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September 29, 2020

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

RE: Proposed Accounting Standards Update, *Compensation – Stock Compensation (Topic 718): Determining the Current Price of an Underlying Share for Equity-Classified Share-Option Awards* (File Reference No. 2020-200)

Dear Ms. Salo:

We appreciate the opportunity to comment on the proposed ASU, *Compensation – Stock Compensation (Topic 718): Determining the Current Price of an Underlying Share for Equity-Classified Share-Option Awards*.

We support the Board's efforts to develop practical expedients for private companies to help to reduce the cost and complexity associated with applying generally accepted accounting principles (GAAP). However, we believe the proposed ASU, as drafted, would not significantly reduce cost or complexity for private company financial statement preparers.

This letter summarizes our key observations. The Appendix provides our detailed responses to the Board's Questions for Respondents.

Fair Value Measurement Objective

We believe changes are needed for the proposed ASU to achieve its intended objectives. Fair value is the measurement objective for share-based payment transactions recognized under Topic 718. Under the proposals, a private company that elects the practical expedient would use the share price from the most recent valuation under Treasury Regulation 409A as an input in measuring the fair value of equity-classified share options.

We believe that options measured using the 409A valuation as an input likely would meet the fair value measurement objective of Topic 718 only on or shortly after the 409A valuation date. To meet the Topic 718 fair value measurement objective at a date after the 409A valuation date, a private company likely would need to adjust the share price from the most recent 409A valuation and, thus, likely would not be able to elect the proposed practical expedient. To achieve its intended objectives, we believe the final ASU would need to explicitly state that share options measured under the practical expedient using a 409A valuation as an input would satisfy the Topic 718 fair value measurement objective.

The Treasury Regulations allow companies to use a 409A valuation for up to twelve months, unless subsequent information renders the valuation grossly unreasonable. Under the proposals, private companies would need to assess whether other information exists after the 409A valuation date and update the valuation as necessary. Grossly unreasonable is not defined in US GAAP or the Treasury

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Regulations, which may lead to diversity in practice. In addition, financial reporting and audit considerations with respect to evaluating grossly unreasonable for US GAAP may differ from the considerations that apply to evaluations of that threshold under the Treasury Regulations, due to materiality considerations required for US GAAP.

Audit Considerations

Unless there are also changes to the standards[1] for auditing fair value estimates, we believe auditing a share price determined from a 409A valuation would not result in a significantly different level of audit effort compared with auditing a share price that meets the fair value measurement objective under Topic 718. If fair value continues to be the Topic 718 measurement objective, auditors would continue to be required to determine whether the share price represents fair value. Adjustments (or lack thereof) to the share price developed under the 409A valuation would need to be considered, as that share price is a key input in determining the share option value.

Although the proposed ASU would permit a change in the approach to determining the share price input for a share option award, auditors would still be required to audit the 409A valuation and assess the inputs, assumptions and data used to develop the share price input, to determine whether the fair value measurement objective is achieved. Auditors also would need to consider other audit evidence that assists in determining whether the fair value measurement objective is met, including share price values obtained through primary or secondary offerings of the same or similar underlying shares. Auditors would continue to assess the competency of the third-party specialists that management used to perform the 409A valuation, and would continue to engage their own specialists to audit the valuation, who may be different from or incremental to those used under the previous methodology (e.g. tax specialists).

However, if the Board explicitly states that share options measured under the practical expedient using a 409A valuation as an input would satisfy the Topic 718 fair value measurement objective, then the audit effort would shift to focus on whether the valuation is compliant with 409A, including that it is not grossly unreasonable. As that term is not defined by US GAAP or the Treasury Regulations, the level of audit effort involved in determining whether a 409A valuation is not grossly unreasonable may vary significantly, depending on the facts and circumstances.

Scope

We believe the Board should expand the scope of the proposed ASU to include restricted share awards, as the share price value that is developed under the 409A valuation to value share option awards is the same value that a private company would use to value restricted share awards, if both were granted on the same 409A valuation date.

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If you have questions about our comments or wish to discuss the matters addressed in this comment letter, please contact Kimber Bascom at (212) 909-5664 or kbascom@kpmg.com or Regina Croucher at (816) 447-6587 or rcroucher@kpmg.com.

[1] AU-C Section 540, Auditing Accounting Estimates, Including Value Accounting Estimates, and Related Disclosures

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Sincerely,

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Appendix – Responses to Questions for Respondents

Question 1:

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

We believe changes are needed to the Topic 718 fair value measurement objective for the proposed ASU to achieve its intended objectives. Specifically, to achieve its intended objectives, we believe the final ASU would need to explicitly state that share options measured under the practical expedient using a 409A valuation as an input would satisfy the Topic 718 fair value measurement objective at the valuation date, and at subsequent dates for which the 409A valuation remains valid for tax purposes. The share price measurement under a 409A valuation often approximates fair value as of the 409A valuation date, but once that date passes it may no longer approximate fair value. A company that grants a stock-based award after the 409A valuation date would have to assess whether the share price value needs to be adjusted for factors and subsequent developments that would affect whether the share price represents fair value. Once a private company adjusts the share price from the 409A valuation for those developments, we do not believe the company would be able to use the proposed practical expedient. Thus, a private company that grants an award after the 409A valuation date may not be able to apply the practical expedient to that award.

We have additional concerns about the operationality of the proposed ASU:

- *Consideration of grossly unreasonable* – The Treasury Regulations allow private companies to use a 409A valuation for up to twelve months unless subsequent information renders the valuation grossly unreasonable. Under the proposals, private companies would need to assess whether other information exists after the 409A valuation date and update the valuation as necessary. Grossly unreasonable is not defined in US GAAP or the Treasury Regulations, which may lead to diversity in practice. For example, assume a private company obtains a 409A valuation of its common shares at $10 per share in March 20X0. The private company raises additional capital in July 20X0 at $15 per share. The private company grants share option awards to its employees in August 20X0. It is unclear under the proposals how a private company would evaluate the new information from July 20X0 to determine whether to revise the March 20X0 409A valuation in measuring the awards granted in August 20X0. For tax purposes, the March 20X0 409A valuation may not be deemed to be grossly unreasonable. However, financial reporting and audit considerations with respect to evaluating grossly unreasonable for US GAAP may differ from the considerations that apply to evaluations of that threshold under the Treasury Regulations, due to materiality considerations required for US GAAP.
- *Length of time the 409A valuation is valid* – Proposed ASC paragraph 718-10-30-20C is silent about the time frame in which a nonpublic company may use a 409A valuation. Paragraph BC19 of the proposals discusses the presumption of reasonableness requirements of Section 409A, including that the valuation would need to have been performed within the 12 months preceding the grant date. We believe that the final ASU should explicitly state how much time can elapse between a 409A valuation used in measuring the fair value of share option awards and the grant date for those awards. However, establishing a 12-month bright-line threshold could reduce the usefulness of the information, as the share-based option awards would not be recognized at fair value.
- *Subsequent changes to the Treasury Regulations* – Proposed ASC paragraph 718-10-30-20C refers to Treasury Regulations, which are outside the FASB's oversight or control. Future changes or interpretations to the Treasury Regulations may result in unintended accounting consequences, or outcomes that conflict with the Board's objectives in the proposed ASU. We recommend that the Board provide additional guidance about whether the Treasury Regulations

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referenced in ASC paragraph 718-10-30-20C are those in effect as of a specific date, or address how entities should consider changes to the Treasury Regulations and the timing of when they would be applied in a company's fiscal period.

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 believe the Board should expand the scope of the practical expedient to include nonvested share awards (also, in practice, referred to at times as "restricted share awards"), as the share price value that is developed under the 409A valuation to value share option awards also likely would be used to value nonvested share awards, if both were granted on the same grant date. Further, we do not see a distinction between the valuation method for the share price input for a share option, and the valuation method for a nonvested share award, as it is usually the same underlying common stock. Applying the practical expedient for share option awards but not for nonvested share awards could result in different share price measurements for the same underlying shares if both types of instruments are granted on or about the same date. It could also require private companies to obtain two valuations, one for Topic 718 and one for Section 409A, which seems contrary to the objectives of the proposed ASU. However, we do recognize that a 409A valuation is not always obtained for nonvested share awards on the grant date, as it is usually obtained upon exercise to determine the tax effect.

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 drafted, we do not believe that the proposed practical expedient would significantly reduce costs, including audit costs or fees, associated with the current price input. This is mainly driven by a need to change the Topic 718 fair value measurement objective for private companies that apply the practical expedient (see our response to Question 1), as well as a need to change the auditing guidance for auditing fair value estimates, in order to reduce audit effort. Regardless of the method used to value the share options, under the Topic 718 fair value measurement objective, the methodology for estimating the fair value of the share price input, including the related assumptions and data inputs, would continue to be subject to audit procedures. Even if paragraph 718-10-30-20C stated that a 409A valuation satisfied the Topic 718 fair value measurement objective, applying the proposals would still require auditors to audit the 409A valuations, which is likely to require a similar or increased level of audit effort as auditing a non-409A valuation prepared to comply with the fair value measurement objective.

Auditors would continue to assess the competency of the third-party specialists that management used to perform the 409A valuation, and would continue to engage their own specialists to audit the valuation. We would not anticipate a reduction in specialists' hours but, rather, a shift from option valuation specialists with expertise in Topic 718 fair value measurements to specialists with expertise in applying Section 409A of the Treasury Regulations. As a result, involvement of specialists may be different from or incremental to those used under the previous methodology (e.g. tax specialists). Audit procedures over the 409A value would be performed, and if time has passed since the 409A valuation was performed, other procedures also would be required to determine whether the value is grossly unreasonable. These procedures could include assessing other events that took place after the 409A valuation date to determine

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whether adjustments are needed to meet the Topic 718 fair value measurement objective. It is likely that the level of audit effort necessary to support a 409A valuation for financial reporting purposes will be greater than the level of effort necessary to support such a valuation for tax purposes.

We have identified other areas in which there may be incremental audit effort, or no reduction in audit effort, as a result of the proposed ASU:

- If a private company has historically obtained a Topic 718 valuation to value its share option awards, and applies the practical expedient in a later year, differences between the Topic 718 and the 409A valuations may need to be considered and/or reconciled as each valuation purports to be a fair value measurement. There may be additional audit procedures in the year of adoption of the final ASU as a result of these additional considerations.
- In our experience, although practice is mixed, many private companies do **not** obtain, for the same share value, a Topic 718 and a 409A valuation. Therefore, we would not expect these private companies to have a reduction in audit costs as they generally would not have fewer valuations that are subject to audit considerations.
- When a private company goes public, the SEC typically does not permit the use of practical expedients in filings that include prior periods. As a result, absent SEC action, a private company that goes public could no longer apply the practical expedient, and the company would need to measure its share option awards for its prior periods using a Topic 718 valuation. For private companies that are considering an IPO, use of the practical expedient could result in additional audit fees in periods the private companies are recasting or for which they are obtaining additional valuations in preparation for the IPO. As a result, we would not anticipate that companies that are considering an IPO would use the practical expedient.

However, we believe there could be some limited reduction in audit costs and effort if the final ASU explicitly states (1) that share options measured under the practical expedient using a 409A valuation as an input would satisfy the Topic 718 fair value measurement objective at the valuation date and at subsequent dates, and (2) that the 409A value could be used for 12 months without an adjustment to meet the related Topic 718 fair value measurement objective.

Question 4:

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

As discussed in our response to Question 3, although practice is mixed, in our experience, many private companies do not obtain, for the same share value, separate valuations to satisfy the Topic 718 requirements and tax regulations. Regardless of which type of valuation a private company obtains, depending on how current the valuation is, the company typically adjusts the value for grants at dates other than the measurement date or obtains more frequent valuations to meet the Topic 718 fair value measurement objective.

Question 5:

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

We agree with allowing the proposed practical expedient to be elected on an award-by-award basis. However, we believe the award-by-award basis wording in paragraph 718-10-30-20C may be unclear in

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relation to the Board's intent as it is drafted. Paragraph 718-10-30-20C could be interpreted to require that for *every* grant of awards (i.e. on an award-by-award basis), the company is required to obtain a 409A valuation under the Treasury Regulations, which is not what we believe the Board intended. We believe to avoid this unintended interpretation, the Board should explicitly state that applying the practical expedient, not obtaining a valuation, is elected on an award-by-award basis.

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.

In general, we do not believe the proposed practical expedient would compromise the decision usefulness of information related to equity-classified share-option awards. However, it could result in a lack of comparability both within companies (i.e. being able to use a 409A value as an input for some share option award valuations and not others or for share option awards but not restricted share awards) and between companies (i.e., some companies using a 409A value as an input for their share option valuations and other companies using a Topic 718 valuation methodology). As a result, when applying the practical expedient under the proposed ASU, we believe that companies should disclose which awards they valued using the practical expedient and which they valued without using the practical expedient to enhance the decision usefulness of the information.

Question 7:

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

We agree that a private company that elects the practical expedient should apply it prospectively for new awards and for modifications of existing awards.

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