June 12, 2017

Ms. Susan M. Cosper
Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

File Reference No. 2017-220

Dear Ms. Cosper:

Connor Group, Inc. is pleased to provide our comments on the FASB’s Exposure Draft (ED), Proposed Accounting Standards Update, Compensation – Stock Compensation, *Improvements to Nonemployee Share-Based Payment Accounting*. Connor Group was founded in 2005 and is a technical accounting advisory firm built of Big 4 alumni and industry executives. We currently have over 150 accounting professionals and over 500 clients, and specialize in helping our clients solve complex technical accounting issues under both U.S. GAAP and IFRS. Our clients represent industries such as technology, software, internet, cloud services, life sciences and manufacturing, amongst others. Many of our clients are emerging growth mid-cap or small-cap public entities, companies aspiring to become public in the near future, or high-growth private companies.

We agree with and support the Board’s overarching goal to simplify accounting for share-based payments to nonemployees. We agree that in many instances, employee and nonemployees awards are economically similar, and further, there are no significant differences between employee and nonemployee behavior and award exercise patterns. Thus, we believe similar awards to employees and nonemployees should produce similar economic results. We believe the ED accomplishes this objective in many instances and thereby reduces, to some extent, the cost and complexity of accounting for nonemployee awards (Question for Respondents #1).

Further, we support the approaches taken by the Board in the ED as related to the matters addressed in Questions for Respondents ##2, 3, 5, 6, 7, 8, 9, 11 and 12. With respect to Question for Respondents #13, we do not anticipate the adoption of the final ASU will require significant time for most entities, and nonpublic entities may be able to complete the adoption in the same timeframe as public entities.

However, in certain other respects, the ED retains differences between employee and nonemployee accounting models, where we believe alignment could be appropriate. We have summarized these areas below.

1. The use of the contractual term as an input to measure the value of options and similar instruments issued to nonemployees (Question for Respondents #4). Notwithstanding the Board’s rationale in BC12, we believe entities should have flexibility to use estimates of the expected term where there is a reasonable basis to develop such estimates and other factors, such as transferability restrictions, may indicate that use of the expected term is more appropriate. While nonemployees may
theoretically benefit from ability to sell some of their vested options or warrants, most nonemployee awards are granted by nonpublic entities, where the ability to sell (or hedge) is inherently limited. Further, nonpublic companies typically maintain capitalization tables with registers of all shareholders, including option holders, and thus have the knowledge of whether specific options have been exercised or sold (transferred). We are rarely aware of circumstances where such sales (transfers) occur.

Another practical aspect related to the use of the contractual term is that for many awards, the contractual term could change. For example, many consultant awards have a typical 10- or 7-year contractual term; however, they would contractually expire within 90 days after the consultant completed their service to the entity, unless exercised. In other awards, the contractual term is truncated to 90-180 days if vesting is accelerated based upon a certain performance condition (e.g. occurrence of a liquidity event). The contractual term is not truncated if vesting occurs for any other reason, e.g. with service. When the contractual term is subject to change, it is not clear whether the ED contemplates for entities to use the longest possible contractual term date, the estimate of the likely term, or, for example, the expected contractual term determined based on various scenarios outside of nonemployee’s control. We note that estimating the contractual term is not practically much different from estimating the term until the exercise of the option.

Many private entities from time to time prepare a valuation of their common stock, e.g. for IRC 409(a) purposes. The option pricing method (OPM) and probability-weighted expected return model (PWERM) frequently used in valuations involve determining fair values of various outstanding instruments including nonemployee options and warrants. Both OPM and PWERM require management to make assumptions about the expected timing of a future liquidity event. Valuation of all outstanding instruments (including nonemployee awards) in the OPM or PWERM is thus based on the expected timing of the liquidity event. Thus, values of nonemployee awards derived from the valuation models may differ from those determined using the contractual terms. Entities do use the results of the valuation for accounting purposes, e.g. to estimate the fair value of common stock, and in the case of certain complex transactions, estimate fair values of other instruments. Some entities also utilize appraisal-based value of employee and nonemployee awards to account for these awards. For some entities valuation of nonemployee awards would directly influence the value of common stock, e.g. if the stock into which the nonemployee award can be exercised is senior in distribution to common stock. Thus, the requirement to use the contractual term to value nonemployee awards would result in use of inconsistent valuation premises in entities’ accounting.

Additionally, while it is simpler to use the contractual term for nonemployee awards in lieu of an estimated term until the exercise, on the other hand, these benefits would be partially or fully negated due to complexities from (a) using separate sets of valuation inputs (not just expected term, but also volatility, which can be a relatively complex estimate, risk-free interest rates and dividend rates over different periods) for employees and nonemployees; (b) determining if a particular individual qualifies as an employee (common law employee), and (c) estimating the contractual term where relevant, as discussed above.

We expect this retained difference in inputs to valuation of employee and nonemployee awards would limit the extent of simplification the ED allows for some entities. Thus, we recommend to give entities ability to apply judgment in determining the expected term input to the fair value of nonemployee awards.
2. The use of the “as if cash were paid” attribution method for nonemployee awards. The ED highlights that this results in difference in attribution of employee and nonemployee awards. While in some instances, such differences could be relatively minor, in other cases, for example, for certain performance and service awards, they could be significant.

For example, an award with multiple tranches of equal number of shares that vest over consecutive periods with achievement of performance targets, or over time (service awards) if the entity has made the corresponding attribution policy election, would be recognized using the accelerated method if it is an employee award. However, non-employee awards in many instances would be recognized straight-line, because the level of effort by nonemployee could be approximately the same in each period. Thus, cash-based attribution could be on a basis similar to straight-line.

In another example, an entity that has elected straight-line attribution policy for service awards will recognize an employee award with progressively increasing number of shares vesting in consecutive periods straight-line. However, the same entity would likely recognize a similar nonemployee award in a manner proportionate to the number of shares in each tranche. This is because cash-based attribution would likely follow this method.

In another common example, the vesting of an award may not be proportionate throughout the vesting period. This may occur, for example, if the awards are designed with a delayed vesting date; e.g., an award vested 25% after a two-year cliff, with the remaining shares vest quarterly over three years. The straight-line attribution of this award granted to an employee would result in 20% of the awards value to be recognized over the first year. An “as if cash were paid” attribution method would result in 12.5% of the award’s cost to be recognized over the first year (1/2 of the two-year period for 25% of the award).

We note that while the proposed 718-10-25-2C does not change the attribution requirements for nonemployee awards, and simply moves the existing language from 505-50-25-4, we believe this move will change the existing practice for various entities. This is because many entities interpret the current 505-50-25-4 as indicating only whether the nonemployee awards should be expensed or capitalized. We note the language specifically defines the “manner” of recognition as “capitalize versus expense”. However, as Topic 505-50 contains no guidance regarding attribution for those awards that were expensed, we believe many entities routinely analogized to the corresponding employee provisions, for example, 718-10-35-8 for awards with graded vesting. With the relocation of Topic 505-50 inside Topic 718, we believe such analogy becomes unsustainable, as Topic 718 would now contain separate recognition provisions for employee and nonemployee awards.

In summary, we expect the proposed difference in attribution methods would limit the extent of simplification the ED allows for some entities, and additionally, may result in changes in practice to some entities. Thus, we recommend to include in the final ASU language that would allow entities to analogize to employee award attribution models for awards that are economically similar.

3. Handling replacement awards in a business combination. We believe the framework proposed in the ED may not always lead to a reasonable outcome, and further, is inconsistent with the “as if cash were paid” attribution method for nonemployee awards. Specifically, the proposed 805-30-55-8 and 55-9 require entities to determine the pre-combination portion of the awards based on the ratio of the nonemployee’s pre-combination vesting period to the greater of the total applicable period or the original applicable period of the award, i.e. on the basis of passage of time. We agree this method
is appropriate for employee awards, as progress of service can be said to be commensurate with the passage of time, even for performance awards (if probable of vesting). We believe this method would also be appropriate for certain nonemployee awards (e.g. service awards), where progress towards vesting is commensurate with time.

However, this method is significantly inconsistent with the terms of other nonemployee awards where progress towards vesting is based on the units delivered. As an example, assume a nonemployee contracted to deliver to the entity 100 units of an inventory item (or 100 hours of consulting time) over a 12-month period in exchange for stock options that cliff vest with the final delivered unit (hour). Assume further that at the time the entity was acquired, 6 months into the delivery period, 90 units (hours) have been delivered. The acquiree would have recognized (in inventory or expense) 90% of the grant-date fair value of the options using the “as if cash were paid” method. However, in determining the post-combination expense, applying the proposed 805-30-55-8 and 55-9, the acquirer would only be able to attribute 50% (6 months/12 months based on the passage of time) of the pre-acquisition value of the acquiree options to the pre-acquisition period. Thus, the acquirer would recognize (in inventory or expense) the remaining 50% of the value of the replacement award, in the post-acquisition period, and attribute this cost to the 10 units (hours) remaining to be delivered. We do not believe this approach results in a reasonable accounting outcome.

We recommend to modify the proposed 805-30-55-8 and 55-9 to reflect the allocation method that is either time- or units-based depending on how progress towards satisfaction of the vesting conditions is measured.

4. Transition provisions (Question for Respondents #10). We believe one aspect of the proposed 718-10-65-11 (and other transition paragraphs) may be difficult for entities. Specifically, applying the modified retrospective method to all awards unsettled as of the effective date. This is because this would require remeasuring all such awards as of the grant (and/or modification, as applicable) date. We believe many entities may not have readily available grant- or modification-date fair values of nonemployee awards, because in some instances, those awards were granted many years ago. Further, at grant or modification these fair values were not required, because for recognition purposes, entities only had to measure the value of the award as of the vesting (or period-end) dates. Some entities also likely did not have a robust process to establish grant dates of nonemployee awards, specifically, validating that all requisite approvals have been received, because establishing a precise grant date was not required for accounting purposes. Thus, upon transition these entities may have to retrospectively make what could be complex and difficult to audit judgments about grant date, fair value of common (or preferred) stock as of such date, and relevant assumptions (volatility, etc.).

Instead, we recommend to add an adoption alternative that would allow prospective application. The concept is (1) to allow to reclassify any liability-classified instruments that should be classified as equity at their current carrying value, and (2) to use, as much as possible, the most recently measured fair value of the awards for accounting purposes for the remainder of the award’s existence. We also want to encourage the Board to allow the early adoption alternative.

Additionally, we have the following minor comments on various sections of the document.
5. The proposed 718-10-25-2B and 25-2C refer to “equity instruments” instead of “share-based payments” as in the rest of the document. We understand the proposed guidance should be applied to all share-based payments regardless of whether they are equity or liability classified. We recommend to clarify the language accordingly.

6. There is potential for a conflict between the provisions of the proposed 718-10-55-82 (determination of the grant date) and 718-10-35-1C (recognition of the nonemployee awards using “as if cash were paid” method). This is because for cash-based awards, entities may conclude cost has been incurred prior to completion of all requisite approvals, if, for example, the nonemployee service has been initiated, or goods received, prior to completion of formal approval requirements by either party, as defined in 718-10-55-82. In the case of employee service, there is no accounting for services received (sometimes, for extended time periods) until the formal grant date has been established. However, it is not clear whether the same approach should be used for nonemployee awards, if, for example, the awards relate to tangible items (e.g. inventories) that have been received and included in the entity’s assets.

7. The proposed 718-20-55-109B, 55-120B and 55-122B all provide additional context on how to apply the applicable illustrative examples to nonemployee awards. However, these paragraphs do not explicitly state that they apply to nonemployee awards only. We recommend to clarify, e.g. in the first sentence of each of these paragraphs, “[a]ny additional compensation cost for nonemployee awards should be recognized by applying the guidance...”.

We would be pleased to respond to any questions the FASB or its staff may have concerning our comments.

Sincerely,

Connor Group, Inc.

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