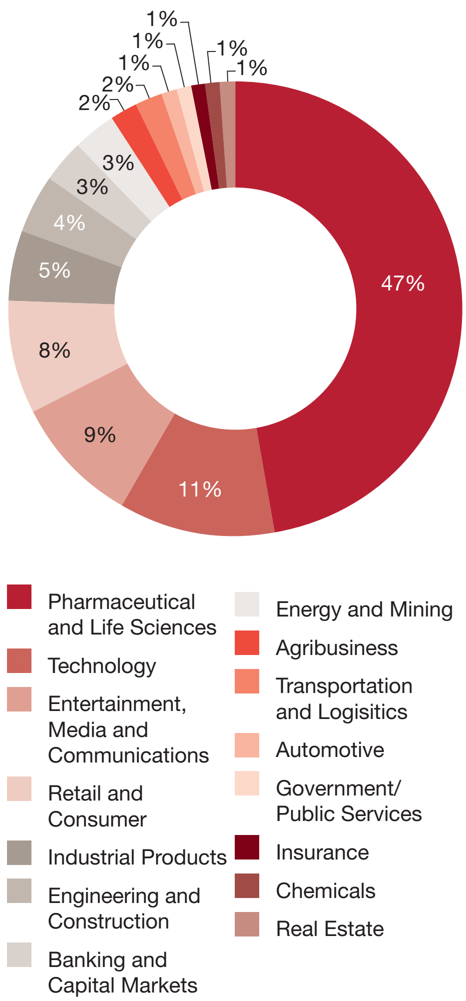


% of Comments by Form



- **47%** of the comments received related to companies in the Pharmaceutical and Life Sciences industry and 11% related to the Technology industry, with the remainder across a variety of sectors. In more established industries, such as industrial products and automotive, we noted a small percentage of comments (5% or less in each). This is not surprising, as the majority of SEC staff comments focused on registration statements for companies going through IPOs, which was dominated by the technology and pharmaceutical/ life sciences sectors in 2014.

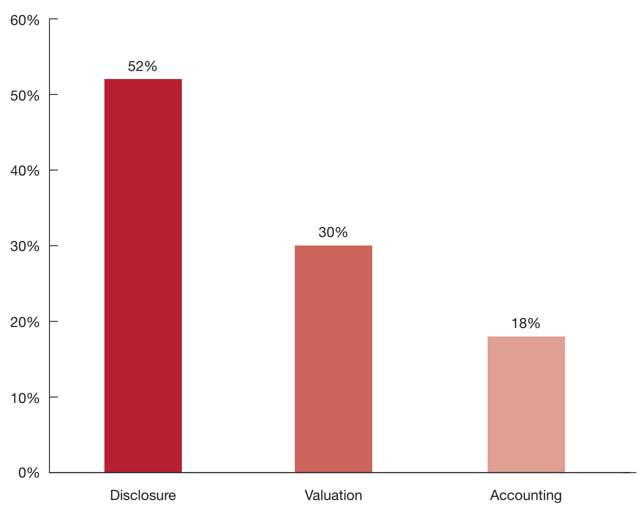
% of Comments by industry



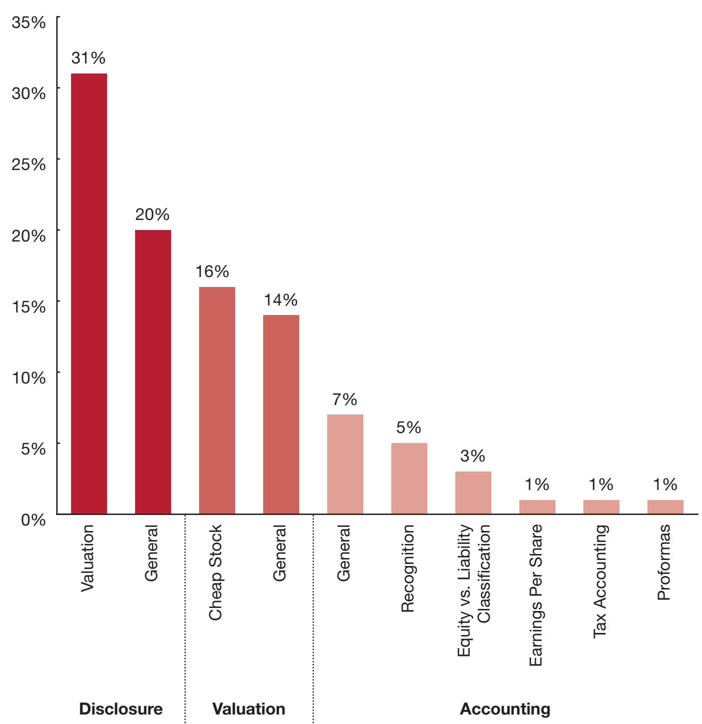
SEC comments by topic

We found the SEC staff's comments related to employee stock compensation fall into three main categories: disclosure, valuation, and accounting recognition. The table below shows that breakdown, including further "sub-categories" where we noted trends.

% of Comments by Category



% of Comments by Category



Disclosure

Of the 223 stock compensation comments received for 2014, 115 comments (52%) related to disclosure. Of those, 30% of the disclosure comments related to disclosure of valuation information.

The following are a sample of the disclosure comments related to disclosures of valuation information:

1. You mention equity-based compensation as being an area where you must make estimates and assumptions that affect the amounts reported in your financial statements and accompanying notes. Please revise your footnotes to provide your accounting policy for equity-based compensation. In addition, please provide the disclosures required by ASC 718-10-50-1 and 50-2 in a separate footnote or tell us why such disclosure is not warranted.
2. More fully explain in the disclosure the increase in fair value of your ordinary shares from June 29, 2013 to August 5, 2013. Quantify the effect of each factor that caused a change in the fair value. Specify what events occurred between June 29, 2013 and August 5, 2013 and the effect of that event on the fair value.
3. Regarding your October 2013 valuation, please disclose the updated discount rate for lack of marketability. Separately, tell us what exit markets a major shareholder has that a minor shareholder does not have and why this affects the discount rate.

There were a number of comments that requested additional disclosure related to an IPO.

The following are a sample of disclosure-related IPO comments:

1. Please disclose the intrinsic value of outstanding vested and unvested options as of the most recent balance sheet date based on the estimated IPO price. Please provide quantitative and qualitative disclosures explaining the difference between the estimated offering price and the fair value of each equity issuance.
2. While we note that you have not granted employee stock options in recent periods, there are other measurements in your financial statements that are in-part dependent on the estimated fair value of your common stock. Accordingly, please expand to provide a specific discussion of each key factor contributing to any significant difference between the estimated fair value of your common stock and the estimated offering price (or pricing range) for the 12 months prior to the contemplated offering.
3. Please disclose the total amount of stock compensation expense that will be recognized upon completion of your Initial Public Offering.
4. We note that 400,000 units of equity were distributed to employees as compensation in January 2014. Tell us and disclose how you accounted for stock compensation and how you determined the value of these equity units in the absence of active trading.

Valuation

Of the 223 stock compensation comments received for 2014, 67 comments (31%) related to valuation. Of these, roughly half related specifically to “cheap stock”. Cheap stock refers to the issuance of equity securities (e.g., options, warrants, common stock or restricted stock) during the period preceding an IPO for a price (or with a strike price) that is below the expected IPO price. Typically, this issue arises in connection with the granting of employee stock options. The SEC staff’s view is that a company’s IPO pricing range is indicative of the fair value of its stock leading up to the IPO and they are, therefore, skeptical of valuations in the 12 months prior to the filing that are significantly lower than that range.

The disclosures regarding valuation should be included as part of MD&A and should include:

- the methods that management used to determine the fair value of the company’s shares,
- the nature of the material assumptions involved, and
- the extent to which the estimates are considered highly complex and subjective.

During early 2014, the SEC staff revised the Financial Reporting Manual (“FRM”) guidance regarding the extent of critical accounting estimate disclosures related to stock-based compensation. In February 2014, the SEC staff updated the FRM to describe the reduced disclosures required related to share-based compensation in IPOs. Specifically, a company’s critical accounting policy disclosures should include discussion of the methods and material assumptions used to determine the fair value of the company’s stock. Any comments issued by the SEC staff about unusual changes in the stock valuations are intended only to confirm the appropriateness of the accounting and not necessarily to request additional disclosures in the registration statement.

In the past, the SEC staff questions related to grant dates two to three years prior to the IPO date resulted in disclosure of the specific assumptions used in the income approach, the comparable companies used in the market approach, the weighting of the different models used, and significant factors contributing to the change in fair value at each valuation date. Since the change in the SEC staff’s guidance, this information may still be requested, but has generally not been required to be included in the filing.

As a registrant completes its roadshow and commences discussion with its underwriters regarding the estimated offering price range, it is becoming more common for the registrant to initiate communication with the SEC staff, before receiving a formal comment. Typically, the registrant sends a letter describing the valuation of its common stock leading up the IPO. The letter may include a quantitative and qualitative analysis explaining the difference between the estimated offering price and the fair value of each equity issuance for the preceding 12 months.

The following are a sample of the valuation comments related to "cheap stock". The first comment was the most prevalent one noted in our review of the 2014 comments related to share based compensation.

1. Please supplementally provide us with a quantitative and qualitative analysis explaining the difference between the estimated offering price and the fair value of each equity issuance through the date of effectiveness for the preceding twelve months.
2. You cite improved capital market conditions for companies in your industry as a reason for the increase in fair value, reflected in the estimated IPO price. Please explain to us why you were unaware of this information and presumably did not include it in your September 24, 2013 common stock valuation.
3. Please tell us whether you have had any preliminary pricing discussions with your underwriters. If so, please tell us about the substance of those discussions and tell us whether those discussions were considered in determining the estimated fair value of your common stock.
4. Please tell us about each significant factor contributing to the difference between the estimated IPO Price and the fair value of your shares for each grant in fiscal 2013, the first quarter of fiscal 2014 and any subsequent grants through the date of your response. In your response, please tell us about significant intervening events and reasons for changes in assumptions, as well as the weighting of expected outcomes and selection of valuation techniques employed.

The following valuation comment was noted in regards to illiquidity discounts in excess of 15%:

1. As previously noted, given that LLC was your principal shareholder at the time of this transaction, we do not necessarily believe that their purchase of your restricted shares provides an objective independent basis for valuing your common shares. Furthermore, it is generally staff position that illiquidity discounts in excess of 15% should not be used in valuing stock based compensation grants unless there are substantive long-term restrictions impacting the marketability of the underlying shares. Unless there is objective evidence to justify such substantive long-term restrictions, please revise accordingly.

There were also a number of comments related to use of the "simplified method" for establishing the expected term assumption for stock option valuation:

1. We note your disclosure that the expected term of your options is determined using the simplified method. Please explain your basis for using the simplified method, specifically addressing how you determined that there was not sufficient historical data in determining your expected term. In this regard, we note that approximately 3.2 million options have been exercised during the past three years. Further, tell us what consideration was given to including the disclosures required by SAB No. 110 when using the simplified method, including the reason why the method was used, the types of share option grants for which the method was used if the method was not used for all share option grants, and the periods for which the method was used if the method was not used in all periods.
2. We note that you used the simplified method to estimate the expected term for stock options granted under the 2013 Plan, as your stock option exercise history does not provide a reasonable basis to compute the expected term. Please tell us why the historical exercise data of Other Stock Incentive Plans cannot be used to estimate the expected term for the 2013 Plan. Refer to Question 6 of SAB Topic 14.D.2.

Accounting recognition

Of the 223 stock compensation comments received for 2014, 41 comments (18%) related to accounting recognition.

While the comments spanned a variety of areas of stock compensation accounting, the most prevalent comments related to more complex and judgmental areas, including expense recognition, classification of awards as equity versus liability, earnings per share, tax implications, and proforma financial disclosures.

Below are examples of some of the more complex and judgmental accounting recognition comments:

1. It is unclear to us how you determined the $4.5 million in expense recorded in 2013. In this regard, we note that the total expense related to these options is $10.8 million and the options vest over a four year period. Please provide us with your calculation supporting the $4.5 million in expense recorded in 2013.
2. Please tell us the currency in which stock option exercise prices are denominated and your consideration of such currency when determining whether the stock options should be classified as liability awards. Refer to ASC 718-10-25-14A.
3. You disclose that dividends accrue on all restricted stock units. Please tell us whether the restricted stock units are participating securities and how you considered the units for purposes of basic earnings per share. Refer to FASB ASC 260-10-45-61A.
4. Reference is made to your statement in the second paragraph on page F-33 that no income tax benefit was recognized in the statements of operations for share-based compensation arrangements as no tax deduction was claimed. Please tell us whether deferred tax assets and deferred tax benefits were recognized and if not, why. Refer to ASC 718-740-25-2.
5. Please tell us how the adjustments made to reflect the modification to MMREIS's book value stock-based compensation award program, grants of vested unrestricted stock, and the resulting change in income tax expense is expected to have a continuing impact. Refer to Rule 11-02(b)(5) of Regulation S-X.

Comments related to acceleration of stock compensation expense upon a liquidity event were also noted:

1. We note your disclosure regarding the options issued to officers that are subject to acceleration upon an exit event which, according to your disclosures, includes this offering. Please tell us how you are accounting for these options and explain how the acceleration at the IPO impacts your accounting. Please refer to the authoritative guidance that supports your accounting.

About PwC's human resource services practice

As a leading provider of HR advisory services, PwC brings together a broad range of professionals working in the human resource service arena—compensation, benefits, retirement, HR strategy, international assignment, regulatory compliance, tax, process management, culture and change, communications and financial reporting—affording our clients a tremendous breadth and depth of expertise, both locally and globally.

Our expertise in tax, accounting, actuarial, finance, operations and compliance; our leadership in human capital management, measurement and program development; and our disciplined approach to execution and change sets us apart. With more than 7,000 HR practitioners in 150 countries—including over 1,500 HR practitioners in the US—PwC helps to align human capital strategies with business strategies and drive shareholder value for our clients.

PwC is at the forefront of understanding the strategic importance of human resources as a sustainable competitive advantage and has developed sophisticated assessment methodologies to assess the entire human resources function moving from paper management driven by compliance, regulations and a control philosophy to a role of contributing to the enterprise mission of recruiting, retaining, retraining, measuring, motivating and rewarding human resource capital. Assisting organizations to realign human resources to better meet customer requirements, PwC experts review all human resources activities to ascertain opportunities for automation, streamlining, elimination and reduction of non-value adding processes.

For more information, feel free to contact the authors:

Ken Stoler
Partner
(646) 471-5745
ken.stoler@us.pwc.com

Teresa Yannacone
Director
(267) 330-1377
teresa.yannacone@us.pwc.com

If you'd like to find out more about PwC, our HRS practice, or the knowledge sharing external websites we have set up for our clients, we suggest you visit one or more of the following websites. If you're interested in receiving important announcements or various mailings throughout the year, take advantage of the easy sign-up feature to be found on the www.pwc.com website.

Acknowledgements

This publication represents the efforts and ideas of many individuals within PwC, including members of the Human Resource Services practice. The following PwC personnel contributed to the contents or served as technical reviewers of this publication:

Nicole Berman
Director
(973) 236-4202
nicole.s.berman@us.pwc.com

Katherine Frazier
Senior Associate
(267) 330-2216
katherine.a.frazier@us.pwc.com

Kiley Stauffer
Associate
(267) 330-2315
kiley.m.stauffer@us.pwc.com

www.pwc.com

The content of this publication is based on information available as of September 15, 2014. Accordingly, certain aspects of this publication may be superseded as new guidance or interpretations emerge.

Financial statement preparers and other users of this publication are therefore cautioned to stay abreast of and carefully evaluate subsequent authoritative and interpretive guidance that is issued.

MW-15-1572