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To the Point

FASB — final guidance

New nonpublic entity practical expedient for fair value of equity-classified share-based awards

The amendments address concerns expressed by private company stakeholders about the cost and complexity of determining the fair value of equity-classified share-based payments.

What you need to know

- The FASB added a practical expedient to ASC 718 that allows nonpublic entities to determine the current price of an underlying share for valuing equity-classified share-based payment awards by using the reasonable application of a reasonable valuation method (e.g., a valuation performed in accordance with Section 409A of the Treasury Regulations).
- A share price calculated in this manner may be used for 12 months from the measurement date unless information that may materially affect the value of the nonpublic entity becomes available.
- A nonpublic entity that elects to apply the practical expedient must do so for all awards with the same underlying share and the same measurement date to determine the fair value on the grant date and upon a modification.
- The guidance is applied prospectively and is effective for fiscal years beginning after 15 December 2021, and interim periods within fiscal years beginning after 15 December 2022. Early adoption is permitted.

Overview

The Financial Accounting Standards Board (FASB or Board) issued amendments[1] to Accounting Standards Codification (ASC) 718, *Compensation — Stock Compensation*, that provide a practical expedient that nonpublic entities can use to determine the current share price for the purpose of calculating the fair value of equity-classified share-based payment awards.

Building a better working world

In issuing the amendments, the FASB is responding to concerns private company stakeholders expressed to the Private Company Council about the cost and complexity of determining the fair value of share-based payment awards. While ASC 718 already provides nonpublic entities with a practical expedient for estimating expected term and an alternative for estimating expected share price volatility in certain cases, there was previously no expedient for estimating the current price of an underlying share needed to value an award. Determining the current share price is complex because there is often no observable market price for private company shares.

Key considerations

The amendments allow nonpublic entities (as defined in ASC 718)[2] to determine the current share price used in the valuation of all equity-classified share-based payment awards using a reasonable application of a reasonable valuation method.

The determination of whether a valuation is reasonable, or whether an application of a valuation method is reasonable, is made based on the facts and circumstances as of the measurement date. Factors to be considered under a reasonable valuation method include:[3]

- The value of tangible and intangible assets
- The present value of anticipated future cash flows
- The market value of stock or equity interests in corporations and other entities engaged in businesses substantially similar to those engaged in by the nonpublic entity that can be readily determined through objective means such as trading prices on an established securities market or an amount paid in an arm's-length private transaction
- Recent arm's-length transactions involving the sale or transfer of the entity's stock or equity interests
- Other relevant factors such as control premiums or discounts for lack of marketability and whether the valuation method is used for other purposes that have a material economic effect on the entity, its stockholders or its creditors
- Whether the entity consistently uses a valuation method to determine the value of its stock or assets for other purposes, including for purposes unrelated to compensation of service providers

The use of a valuation method is not reasonable if it does not take into consideration all available information material to the valuation of the nonpublic entity.

The amendments indicate that a valuation performed in accordance with the Treasury Regulations related to Internal Revenue Code Section 409A (Section 409A)[4] having the characteristics described in the standard is an example of a valuation that is reasonable under the practical expedient.[5]

Under Section 409A, the two primary ways in which an entity may demonstrate that the share value was calculated using a reasonable application of a reasonable valuation method are by (1) considering the facts and circumstances described above as of the measurement date (i.e., the facts and circumstances method) or (2) by meeting a rebuttable presumption of reasonableness.

As noted in the Basis for Conclusions, the following three methods are acceptable under the presumption of reasonableness requirements of Section 409A to determine the fair market value of a share:

- A valuation determined by an independent appraisal within the 12 months preceding the grant date
- A valuation based on a formula that, if used as part of a non-lapse restriction with respect to the share, would be considered the fair market value of the share
- A valuation made reasonably and in good faith that is evidenced by a written report that considers the relevant factors of the illiquid stock of a startup corporation (as defined in the regulations)

The Board expects most nonpublic entities that elect to apply the practical expedient to use a valuation determined by an independent appraisal. The Board noted that many nonpublic entities already use an independent appraisal to achieve the rebuttable presumption for tax purposes under Section 409A.

Nonpublic entities that elect to apply the practical expedient are required to do so on a measurement-date-by-measurement-date basis. That means that the practical expedient must be applied to all equity-classified share-based awards that are valued under ASC 718 that have the same underlying share and the same measurement date. The practical expedient can be used to determine the fair value of equity-classified share-based payment awards when they are granted or modified.

The share value calculated using the practical expedient may be used for a period of 12 months from the measurement date unless information that may materially affect the value of the nonpublic entity subsequently becomes available. The guidance cites the resolution of material litigation and the issuance of a patent as examples of information that would require an entity to reassess its valuation and, if necessary, update it.

How we see it

We believe other examples of information that may have a material effect on the value of the nonpublic entity and, therefore, may require a valuation to be updated include a significant change in macroeconomic, business or industry conditions; a consummated or anticipated merger or acquisition; the disposal of a significant business; a financing transaction; or the launch of a significant product.

A nonpublic entity should consider whether it may become a public business entity (PBE) before electing the expedient because, depending on how it values its shares, it may need to perform additional work to report its results in accordance with US GAAP for PBEs.

Entities that elect to apply the expedient are required to disclose that fact.

Transition and effective date

The amendments are applied prospectively and are effective for nonpublic entities for fiscal years beginning after 15 December 2021, and interim periods within fiscal years beginning after 15 December 2022. Early adoption, including adoption in an interim period, is permitted for financial statements that have not yet been issued or made available for issuance as of 25 October 2021, the date the guidance was issued.

Endnotes:

[1] Accounting Standards Update 2021-07, *Determining the Current Price of an Underlying Share for Equity-Classified Share-Based Awards*.

[2] The Master Glossary in ASC 718 defines a nonpublic entity as "any entity other than one that meets any of the following criteria: (a) Has equity securities that trade in a public market either on a stock exchange (domestic or foreign) or in an over-the-counter market, including securities quoted only locally or regionally (b) Makes a filing with a regulatory agency in preparation for the sale of any class of equity securities in a public market (c) Is controlled by an entity covered by the preceding criteria. An entity that has only debt securities trading in a public market (or that has made a filing with a regulatory agency in preparation to trade only debt securities) is a nonpublic entity."

[3] ASC 718-10-30-20D.

[4] Section 1.409A-1(b)(5)(iv)(B) of the Treasury Regulations.

[5] ASC 718-10-30-20G.