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Technical Director  
Financial Accounting Standards Board  
401 Merritt 7, PO Box 5116  
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Subject: Proposed Accounting Standards Update (“ASU”) - Compensation—Stock Compensation (Topic 718),  
Determining the Current Price of an Underlying Share for Equity-Classified Share-Option Awards

Director:

ST/OCKS appreciates the opportunity to respond to the FASB’s Subject ASU. Our efforts over the last quarter-century have focused on the tax, regulatory, investment, compensation and benefits, valuation and financial reporting aspects of *stock-based compensation* (“SBC”). We commend the FASB and the Private Company Council for this important attempt at clarity in financial reporting.

ST/OCKS has pioneered the use of *listed, exchange-traded options* (“LETOs”) as freely-traded proxies in employee stock option valuation in financial reporting, i.e., ASC 718 employee stock option expense and in estate / gift tax planning, i.e., transferable option valuations for public and private companies.

Background

The confluence of financial reporting responsibilities to the IRS, the SEC & the FASB across three disciplines has resulted in significant *paradigm congestion* as rules and regulations interact in ways not originally intended.<sup>1</sup>

IRC §83, *Property Transferred for the Performance of Services* states an “option” must have a...*readily ascertainable fair market value*, either being exchange-traded or having a market value measured with *reasonable* accuracy.<sup>2</sup> This IRC§ presents two words, i.e., “readily” and “reasonable” that the subject ASU suggests is a nexus for the *practical expedient* that the Private Company Council seeks. The following from ASC 718 [¶22]...

*“The fair value of an equity share option or similar instrument shall be measured based on the observable market price of an option with the same or similar terms and conditions...a similar instrument is one whose fair value differs from its intrinsic value, that is, an instrument that has time value.”<sup>3</sup>*

...comparing the IRS’ reference to ‘exchange-traded’ and ‘market value’ to the FASB’s reference to ‘observable market price’ and...‘time value’ – a “LETO”-specific term.

<sup>1</sup>Significant *paradigm congestion* stems from the bifurcated treatment by the IRS and the FASB as to the grant-based reporting of ESO values. The former under IRC§1.83-7(b)(2) values and taxes ESOs at grant only if they are exchange-traded or have a RAFMV while the FASB values ESO upon their grant. This one issue is responsible for a great deal of compliance burden for corporations and their employees, particularly insiders.

<sup>2</sup>Treas.Reg. 1.83-3(a)(2), 1.83-7(a) and 1.83-7[b] stipulating valuation as set forth in section 20.2031-2.

<sup>3</sup>*Statement of Financial Accounting Standards* (SFAS) No. 123 was released as an Exposure Draft 9 years after the stock compensation ‘project’ was introduced by the FASB. The actual release of SFAS 123 took place in 1995 but its adoption was mandatory for disclosure purposes only, requiring companies who did not adopt its provisions to expense ESOs to provide two sets of earnings per share numbers, i.e., those with and without ESO expensing. SFAS 123(r) followed in 2004 that ultimately required such ESO expensing and then ASC 718 as the FASB changed its classification for such pronouncements.

## Discussion

The FASB's ASU refers to Treasury Regs. §1.409A-1(b)(5)(iv)(B)(2) and its *formulaic* second approach, seeking a *fair market value* standard. This IRC§ uses the term... "not *readily* tradable on an established securities market" stipulating that fair market value should include consideration of *non-lapse restrictions* ("NLRs").

The SEC's 2020-21 agenda includes *Listing Standards for Recovery of Erroneously Awarded Compensation*, and final regulations on Exchange Act §10D [Dodd-Frank's §954]. IRC§83 and IRC§409A issues become more complex with the addition of IRC§162(m), i.e., compensation deductibility. Corporate governance considers issues of *negative discretion* and *clawbacks*, in both the *award* and *recovery* of performance compensation. These restrictions added to other *insider* governance restrictions imposed by public companies have made insider SBC truly *variable* from a financial reporting standpoint. Specifically, public company stock in the hands of the insider may have a value different than that publicly traded on a minority-interest basis.

The SEC agenda may prompt a review of a long-standing *hurdle* issue in the valuation of SBC, i.e., that such value may only be adjusted for compensation purposes if NLRs were present. As the Private Company Council seeks a "rebuttable presumption of reasonableness" as established by IRC§409A,<sup>4</sup> it is reasonable to assume that public company insider restrictions *mimic* the NLRs used in private company valuations.<sup>5</sup>

We suggest two parts to the private company valuation protocol for this ASU:

1. A cost-effective valuation protocol in the valuation of private company stock for this proposed ASU is found in the answers to Questions #1 & #3.
2. In conjunction with #1, the answer to Question #4 provides discussion for a NLR valuation methodology as an adjustment to a freely-traded fair market value for a private company stock valuation.

## Answers to Respondent Questions

**Question 1:** Is the practical expedient as drafted in this proposed Update operable? If not, please explain why.

Yes it is! Valuation professionals may use the following approaches in engagements, i.e., Asset, Income or Market. We suggest variants of the Income and Market approaches for this ASU, where market *comparables* or a *peer group index* is selected. Such an index is common in corporate financial statements and governance, i.e., CD&A, proxy.

We first compare private company to public company comparables in an industry subset by an income approach, e.g., a discounted cash flow ("DCF") analysis of operating earnings over some term. This peer group index is further defined by an added selection filter, i.e., traded LETOs on each peer group index comparable.

The *at-the-money* LETO prices for each peer group index member forms a *data series* for an XY Chart, extended by *trendline* to some stated term.<sup>6</sup> Aggregate *option premium income* ("OPI") serves in a *default* DCF analysis for each peer group index member and as an input in a *modified Black-Scholes Model*. As option model values approach the value of the underlying common stock, the OPI DCFs will aggregate the value of the underlying common stock for each peer group index member then normalized for private company use, e.g., DCF as percent of exercise price.<sup>7</sup>

**Question 2:** The practical expedient in this proposed Update is applicable only for equity-classified share-option awards. Should the scope of the practical expedient in this proposed Update be expanded to include other equity-classified share-based compensation arrangements (for example, nonvested shares)? Please explain why or why not. The 1<sup>st</sup> draft of the *Tax Cuts and Jobs Act* hinted at change in the practice of SBC<sup>8</sup>. This from an article on the subject in the draft legislation...

<sup>4</sup> See Treasury Regs. §1.409A-1(b)(5)(iv)(B)(2)

<sup>5</sup> See IRC§1.83-3(h)-the term and discussion define such restrictions which by their terms will never lapse.

<sup>6</sup> See <https://bigcharts.marketwatch.com> – select "AAPL" – one year chart – select dialog box "options chain" for complete LETO matrix of put and call contract prices.

<sup>7</sup> Ex: BSM inputs - \$50 Stock Px, \$50 Ex Px, 10 yr term, 100% volatility, 0.01% div, 1.60% int rate = \$44.50 option value, i.e., 90% of UCS Px.

<sup>8</sup> 131 STAT. 2054 PUBLIC LAW 115-97—DEC. 22, 2017

“Stock options and equity appreciation rights are included in income upon vesting, whether or not exercised.”<sup>9</sup>

Rising equity markets are necessary in generating the tax receipts thrown off by the current tax treatment of SBC. The Treasury may have signaled their concern over the prospect for such equity appreciation by this draft legislation that could change the tax treatment of SBC. Revisit this question again in a year.

**Question 3:** Will the proposed practical expedient reduce costs, including audit costs or fees, associated with the current price input? Please explain why or why not.

The above LETO DCF approach sets a *dynamic* linkage updating XY charts with LETO market values easily and inexpensively. See discussion to follow on this protocol’s use in the establishment of NLRs for use in private company stock valuations [Answer to Question 4].<sup>10</sup>

**Question 4:** Do you or your clients obtain separate valuations to satisfy GAAP requirements (Topic 718) and tax regulations (Section 409A)?

The SEC’s upcoming mandatory proxy regulations require updated SBC values, i.e., real numbers in executive compensation using the term *compensation actually paid*. This highlights a dichotomy between GAAP and tax valuation protocols for SBC.

The insider governance restrictions discussed above, i.e., negative discretion, clawbacks, variable accounting treatment, etc., imposes valuation *reporting* responsibilities on both the public company...and the insider. The insider has a responsibility to accurately report his or her income to the IRS and pay the tax due.<sup>11</sup>

Corporate governance protocol then seems to overvalue insider SBC for GAAP purposes, creating a direct conflict between employer and employee as established in *Robinson*. A lack of marketability discount may be calculated for insiders within a particular industry subset in a valuation performed on an *ex officio* basis, *in loco hominem*, adjusting the private company aggregate OPI DCF value as discussed above, in lieu of a *private letter ruling* that is also possible to bypass fractionalized results from the national court system.<sup>12</sup>

We have withheld comments to Questions #5 - #7.

Best regards,

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<sup>9</sup> <https://www.skadden.com/insights/publications/2017/11/executive-compensation-under-the-tax-cuts>

<sup>10</sup> *Continuous Valuation Assessment / Linkage* (COVAL™) platform.

<sup>11</sup> See *Robinson v. Commissioner*, 335 F.3d 1365 (Fed. Cir. 2003). The question in the Federal Circuit was employer common stock value as employee income vs. employer deduction, and who was responsible for making such determination. The Federal Circuit overturned Treasury Regulation 1.183-6(a) as inconsistent with Section 83(h) allowing varying SBC “amounts” by both employer and employee.

<sup>12</sup> In other words, a valuation is accomplished for a generic insider as defined by the procedures and protocols generally found in the industry subset among the members of the peer group index. The valuation becomes a template for use within that industry subset.