



September 24, 2020

Hillary H. Salo
Technical Director
Financial Accounting Standards Board
401 Merritt 7, PO Box 5116
Norwalk, CT 06856-5116

RE: File Reference No. 2020-200

Dear Ms. Salo:

PricewaterhouseCoopers LLP appreciates the opportunity to comment on the Proposed Accounting Standards Update (the proposed Update), Compensation—Stock Compensation (Topic 718): *Determining the Current Price of an Underlying Share for Equity-Classified Share-Option Awards, a proposal of the Private Company Council*. We support the FASB's ongoing efforts to provide practical expedients in certain areas of current GAAP to lower the cost and complexity of financial reporting for private companies. However, from our experience in auditing the financial statements of private companies, we do not believe that the proposed practical expedient will have a significant impact on either the efforts required by our clients to estimate the fair value of an underlying share used to measure share-option awards or, in turn, our efforts to audit those estimates. In addition, we are concerned that some of the language in the proposed Update incorrectly implies that preparers' and auditors' responsibilities could change if the proposed practical expedient is applied.

The Appendix contains our detailed responses to the Questions for Respondents.

If you have any questions regarding our comments, please contact David Schmid at (973) 997-0768 or Jay Seliber at (908) 581-2759.

Sincerely,

A handwritten signature in black ink that reads "PricewaterhouseCoopers LLP". The signature is written in a cursive, flowing style.

PricewaterhouseCoopers LLP



Appendix

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

We believe that the practical expedient as drafted in this proposed Update is generally operable as written. However, we have two specific recommendations.

First, proposed paragraph 718-10-30-20C allows the use of a valuation performed in accordance with Treasury Regulation Section 1.409A-1(b)(5)(iv)(B)(2) to determine the current price of the entity's underlying share. However, we recommend that this paragraph also reference the prior section, Treasury Regulation Section 1.409A-1(b)(5)(iv)(B)(1) (or, alternatively, refer to the entire section 1.409A-1(b)(5)(iv)(B)). Without this additional reference, a key aspect of the reasonableness of the valuation is missing, namely that "the use of a value previously calculated under a valuation method is not reasonable as of a later date if such calculation fails to reflect information available after the date of the calculation that may materially affect the value of the corporation."

Similarly, BC21 notes that the use of valuations prepared by independent appraisers that satisfy Section 409A are valid for 12 months unless determined to be "grossly unreasonable." However, we understand that under the Treasury Regulations, a valuation method is not "reasonable" if it fails to reflect information available after the date of the calculation that may materially affect the value of the corporation. Therefore, we recommend that the proposed Update include this requirement as well. Otherwise, practitioners may misinterpret that all valuations may be used for a period of up to 12 months after the date of preparation with minimal consideration and judgment. This could result in fair values being used for the shares underlying share-option awards that do not reflect material information.

Second, we believe that the proposed Update should be clarified to properly reflect the roles of management and independent auditors with regards to significant estimates that are used in the preparation of financial statements. Specifically, in paragraphs BC2, BC22, and BC26, the Board implies that a key aspect of the proposed Update is to reduce the documentation and audit procedures currently required in practice to substantiate the current price input associated with measuring the fair value of stock-based awards. However, procedures performed by auditors do not substantiate the value of the entity's stock. As further described in our response to Question 3, it is management's responsibility to determine, substantiate, and document the fair value of the entity's stock (whether measured under ASC 718 or the Treasury Regulations). It is the auditor's responsibility to evaluate the key judgments and estimates made by management in the context of performing an audit on the financial statements taken as a whole. Nothing in the auditing standards alters management's responsibility associated with the preparation of financial statements in accordance with generally accepted accounting principles. Accordingly, we believe that the discussion in these paragraphs should be revised to eliminate the notion that documentation is prepared solely for the purposes of completing an audit.

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.

We support the Board's conclusion to limit the scope of the proposed Update to equity-classified share-option awards, notwithstanding the fact there is no difference between the fair value of a share underlying an equity-classified share-option award and the fair value of that same share underlying another type of stock-based compensation award subject to ASC 718. Thus, our support for the



proposed scope is largely for practical reasons. We understand that under the provisions of Section 409A, entities must assess the grant date fair value of the shares underlying share-option awards in order to conclude that the exercise price of such options are not lower than the grant-date fair value of the underlying shares, as the failure to do so would have adverse tax consequences to the recipients of such awards. Accordingly, management often engages a third-party valuation firm to prepare a valuation of the underlying stock at the time of granting such share-option awards in order to meet the “presumption of reasonableness” described in Section 409A and effectively assert to the IRS that the fair value of the underlying shares is no greater than the exercise price of the options. The same considerations do not apply to grants of other types of stock-based awards, such as nonvested shares or profits interests. While management is required to determine the fair value of the underlying equity instruments issued in order to account for such awards under ASC 718 (or awards that are liability-classified under ASC 718 and remeasured each reporting period), it may not seek valuations prepared for Section 409A purposes (or make the tax assertions inherent in Section 409A) in such instances.

However, we recommend two further clarifications to the proposed Update on this topic. First, we note that BC6 states that “nonpublic entities are already afforded a practical expedient for liability-classified awards whereby awards may be remeasured on the basis of intrinsic value.” We do not believe this point is relevant to the proposed scope conclusion. When using the intrinsic value practical expedient, nonpublic entities are still typically required to determine the fair value of the underlying stock in order to measure the intrinsic value of the option unless, for example, the stock value is based on a formulaic repurchase price. Therefore, the existing intrinsic value practical expedient does not provide relief from the determination of the fair value of the underlying stock addressed by the proposed Update. We recommend deleting this sentence to avoid potential confusion.

Second, we recommend explicitly clarifying that the scope of the proposed Update includes only those awards that are legally in the form of share options as defined in the Master Glossary, and not other awards that are accounted for in substantially the same way. For example, paragraph 718-10-25-3 states that the sale of shares in exchange for a non-recourse note should be accounted for as a substantive grant of equity share options.

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.

As noted in our response to Question 4, the majority of our nonpublic entity clients do not obtain separate valuations to satisfy their compliance with (a) US GAAP reporting requirements (ASC 718) and (b) tax regulations (Section 409A). Therefore, the cost of obtaining valuations would not be reduced for these entities.

Audit costs or fees are affected by a number of entity-specific factors so we are not able to comment on any impact on costs or fees to financial statement preparers. Notwithstanding this, we do not believe that the proposed practical expedient will significantly reduce the amount of audit effort required to evaluate management’s estimate of the fair value of the underlying share, whether it is prepared in accordance with existing US GAAP requirements (ASC 718) or tax regulations (Section 409A).

Paragraphs A2 and A3 of AU-C Section 200 of the AICPA Professional Standards, *Overall objectives of the independent auditor and the conduct of an audit in accordance with generally accepted auditing standards*, highlight that management of an entity has responsibility for the preparation and fair presentation of the financial statements, including making use of appropriately developed estimates that are reasonable in the circumstances, and for maintaining internal controls relevant to preparing those financial statements. Paragraph A30 of AU-C Section 540 of the AICPA Professional Standards, *Auditing accounting estimates, including fair value accounting estimates, and related disclosures*, states that “assumptions may be made or identified by a specialist to assist management in making the



accounting estimates. Such assumptions, when used by management, become management's assumptions."

We do not believe that the practical expedient in the proposed Update would change these requirements. In performing an audit, auditors are required to evaluate management's estimates and judgments. Since the valuation prepared for Section 409A purposes would be used as an input to the determination of the fair value of a share-option award for financial reporting purposes, if the auditor believes there is a risk of material misstatement related to the valuation (for example, due to the significant assumptions used in preparing it), the auditor would still be required to perform procedures to address that risk as described in paragraph 13 of AU-C Section 540. These procedures are likely to include testing how management made the accounting estimate and the data on which it is based. Other aspects of the auditing standards would also be relevant, including:

- Paragraph A69 of AU-C Section 540, which notes that testing how management made the accounting estimate and the data on which it is based may involve not only testing that the data is accurate, complete, and relevant, but also considering the information provided by management's specialists to assist in making the accounting estimate. This guidance also goes on to state that the auditor must determine how management has taken into account the effect of events, transactions, and changes in circumstances occurring between the date that the estimate or inputs to the estimate were determined and the reporting date, if the estimate was not made as of a date that coincides with the reporting date.
- Paragraph 8 of AU-C Section 500 of the AICPA Professional Standards, *Audit Evidence*, which states that if management utilizes a specialist (such as a valuation firm) to produce information that is used in the preparation of the financial statements which will be relied upon as audit evidence, the auditor is required to evaluate the competence, capabilities, and objectivity of the specialist; obtain an understanding of the work performed by the specialist; and evaluate the appropriateness of the specialist's work. Paragraph A49 of AU-C Section 500 notes that evaluating the appropriateness of the specialist's work includes evaluating the relevance and reasonableness of significant assumptions and methods used by the specialist and the relevance, completeness, and accuracy of any source data provided to the specialist.

We do not believe that any of these audit requirements are supplanted by the guidance in the proposed Update that the entity obtain a valuation from an unrelated appraisal firm which meets the "presumption of reasonableness" in the Treasury Regulations. As described in Treasury Regulation Section 1.409A-1(b)(5)(iv)(B)(1), such a valuation still must be determined by the reasonable application of a reasonable valuation method, which reflects the facts and circumstances as of the valuation date. In particular, that regulation describes factors to be considered in preparing a reasonable valuation, including anticipated cash flows of the entity, the value of assets of the entity, and the market value of similar entities that are traded publicly or were acquired for a known sale price. All of these factors incorporate significant judgments made by management and/or the valuation firm, which would continue to be subject to audit considerations based on the guidance described above.

Accordingly, we believe that the discussion in the Basis for Conclusions paragraphs should be revised to eliminate the inference that auditors would have differing responsibilities under the auditing standards as a result of the practical expedient in the proposed Update.

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

The vast majority of our clients do not obtain separate valuations to satisfy GAAP requirements (ASC 718) and tax regulations (Section 409A).



Question 5: Do you agree with allowing the proposed practical expedient to be elected on an award-by-award basis?

Yes, we agree for the reasons stated by the Board.

Question 6: Will the proposed practical expedient compromise the decision usefulness of information related to equity-classified share-option awards? If yes, please explain how.

The assessment of decision-useful information is primarily a question for the users of the financial statements. However, as noted in BC23 of the proposed Update, the measurement objective—fair value—is the same between ASC 718 and Section 409A. Therefore, properly applied, the resulting determination of the fair value of share-option awards granted by an entity should not be affected by the proposed practical expedient, and, therefore, the decision usefulness of the information resulting from that determination would not be compromised.

However, if the proposed Update creates confusion as to the responsibility of management to prepare adequately supported estimates of fair value, or to consider the impact of information that arises between the date of a previous valuation and the grant date of a new share-option award that may materially affect the value of the corporation (as required by Treasury Regulation Section 1.409A-1(b)(5)(iv)(B)(1)), then there is a risk that the proposed practical expedient could compromise the decision usefulness of the information related to those awards.

Question 7: Do you agree with the proposed prospective transition requirements? If not, please explain why.

Yes, we agree with the proposed prospective transition requirements, as we believe the underlying premise of fair market value is generally consistent between ASC 718 (and the concepts in ASC 820, *Fair value measurement*, that may be relevant in determining fair value of the award or the underlying stock) and the Treasury Regulations.

We do not agree with the notion in BC23 that the requirements of ASC 718 are more robust than those of Section 409A.