STOUT

October 1, 2020

Ms. Hillary H. Salo
Technical Director
File Reference No. 2020-200
FASB
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Re: Proposed Accounting Standards Update
Compensation—Stock Compensation (Topic 718) (File Reference No. 2020-200)

Dear Ms. Salo:

Stout Risius Ross, LLC ("Stout") is pleased to submit the following response to the Financial Accounting Standards Board ("FASB" or the "Board") related to the *Proposed Accounting Standards 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)* (the "Update").

Stout is a global advisory firm whose core service lines are Investment Banking; Transaction Advisory; Valuation Advisory; Disputes, Compliance, & Investigations; and Management Consulting. We serve a range of clients, from Fortune 100 corporations to privately held companies in numerous industries around the world.

Stout's Valuation Advisory group, one of the largest valuation practices in the country, provides specialized expertise across a broad spectrum of industries. Clients come to us for purposes such as financial reporting, corporate tax planning and compliance, trust and estate tax reporting, shareholder and succession planning, and litigation matters. Additionally, we provide Technical Accounting Consulting services on a wide range of accounting topics, including business combinations; complex securities, including stock-based compensation; consolidations; revenue recognition; and lease accounting.

We appreciate the opportunity to submit the following comments on the Exposure Draft. Please direct any follow-up questions to Ryan Gandre at (312) 752-3318 or rgandre@stout.com.

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Prior to responding to the specific questions posed in the Update, we wish to make a few observations. The overall proposal contained within the Update is, on the surface, perfectly reasonable and practical. If a reporting entity is already commissioning a valuation for one purpose (e.g., Section 409A), that same valuation should be applicable for other purposes (e.g., Topic 718). Interestingly, we find that within our own client base, requests for proposals from one company or another may emphasize one purpose over the other. That is, "we need a 409A valuation" or "we need a valuation to satisfy our auditors' requirements." Notwithstanding our clients' emphasis, our valuations are prepared with the intention of meeting the needs of <u>both</u> constituencies.

The following statement is made several times within the Update:

> *…the PCC received feedback that the current share price input is typically the most difficult input for private companies to estimate and substantiate to their auditors, primarily because of the lack of observable prices for private company equity shares.*

Utilizing a Section 409A valuation for Topic 718 purposes does not change the estimation difficulty, nor the lack of observable prices. Thus, what remains in the statement above is audit substantiation. It seems as though the objective of the Update, as written, is to provide a "safe harbor" through the practical expedient—if a Section 409A valuation is good enough for the IRS, then it should be good enough for private company accounting.

We are surprised to hear that the PCC received feedback that entities are obtaining two separate valuations, one for Section 409A and one for Topic 718—although the Alternative View clarifies that it is common for preparers to obtain only one valuation for both GAAP and tax purposes. While we cannot speak to all valuation providers, it is certainly our best practice that valuations intended to satisfy Section 409A should also satisfy Topic 718. In fact, the only reason we can imagine that an entity would obtain two separate valuations is that the Section 409A valuation was not prepared with sufficient diligence, care, and quality to stand up to financial statement audit, and therefore a second report was required.

This view is supported by the statement in BC23 that valuation methods that are compliant for Topic 718 are generally more robust than those performed or obtained to satisfy Section 409A—which, for clarity, we would suggest instead that valuations performed by professionals that primarily focus on Section 409A tend to be less robust than valuations performed by professionals that primarily focus on financial reporting-oriented valuations, in no small part due to the rigor of engaging in audit reviews.

We infer that the auditability of the valuation report is a major underlying issue. Put plainly, is it the FASB's view that the presumption of reasonableness extends to auditing the Section 409A valuation? Can auditors rely on the third-party specialist with lesser procedures as a result of the Update? We again reference Ms. Botosan's Alternative View, where she notes that various members of the AICPA with whom she spoke indicated that the Update would not, in fact, provide a "safe harbor" from the need to undertake audit procedures. Moreover, the presumption of a "safe harbor" seems to be moving in the opposite direction of the Public Company Accounting Oversight Board's ("PCAOB") recent amendments to AS 2501 (recognizing that the Update is intended only for nonpublic entities).

Therefore, if there is not to be a change in audit procedures, but audit substantiation is what is driving multiple valuations in certain cases and/or additional cost, what does that leave us with?

First, it would seem to us that, in part, the Update is simply codifying current practice in which entities engage a reputable valuation firm to perform a valuation for both tax and GAAP purposes rather than eliminating the need to procure two valuations as suggested by BC21, item (a). While we applaud convergence, unless and until the audit community modifies its testing procedures related to the share price input, we are not convinced that the Update will meet its intended objective.

Second, the "grant-date fair value" requirement in Topic 718 differs from the "12 months preceding the grant date" requirement in Section 409A. As we see it, eliminating the requirement for multiple valuations within a year for a nonpublic entity can be a real and meaningful cost reduction for nonpublic entities, provided they are not "grossly unreasonable" due to changes in the business during that period as outlined in BC21, item (b).

Thus, FASB could achieve the same outcome through a practical expedient that simply provides for the share price input to be prepared within the 12 months preceding the grant date rather than as of the grant date specifically, subject to an interim trigger-based assessment that an "up-to-12-month-old" valuation would not have been materially different as of the grant date.

This alternative practical expedient would also align with the goodwill impairment testing framework under Topic 350. To this end, while the unit of account and certain other valuation assumptions are viewed differently under Topic 718 and Topic 350, many of our private clients engage us one time during a fiscal year to perform a series of valuations on the same valuation date that maximizes efficiency through performing a Section 409A, Topic 718, and Topic 350 test contemporaneously.

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

Perhaps. On the surface, the Update is perfectly reasonable and practical. In particular, the ability to utilize a valuation for up to 12 months for grant dates throughout a year, assuming no significant changes have occurred in the underlying business over that timeframe, would be an improvement to the "grant date fair value" in current GAAP.

However, we question the operability of utilizing only a Section 409A report that may be "less robust" than a valuation report prepared to meet the requirements of Topic 718. Unless changes are made to the audit procedures of the share price input, the Update would likely not provide the intended benefits.

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.

Options are generally fair valued through valuation models that include the current share price as an input, whereas the fair value of nonvested shares is measured directly based on the grant-date fair value. If a 409A valuation is deemed acceptable to be used as an input for an option grant, it should likewise be acceptable for the fair value of a nonvested share.

To illustrate, as currently proposed, a plain-vanilla share option with an exercise price of $0.01 after a three-year service vesting period would qualify for the practical expedient, while a nonvested share that vests after the same three-year service period would not. While these instruments are different in form, they are very similar in terms of underlying structure and economics. If the practical expedient cannot be applied to the nonvested shares, companies must determine share prices in other ways – perpetuating the challenges in determining share price that the Update attempts to alleviate.

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 earlier comments, unless changes are made to the audit procedures of the share price input (i.e., allowing a Section 409A report to be taken at face value), we do not believe that there will be a significant reduction in audit costs or related fees. Moreover, for entities already using what we view to be best practice (engaging a valuation provider for both Section 409A and Topic 718 conclusions at the same time), there would be minimal if any cost savings.

There would, however, be a cost benefit for preparers that currently commission multiple valuations throughout a given year to coincide with particular grant dates.

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

We defer to other respondents, but we reiterate that a common best practice is to obtain a single valuation for both purposes.

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

As noted in Question #2, the practical expedient is meant to alleviate the use of alternative procedures for different awards. If a company selects different valuation methodologies for different awards, then there is an opportunity for manipulation by supporting some awards with a Section 409A valuation and computing fair values of others based on different valuations. There is already such a narrow range for applicable instruments, the only reason we could support the award-by-award measurement election would be if a Section 409A valuation was not received in the preceding 12-month period. A prudent private company would align valuation work with annual intervals to support several recurring valuation needs. As such, consistently applying valuation methodologies through an accounting policy would be preferable to award-by-award measurement decisions. If the award-by-award framework prevails, disclosure requirements should be sufficiently detailed to allow the reader of the financial statements to understand the methodology at the same level.

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.

From the perspective of financial statement users, decision usefulness is predicated on accuracy and materiality. If the information is materially accurate, it is decision useful, and vice versa.

The IRS threshold is anchored on reasonableness (which we can interpret as a proxy for accuracy) whereas the GAAP threshold is based on materiality. Although it is expected that these concepts align, there is the potential for divergence:

		409A	
		Reasonable	Not Reasonable
GAAP	Materially Accurate	Goal of the practical expedient. A Section 409A valuation was used and the results were materially accurate.	This would mean that although a Section 409A valuation was not performed, other procedures were done to satisfy GAAP. This is outside the scope of the practical expedient.
	Not Materially Accurate	Although a valuation can be reasonable, there is the potential for a disconnect with materiality.	If a Section 409A valuation was not performed (or not performed according to best practice), the company's financial statements would be inaccurate. This is outside the scope of the practical expedient.

Under GAAP, materiality is defined as "[t]he omission or misstatement of an item in a financial report is material if, in light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item." The concept of "reasonable" does not consider the impact on the overall financial statements as "material" does. For example, a difference of $1 in share price is perhaps reasonable, but extrapolation over 100,000 options granted may yield a material difference in the financial statements of a company.

Although the concepts are generally aligned, our response here is one of caution. Again, referring to the response to Question #1, if audit procedures take Section 409A reports at face value without additional consideration of materiality, the decision usefulness could be compromised.

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

Prospective transition seems like the appropriate adoption method as a full retrospective application would cause a significant amount of time and effort, especially if the historical financial statements were audited and determined to be reasonable/materially accurate. Similarly, a modified retrospective adoption would hinder the benefits of the new practical expedient. As such, the prospective transition seems the most appropriate transition method.

The key consideration here would again be related to disclosures: conveying to the reader the method of computing fair value. These disclosures are most often limited to the inputs to the selected pricing model. Robust disclosures should also be made regarding the share value computation methods, which will allow the reader to better identify the timing and impact of any changes in such methods.

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We appreciate the opportunity to comment on this topic and look forward to reviewing the comments received by the FASB.

Sincerely,

Stout Risius Ross, LLC

STOUT RISIUS ROSS, LLC