

Client Alert

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Cheap Stock: An IPO Survival Guide

Introduction

This *Client Alert* is a survival guide for initial public offering (IPO) candidates seeking to grant equity awards to their employees during the 12-month window preceding the filing of an IPO registration statement.

When a company makes pre-IPO equity awards at valuations substantially lower than the IPO price, questions arise under accounting and tax rules that apply to equity awards. Under these rules, the value of an equity award on the grant date is considered compensation expense on the company's income statement for purposes of US generally accepted accounting principles (GAAP) and may constitute taxable income to the employee for US income tax purposes. This collection of issues is known as the "cheap stock" problem.

This *Client Alert* includes a review of the accounting and tax issues associated with equity awards to company employees during the months preceding an IPO, as well as a summary of the related concerns of the Staff of the Securities and Exchange Commission (SEC). We also include some specific, practical guidance on how best to navigate these choppy waters so you can sail safely through the IPO process rather than running aground on cheap

stock issues during the SEC Staff's review of your registration statement.

The Accounting Rules: ASC 718

Any company issuing stock or options to its employees has a strong interest in knowing that these awards are accounted for appropriately for financial reporting purposes. No company wants to restate its historical financial statements to reflect an increase in compensation expense associated with prior equity awards. The key to avoiding subsequent second-guessing of the accounting for stock-based compensation arrangements is to understand the accounting rules before making any grants and, when valuing the grants, to make reasonable assumptions that are supported by contemporaneous independent valuations.

The standards for accounting for stock-based compensation arrangements for employees under GAAP can be found in the FASB's Accounting Standards Codification Topic 718 (formerly Statement of Financial Accounting Standards No. 123R, now codified in ASC 718).¹ ASC 718 applies to stock-based compensation at both public and private companies and includes hundreds of pages of explanatory text and examples of how to account for the

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most complex forms of employee equity plans. In order to focus on the issues most relevant to private companies during the run up to an IPO, we will simplify ASC 718 to its most basic principles:

- the fair value of equity instruments awarded to employees in exchange for services must be *established on the grant date* of the award;
- fair value must be determined *based on the information available as of the grant date* (and, in theory, changes in fair value after the grant date do not indicate that the grant-date determination of fair value was incorrect); and
- the grant-date fair value will be *recognized as compensation expense over the period during which the employee is required to render services* in exchange for the award (in most cases, this is the award's vesting period).²

What does this mean in practice? A few examples will be helpful. In the most basic scenario, if an entity gives its employee a discretionary bonus at year end in the form of fully-vested "free" stock, the entity has compensation expense equal to 100 percent of the fair value of the stock at the grant date. If the employee is given a bonus in the form of fully-vested stock options, then the entity has compensation expense equal to 100 percent of the fair value of the options as of the grant date. If the stock or options vest over the three-year period following the grant date, then the grant-date fair value of those shares or options will be booked as compensation expense over the three-year vesting period (in equal amounts, absent a reason to do otherwise).

Under ASC 718, options are valued at their "fair value" using Black-Scholes or another accepted option pricing model, rather than at their "intrinsic value" (the "spread" between the value of the stock on the grant date less the exercise price of the option on that date). This is a change from the intrinsic value approach taken by APB 25, which was superseded in 2005, and most consider

the change to be an improvement.³ The grant-date fair value approach adopted with the standard now codified in ASC 718 also helped to bring GAAP in line with International Financial Reporting Standards, which had moved to the fair value approach almost a year earlier.

In the cheap stock context, the transition from APB 25 to ASC 718 had significant consequences:

- Valuation issues were typically more straightforward under APB 25 than under ASC 718 because stock is generally easier to value than options. After a company determined the stock's fair value, APB 25 required only simple arithmetic (the underlying stock's fair value minus the option's exercise price) to determine intrinsic value.
- ASC 718 introduced more complexity, as well as management judgment, by focusing on the fair value of the option itself. This required a more complicated valuation methodology, which in turn increased the likelihood that companies would regularly involve an independent valuation consultant.
- Under ASC 718, both public and private companies are required to record a compensation expense for equity awards even when those awards have no intrinsic value. In contrast, APB 25 did not require companies to recognize any compensation expense for options granted with an intrinsic value of zero, so companies generally did not need to recognize any compensation expense as long as they correctly valued their stock and issued stock options with an exercise price equal to the fair value of the stock at the grant date, which most companies did.
- Under APB 25, compensation expense was an all-or-nothing proposition: companies would either recognize no compensation charge at all, or they were required to recognize a charge equal to the value of the spread. Under ASC 718, however, companies must recognize some compensation expense each time they grant equity

awards, meaning that the associated compensation expense is no longer all-or-nothing.

Today, in an ASC 718 world, the issue for a pre-IPO company is how to determine the fair value of its stock and any options to purchase its stock on the date of an equity award. ASC 718 instructs clearly that an entity should determine fair value based upon all expectations and information available on the grant date but provides little specific guidance on how to implement this facts-and-circumstances test. In some cases, for example, where there is a contemporaneous arm's-length sale to an independent third party, valuing an equity award may not be difficult.

In the absence of such a clear independent valuation event, however, private companies may be ill-equipped to determine the fair value of a particular equity award. This is particularly true in the case of options and awards that are subject to contingencies that need to be taken into account in determining grant-date fair value.

ASC 718 contains no specific requirement to seek professional advice in the fair value determination (indeed, the phrase "independent valuation" is nowhere used in ASC 718). However, most private companies retain the services of an independent valuation consultant to help them determine grant-date fair value. Valuing equity instruments often requires considerable judgment, and the available methodologies are complex. There are a number of valuation specialists available to private companies who are familiar with the available valuation techniques and can assist in valuing even the most complicated equity awards. Many private company directors take comfort in knowing that this esoteric task has been outsourced to an expert in the field.

Many private companies will endeavor to grant equity to employees only on predetermined dates (the first day of a quarter, for example) and many will

obtain an independent valuation on each grant date that will provide support for the grant-date determination of fair value. This practice provides directors with comfort that the compensation expense in the issuer's financial statements has been calculated properly.

Inevitably, however, there will be equity awards on dates on which no valuation was obtained for all sorts of good reasons (new employee hired, acquisition completed, major milestone reached, etc.). In these cases, the company will be left to determine a grant-date fair value using reasonable assumptions and methodologies, based on all information available to it, including of course any new information that has become available since the date of the last independent valuation.

These are the situations that the SEC Staff invariably finds most interesting because, without an independent contemporaneous valuation, the use of management judgment is the greatest. As a result, these scenarios are most likely to generate comments when the SEC Staff reviews the company's IPO registration statement.

The Tax Rules: Section 409A and Incentive Stock Options

A primary concern of an employee receiving an equity-based compensation award such as a stock option or a stock grant is the tax treatment of the award. The employer also has a stake in the tax treatment of the award, but the issue is much more personal for the employees. Let's review the basic tax treatment of equity awards under the Internal Revenue Code.

To begin, remember that a stock option reflects a promise to deliver a share of stock in the future at a price that is fixed on the grant date (the exercise price), while a stock grant represents an actual share transfer on the date of grant (typically for a nominal purchase price, if any). Under US tax law, there are two general categories of compensatory options: nonqualified stock options (NSOs) and tax-qualified incentive stock

options (ISOs). The key dates for tax events associated with these awards are the grant date, vesting date (when an award ceases to be forfeitable by the employee based on continued service or satisfaction of some other condition), exercise date and ultimate sale of the shares.

The following table illustrates the basic tax treatment of employees and employers in connection with stock and options on each of these key dates. The potential impact of Internal Revenue Code Section 409A, is separately discussed below.⁴

TAX TREATMENT OF EQUITY AWARDS ON KEY DATES					
		Grant Date	Vesting Date	Exercise Date	Sale of Shares
NSO Tax Effect	Employee	No tax consequences	No tax consequences	Excess of value of the shares on the exercise date over the exercise price (the "spread") is taxed at ordinary income tax rates ⁵	Capital gain or capital loss when the shares are sold, depending on whether the shares increase or decrease in value after exercise
	Employer	No tax consequences	No tax consequences	Reporting and withholding of income and employment taxes and, generally, deduction on the spread	No tax consequences
ISO Tax Effect⁶	Employee	No tax consequences	No tax consequences	No tax consequences	Long-term capital gain or loss when the shares are sold, depending on whether the shares increase or decrease in value from the grant date
	Employer	No tax consequences	No tax consequences	No tax consequences	No tax consequences
Stock Grant Tax Effect	Employee	No tax consequences	Taxed at ordinary income rates on value of shares on vesting date	N/A	Capital gain or capital loss when the shares are sold, depending on whether the shares increase or decrease in value after the initial tax event
	Employer	No tax consequences	Reporting and withholding of income and employment taxes and, generally, deduction for value of the shares on the vesting date ⁷	N/A	No tax consequences

In order to obtain the favorable tax treatment associated with ISOs (as described in the table above), they must be granted with an exercise price that is no less than the fair value⁸ of the underlying shares on the date the ISO is granted. In addition, in order to qualify as ISOs, the shares subject to the ISOs must be held until the later of one year from the date of exercise or two years from the date of grant of the ISOs. Several additional requirements and limitations apply to ISOs — if all such requirements and limitations are not satisfied, the ISOs will typically be taxed as NSOs.

Prior to late 2004, there were no requirements under the tax code as to the exercise price of NSOs. However, since the enactment of Section 409A in late 2004, any NSO granted with an exercise price that is lower than the fair value of the underlying shares on the applicable grant date (a “discount option”) may be subject to substantial additional taxes under Section 409A, as discussed below. ISOs are exempt from Section 409A, but an ISO granted as a discount option will lose its ISO status and may become subject to additional taxes under Section 409A.

Section 409A imposes on individual employees a 20 percent additional income tax, plus potential premium interest taxes on deferred compensation arrangements that do not meet specified criteria, including discount options that permit exercise over a period of years after vesting (as is typical of stock options).

Section 409A taxes (i) are imposed on the option recipient in the year in which the options vest (as opposed to exercise); (ii) accelerate the imposition of ordinary income taxes to the year of vesting (regardless of exercise); (iii) apply over and above ordinary income taxes and (iv) may be further increased by similar additional state income taxes (for example, California applies its own 20 percent penalty tax). The employer is required to report to the IRS and withhold income taxes in the year of vesting (though employers are not

currently required to withhold Section 409A taxes).

If the SEC Staff requires an issuer to increase the compensation charge associated with a grant of stock options, this charge indicates that, at least for accounting purposes, the issuer has determined (or is taking the position) that it has granted discount options. If, by implication, these stock options are also treated as discount options for tax purposes, the options may be subject to additional income taxes under Section 409A and may be ineligible for preferential ISO tax treatment.

The question then becomes whether the issuer can continue to rely for tax purposes on the fair value used in setting the exercise price, notwithstanding its accounting position.

The IRS has issued no formal guidance on the interplay of cheap stock accounting charges and fair value for Section 409A and ISO purposes. In its review of an IPO registration statement, the SEC Staff will typically review and assess the actual and implied valuation of grants of the company's securities over the 12-month period prior to the initial filing of the registration statement, as well as all subsequent grants. As part of that process, the SEC Staff expects to see a steady increase in the value of the company's securities, subject to the ups and downs of events in the company's development.

By contrast, the Section 409A and ISO regulations generally require exercise price determinations based on stock valuations performed contemporaneously with or prior to the relevant stock option grants. For ISO purposes, the fair value exercise price requirement is satisfied if the valuation is obtained by “any reasonable valuation method.” Section 409A applies a more rigorous standard, requiring that fair value be determined by “the reasonable application of a reasonable valuation method” taking into consideration the following non-exclusive list of factors:

- the value of tangible and intangible assets of the corporation;

- the present value of anticipated future cash-flows of the corporation;
- the market value of stock or equity interests in similar corporations and other entities engaged in businesses substantially similar to those engaged by the company;
- recent arm's length transactions involving the sale or transfer of the stock or equity interests;
- control premiums or minority discounts and use of the valuation method for other purposes having a material economic effect on the entity, its equity holders or its creditors; and
- consistent use of a valuation method for purposes unrelated to compensation.

The Section 409A regulations caution, however, that a selected valuation method will not be deemed reasonable for Section 409A purposes unless all available information material to the value of the corporation is considered. In addition, reliance on a valuation will not be considered reasonable for Section 409A purposes if the valuation is more than 12 months old or fails to reflect information that may materially affect the valuation and is available to the issuer at the time of any post-valuation stock option grant.

To help mitigate uncertainty under this valuation standard, Section 409A provides that each of the following valuation approaches is entitled to a presumption of reasonableness (absent a finding of gross unreasonableness in its calculation or application):

- *Independent appraisal.* A valuation determined by an independent appraisal that is dated no more than 12 months before the relevant grant date.
- *Start-up company.* With respect to the "illiquid stock of a start-up corporation" that (i) has conducted business for less than 10 years; (ii) is not contemplating an IPO or change in control within 180 days or 90 days, respectively and (iii) the stock of which is not subject to any put or call right (with limited exceptions), a written valuation that takes into

account the factors described above and is performed by a person who is qualified based on the person's "significant knowledge and experience or training."

- *Formula price.* A valuation of stock based on a formula that does not lapse or expire (for example, book value) if used for all valuations of the stock, except that this presumption of reasonableness does not apply with respect to an option that is exercisable for stock that can be transferred without regard to the formula price. In other words, a formula price mechanism is of limited utility because, if used, it must be built in to the terms of the security so it applies to all future owners.⁹

Despite the availability of these safe-harbor valuation alternatives, issuers taking cheap stock charges in connection with an IPO may have difficulty in substantiating their stock option fair value determinations in a Section 409A audit. This concern has been amplified by the IRS's recent initiative targeting 6,000 employers (through 2012) with audits relating to potential Section 409A and employment tax violations and other potential issues.

Since Section 409A's enactment in late 2004, Department of Treasury representatives have, on occasion, informally acknowledged that the SEC's retrospective accounting valuation is not necessarily determinative of fair market value for purposes of Section 409A. Nevertheless, with an IRS audit initiative underway and a federal government in dire need of revenue, issuers contemplating an IPO should consider obtaining independent appraisals and limiting or eliminating pre-IPO stock option grants to help reduce the likelihood of cheap stock charges and the related Section 409A tax risks. These actions are discussed in detail below.

The IPO Process

In the review of a company's IPO registration statement, the SEC Staff focuses on both the compensation

expense associated with cheap stock grants and the valuation methodology employed by the company in connection with its equity award process, as well as the related disclosure. However, in the years since the demise of ABP 25's intrinsic value approach to accounting for equity awards, comments issued by the SEC Staff have focused more on issues surrounding the narrative discussion of valuation methodology in the Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) section of the registration statement and less on the size of the actual compensation charge.

We undertook a comprehensive review of recent SEC Staff comments issued in the IPO context with respect to pre-IPO equity awards, related valuation methodologies and circumstances potentially affecting valuation issues. Our review confirmed the shift toward

more detailed MD&A disclosure and revealed consistently recurring themes coming out of the comment process.

Typical comments from the SEC Staff include:

- asking the company to explain the valuation of its common stock at each of the grant dates;
- calling for more detail on vesting provisions for stock options;
- requiring an expanded disclosure regarding the company's stock option awards in the MD&A section of the registration statement; and
- requesting an itemized chronology describing historical pre-IPO equity awards and bridging management's historical fair value determinations to the mid-point of the IPO price range.

Below we have included a representative selection of these types of comments.

REPRESENTATIVE SEC COMMENTS

- Tell us how you determined the fair value of your common stock at each of the stock option grant dates through the date of your response letter.¹⁰
- Disclose vesting provisions for stock options. Also disclose whether the valuation used to determine the fair value of the common stock was contemporaneous or retrospective. If you used a valuation specialist that was a related party, include a statement indicating that fact.
- Please disclose in MD&A the following information relating to your issuances of stock options:
 - discussion of the significant factors, assumptions and methodologies used in determining fair value;
 - 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;
 - the valuation alternative selected and, if applicable, the reason management chose not to obtain contemporaneous valuation by an unrelated valuation specialist; and
 - the intrinsic value of outstanding vested and unvested options based on the estimated IPO price and the options outstanding as of the most recent balance sheet date presented in your registration statement.
- In order for us to fully understand the equity fair market valuations reflected in your financial statements, please provide an itemized chronological schedule covering all equity instruments issued since [*the beginning of the first or second fiscal year prior to the initial filing of the registration statement*] through the date of your response. Please provide the following information separately for each equity issuance:
 - the date of the transaction;
 - the number of shares or options granted;
 - the exercise price or per share amount paid;
 - management's fair market value per share estimate and how the estimate was made;
 - an explanation of how the fair value of the convertible preferred stock and common stock relate, given the one for one conversion ratio;
 - the identity of the recipient, indicating if the recipient was a related party;
 - nature and terms of concurrent transactions; and
 - the amount of any compensation or interest expense element.

Progressively bridge management's fair value determinations to the current 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.

The Cheap Stock Survival Guide

The best way to avoid trouble with cheap stock issues is to avoid equity awards entirely during the 12-month period before the filing of your IPO. That is not a realistic possibility for many pre-IPO companies, though, and the second-best solution is to plan ahead:

- Obtain contemporaneous independent valuations that follow the valuation guidance in the AICPA's VPES Practice Aid,¹¹ with respect to all equity awards made during at least the 12-month period before an IPO filing.
- Preemptively address the SEC's focus on cheap stock issues by including robust disclosure in the IPO registration statement regarding the process and substance behind the company's valuations of its equity awards, including the factors and events that resulted in changes in the equity value and ultimately the IPO price.
- Be ready to provide the SEC Staff with a detailed analysis regarding the process and substance behind your valuation determinations. If you obtained contemporaneous independent valuations on each of the targeted grant dates, you will be well armed to discuss the key drivers in these earlier valuation determinations.

The accompanying Cheap Stock Survival Guide at the end of this *Client Alert* discusses in detail the specific information you need to provide in the disclosure in your IPO registration statement, in your SEC comment responses, or both.

Conclusion

IPO candidates should be aware of the accounting, tax and SEC implications of cheap stock grants during the 12-month period prior to the filing of the IPO registration statement. Plan ahead by obtaining independent appraisals of equity awards made during that period. Include robust disclosure in the IPO registration statement regarding the process and substance behind the company's valuations of its equity awards. These and the other tips in the accompanying Survival Guide will help IPO candidates proactively address cheap stock issues and help increase your chances of sailing smoothly through the SEC registration process.

Endnotes

- ¹ ASC 718 includes guidance specifically for nonpublic entities, such as the section entitled "Calculated Value for Certain Nonpublic Entities," starting in paragraph 718-10-55-51. The SEC Staff has also issued guidance in Staff Accounting Bulletin 107. See SAB Topic 14 — Share-Based Payment, Section B. Transition from Nonpublic to Public Entity Status.
- ² This *Client Alert* does not address the accounting for current and deferred income taxes that results from share-based payment arrangements. For further information, see ASC Subtopic 718-740-05.
- ³ In a 2002 critique of APB 25's intrinsic value approach, Warren Buffett observed, "When a company gives something of value to its employees in return for their services, it is clearly a compensation expense. And if expenses don't belong in the earnings statement, where in the world do they belong?"
- ⁴ There are many nuances under the tax code — this table presents only the basic tax treatment of these awards.
- ⁵ Though distinct, FICA taxes, including Medicare and Social Security, are intended to be picked up by the term "ordinary income taxes" for ease of reference in this discussion.

⁶ As this table illustrates, ISOs receive a more favorable tax treatment than NSOs because ISOs are not taxed at all upon exercise and are taxed at lower capital gains rates upon disposition of the underlying shares. Note, however, that the exercise of an ISO may have alternative minimum tax implications for the employee.

⁷ Note that if the shares are vested upon grant (*i.e.*, the grant date is the vesting date), then the vesting date tax consequences will apply on the grant date. Note also that recipients of unvested stock grants may elect to accelerate their ordinary income tax obligation by making a “Section 83(b)” election within 30 days after the grant date, in which case the tax consequences described under “Vesting Date” will apply on the date of such election instead, based on the grant date value of the shares.

⁸ Although the tax rules speak of “fair market value,” the concept is equivalent to the notion of “fair value” in the accounting literature.

⁹ For additional description of these safe harbor valuations, see “Final Regulations under Section 409A — Important Issues for Stock Options and Other Stock Rights,” available at http://www.lw.com/upload/pubContent/pdf/pub1835_1.pdf.

¹⁰ In the absence of contemporaneous cash transactions with independent third parties, or independent valuations, the SEC will look to the estimated IPO price as a leading indicator of the company’s stock value in the months prior to the filing of the IPO.

¹¹ A 2004 publication by the American Institute of CPAs, Valuation of Privately-Held-Company Equity Securities (VPES) Issued as Compensation. Note that the VPES Practice Aid is being updated by a Task Force of the AICPA as this *Client Alert* goes to press, primarily to reflect guidance in Statement of Financial Accounting Standards No. 157, Fair Value Measurements, issued in 2006 and codified in ASC 820.

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THE CHEAP STOCK SURVIVAL GUIDE

General approach. You should consider proactively addressing the SEC's focus on cheap stock issues by including robust disclosure in the IPO registration statement regarding the process and substance behind the company's valuations of its equity awards. If you receive SEC comments on cheap stock issues, expect to discuss the following issues in your comment response.

Explain how the company determined the fair value of its common stock for purposes of equity awards. Highlight the use of objective evidence to determine fair value, including valuation reports or documented cash sales transactions of the same or a similar company security in the same timeframe as the equity award to a willing unrelated party.

If appropriate, describe the role of independent valuation firms. In your registration statement or your SEC comment response letter, you may want to describe how the company hired independent valuation firms to conduct contemporaneous valuation analyses to assess the fair value of the company's common stock at certain dates. However, you will not want to do this if you are not prepared to obtain the valuation firm's consent to be named as an expert in the registration statement, a privilege for which most firms charge an additional fee. (See the discussion of expert consents below.)

Where valuation firms are named in the disclosure, robust discussions of the independent valuation firms include:

- the name of the valuation firm and whether the valuation firm was a related party;
- steps taken by the valuation firm in conducting the analysis, including the steps discussed in detail above;
- qualifications of the independent valuation firms (e.g., extensive experience providing similar valuations of common stock); and
- how the valuation reports were used by the company to assist in its determination of the price of the common stock as of the date of grant.

Note that if the valuation firm is named, the company will need to obtain the consent of the valuation firm to be filed as an exhibit to the IPO registration statement. Based on Section 7 of the Securities Act, the SEC Staff's position is that if disclosure in a registration statement attributes a valuation to a third party expert rather than the registrant, then the registrant must name the expert and file the expert's written consent as an exhibit to the registration statement. Compliance and Disclosure Interpretation (C&DI) 141.02.

Alternatively, if you used an independent valuation firm but do not plan to obtain their consent to being named in the registration statement as an expert, you need to be prepared to own the analysis and describe the elements of the methodology employed. As the SEC Staff has explained, there is "no requirement to make reference to a third party expert simply because the registrant used or relied on the third party expert's report or valuation or opinion in connection with the preparation of a Securities Act registration statement." You are not required to provide the valuation expert's consent if your disclosure (i) attributes the valuation analysis to the registrant and not the third party expert; or (ii) says that management or the board of directors determined the value and, in doing so, considered or relied in part upon a third party's report. C&DI 141.02.

Describe each of the significant factors considered by the company in determining the fair value of the company's common stock for equity awards. This is particularly important when no independent valuations were obtained. Examples of such factors include:

- business conditions and results, such as:
 - the company's actual financial condition and results of operations during the relevant period;
 - strategic initiatives to increase the target market for the company's services or goods;
 - competitive environment that existed at the time of the valuation;
 - other important developments for the company, such as:
 1. material acquisitions;
 2. major new customers, contracts or relationships;
 3. progress of the company's business model, including the introduction of new services and international expansion;
 4. development of the research and development pipeline of the company over the ordinary course of its business; and
 - status of the company's efforts to build its management team and to retain and recruit the talent and organization required to support the company's anticipated growth;
- market conditions, such as:
 - industry-specific economic conditions;
 - general economic outlook in the U.S. and globally, if applicable;
 - increase in representative comparable company's stock price; and
 - general increase in the stock market;

THE CHEAP STOCK SURVIVAL GUIDE (continued)

- liquidity and valuation issues, such as:
 - price of equity awards (illiquid securities in a private company) compared to the IPO price:
 1. the IPO price will not include the discount for the lack of liquidity of the company's common stock prior to the IPO;
 2. the IPO price will be based on then-current financial performance and outlook for the company which may have improved since the date of the grant; and
 - likelihood of achieving a liquidity event for the shares of common stock underlying the options, such as an IPO or sale of the company's common stock, given prevailing market conditions and the company's relative financial condition at the time of grant.

Identify each assumption made by the company in its valuation analysis. Address any changes in assumptions and significant intervening events that may have occurred between grant dates. Also consider discussing each significant assumption or event contributing to the changes in fair value determined, as of the date of each grant and equity related issuance, through the estimated IPO price.

Describe the methodologies used by the company in its valuation analysis. Such methodologies can include:

- an income-based approach, e.g. management's valuation of common stock based on the most recent earnings of the company as measured by its historical EBITDA;
- an approach based on other valuation methodologies described in the VPES Practice Aid; and
- an option pricing method using a blended weighting of the company's financial results from the last 12 months and projected financial results.

Explain how the company weighed each approach used in its valuation (e.g., discounted cash flow, comparable company and comparative transaction methods). The discussion should:

- explain the company's basis for determining that the weightings were appropriate;
- ensure that the discussion addresses all grants made on each grant date before the IPO; and
- discuss recently made or contemplated equity awards and the rationale justifying the fair market value for such equity awards (a situation that may arise in the context of employment agreements with executives who have recently joined or will join the company).

Ensure that your MD&A includes discussion of how management prepared its valuations and a discussion of the fair value methodologies employed by the company. You can expect the SEC Staff to require your MD&A disclosure to include:

- a specific and comprehensive discussion of the factors that led to the increase in the fair value of the company's common stock;
- the principal reasons for any difference between fair value of the company's common stock on the most recent grant date to the IPO and the IPO price; and
- a discussion, to the extent that the company did not obtain a valuation performed by an independent valuation specialist, of the company's valuation methodology and why the company chose not to obtain a contemporaneous valuation by an independent valuation specialist.

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