FINANCIAL ACCOUNTING STANDARDS BOARD

| | | |
|---|---|---|
| **MEMO** | Memo No. | **6** |
| | Issue Date | **March 22, 2019** |
| | Meeting Date(s) | **April 1-2, 2019** |



| | | | |
|---|---|---|---|
| Contact(s) | **Christopher Roberge** | Senior Project Manager/ Project Lead | (203) 956-5274 |
| | **Darien Williams** | Postgraduate Technical Assistant | (203) 956-3462 |
| | **Rebecca Harris** | Postgraduate Technical Assistant | (203) 956-5376 |



| | |
|---|---|
| Project | **PCC Issue No.18-01, "Practical Expedient to Measuring Grant-Date Fair Value for Equity-Classified Share-Based Payments"** |
| Project Stage | **Initial Deliberations** |
| Date previously discussed by PCC | **December 11, 2018** |
| Previously distributed Memo Number | **Memo No. 5 – Share-Based Payments: Agenda Decision** |

## Memo Purpose

1. The purpose of this memo is to provide the Private Company Council (PCC) with analysis of and recommended next steps for PCC Issue No. 18-01, "Practical Expedient to Measuring Grant-Date Fair Value for Equity-Classified Share-Based Payments." This memo will be used at the April 2019 PCC meeting to obtain additional information from the PCC about private company share-based payment awards. Moreover, this memo specifies additional outreach that the staff believes is needed to further develop the practical expedient. See Appendix A to this memo for specific items/questions to be discussed.

## Background

2. Since 2013, the accounting for share-based compensation (SBC) awards has been discussed by the PCC on several occasions and extensive outreach has been performed with different stakeholder types to determine whether the accounting for these awards could be simplified for private companies. PCC members raised concerns that the permitted methods for valuing SBC awards using option-pricing models are significantly more difficult to apply for private company

awards than for public business entity awards. Specifically, private companies have asserted that because of the lack of active markets/prices for private company equity shares, determining the current price of a private company's equity shares at grant date (which is a required input to an option-pricing model for purposes of determining grant-date fair value of an award) may be costly and complex. The staff's understanding is that practice typically requires a complex valuation to be completed in accordance with generally accepted accounting principles (GAAP) to determine the current price of the underlying shares.

3. Certain alternatives to simplify SBC accounting for private companies have been considered since 2013 but were ultimately rejected because the alternatives:
   a. Resulted in significantly different grant-date fair value amounts when compared to existing GAAP
   b. Did not simplify the application of the existing guidance
   c. Compromised the decision-usefulness of SBC information.

4. During 2018, the staff performed research and significant outreach with valuation experts, legal experts, and tax experts about the potential for a practical expedient for determining the current price of the underlying share in an SBC award for purposes of determining grant-date fair value. Broadly, this practical expedient (the PE) would allow private companies to use the exercise price of the underlying share as the current price if the related SBC award is not in the money at the grant date. Based on the staff's initial research, the PCC, at its December 11, 2018 meeting, unanimously voted in favor of adding a project to the PCC's agenda to consider a PE for private companies. The PCC requested that the staff continue to research and refine the language of the PE and provide analysis and alternatives on specific issues to be discussed at the April 2, 2019 PCC meeting.

5. In determining whether to develop a **practical expedient** as opposed to an **accounting alternative**, the PCC and the Board considered the guidance in the *Private Company Decision-Making Framework: A Guide for Evaluating Financial Accounting and Reporting for Private Companies* (PCDMF or the Guide). Specifically, the Guide acknowledges two possibilities for recognition and measurement differences between private companies and public companies: a private company accounting alternative and a practical expedient. As indicated in paragraph 1.3 of the Guide, an alternative is a different method for recognizing or measuring a transaction or event, whereas a practical expedient is "a more cost-effective way of achieving the same or a similar accounting or reporting objective."

6. Paragraphs 1.1 – 1.4 of the Guide provide guidance on determining whether a private company practical expedient or an accounting alternative is warranted. First, the PCC and the Board must consider the relevance of the information. If the information is relevant to the users of private company financial statements, then a practical expedient should be used to lower the cost and

complexity of applying the guidance. If the information is not relevant or if it is relevant but costly and no practical expedient is available, *only then* should the PCC and the Board consider an accounting alternative for recognition and measurement. Note that the Guide helps to determine *whether* an accounting alternative may be necessary in lieu of a practical expedient, not *what* that accounting alternative should be.

7. The FASB staff's research and outreach with users of private company financial statements in 2013 through 2014 and 2018 indicates that share-based payment expense information is relevant to users of private company financial statements. Consequently, the Guide would support considering a practical expedient that would achieve the same objective as the current guidance. Per paragraph 718-10-30-6, "The measurement objective for equity instruments awarded to employees is to estimate the fair value at the grant date of the equity instruments that the entity is obligated to issue [when the conditions are met]."[1] Thus, it was concluded that to measure the grant-date fair value of an award, a practical expedient (as opposed to an accounting alternative) should be developed.

## Analysis and Recommended Next Steps

*Analysis*

8. Determining the appropriate language for the PE is critical if practice is to apply and audit the PE and obtain sufficient comfort that the SBC awards are not in the money at grant date. The staff developed the following preliminary language as a starting point for the PE. The staff would like to point out that the language for management assertions that awards are not in the money at grant date or factors to consider to substantiate the assertion are not yet included. This is because the staff believes that further research is needed to properly establish this critical part of the expedient (see discussion below):

> In situations in which the current price of the underlying share (see paragraph 718-10-55-21(c)) is not readily observable at the grant date of an employee share-based payment award, a private company may, as a practical expedient, use the exercise price of the underlying share as its current price for purposes of determining the grant-date fair value of an award that is classified as equity in accordance with paragraphs 718-10-25-6 through 25-19A. The practical expedient shall not be applied if the award is in the money at the grant date.

9. Without providing additional guidance for determining whether an SBC award is in the money at the grant date, the PE would solely rely on the premise that companies are naturally governed by

[1] Once Accounting Standards Update No. 2018-07, *Compensation—Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting*, is effective, this paragraph will be updated to apply to all grantees and not just employees. The measurement objective remains the same, however: "The measurement objective for equity instruments awarded to grantees is to estimate the fair value at the grant date of the equity instruments that the entity is obligated to issue [when the conditions are met]."

external factors incentivizing private companies to not issue in-the-money awards. Those governing factors include:

a. The existence of Internal Revenue Code (IRC) Section 409A, which regulates taxation of nonqualified deferred compensation and is applicable to awards issued to employees (including the board of directors). Generally, if options are issued in-the-money, the option becomes subject to IRC 409A taxation, which includes a significant 20 percent penalty (plus interest) to the employee receiving the award. Previous outreach indicated that IRC 409A may serve as a deterrent to issuing in-the-money awards because the primary purpose of such compensation is to incentivize employees; having additional IRC 409A taxes levied on an employee's compensation runs counter to that objective.

b. The premise that employers are dissuaded from issuing in-the-money awards because of the dilutive effect on existing shareholders.

10. Relying on those governing factors alone may not be acceptable. In other words, merely presuming, absent other evidence that the awards are not in the money, will not be sufficient for developing a PE. The staff considered whether requiring private companies to provide an assertion that awards are not issued in the money would be appropriate for substantiation. When considering whether to require an assertion, the staff noted that external governing factors, such as IRC 409A discussed in Issue 1, may deter, but not completely eliminate, the potential for issuance of awards that are in-the-money. Requiring that an assertion be made holds management accountable and could be considered evidence that they are putting forth an effort to demonstrate that an award that is not issued in the money should be afforded a PE. Furthermore, an assertion could possibly be supported by share price calculations that exist as of grant date, although such calculations will often not be as robust as a valuation performed in accordance with Topic 820, Fair Value Measurement.

11. Alternatively, requiring management to make an assertion without other supporting guidance could complicate a PE because documentation for the significant judgement about whether the award is in the money would be required to be made by preparers and subject to audit by practitioners. An obvious question will be how much effort needs to be expended by private companies to prove that awards are not in the money at grant date. Detailed guidance about how to determine whether awards are in the money, including a list of factors to consider, may be easier for practice to apply and would essentially remove a significant amount of judgment that otherwise would have been required. The detailed guidance developed would have to be easier to apply than a robust GAAP-compliant valuation for the PE to be cost-beneficial.

12. To determine whether an effective cost-beneficial PE can be developed, the staff believes that additional outreach and research are necessary. Insight into current processes and documentation about the development of exercise prices is needed, including the level of detail that goes into

setting those prices. Determining how much reliance is placed on IRC 409A valuations and other items related to IRC 409A is important. Given that even under an intrinsic value method that existed previously under APB Opinion No. 25, *Accounting for Stock Issued to Employees*, employers were required to determine fair value at grant date, it is important to understand what has changed in practice driving the need for a PE. These are just a few of the issues/questions that the staff needs to address to gain a better understanding of private company and auditor processes around the current price used for establishing grant-date fair value. A detailed list of items for which the staff believes additional outreach and education are needed is included within Appendix A. The items in Appendix A will serve as the basis for discussion at the April 2019 PCC meeting. Separately, the staff has been considering issues that would need to be addressed after this additional research is performed. For informational purposes, these issues are contained in Appendix B.

*Next Steps*

13. A PE, as opposed to an accounting alternative, is being developed. Therefore, the expedient should result in a recognition and measurement conclusion that results in the same or a similar accounting or reporting objective (existing GAAP). To achieve this, the staff thinks that additional outreach and education from the PCC and other stakeholders are necessary to sufficiently understand current processes, information available, and audit practices for determining whether SBC awards are not in the money at grant date. Along with discussing these items at the April PCC meeting, the staff thinks it may be beneficial to hold a roundtable/workshop with preparer and practitioner stakeholders of various sizes to ensure that the staff is sufficiently educated before developing the language for a PE and addressing ancillary issues. The discussion at the April PCC meeting will help the staff further refine the issues to be discussed at a roundtable/workshop.

# Appendix A – Outstanding Items Requiring Further Research

1. What is the process used by private companies to establish the exercise price of an SBC award? Is there a valuation? If so, how robust is the valuation?
2. Is the process and/or method for determining exercise price documented in legal documents (for example, the contract with the recipient) or Board minutes?
3. How often are IRC 409A valuations performed (for example, upon issuance of awards, annually, another date)?
4. How much reliance is placed on IRC 409A valuations for concluding that awards are not issued in the money?
5. What is the reason(s) for practitioners requiring a valuation performed in accordance with Topic 820 for determining the current price of the underlying share? Is the process and/or documentation provided by the private company not robust enough to substantiate the current price? If so, why?
6. When a private company elects the practical expedient in paragraph 718-10-30A for expected term, a requirement is that the award is granted at the money. How do private companies substantiate that awards are at the money for purposes of that practical expedient?
7. Opinion 25 (intrinsic value) required all entities to determine the fair value of the underlying share for determining the intrinsic value of an award at grant date. What has changed in practice that necessitates additional procedures be performed for determining the fair value of the underlying share?
8. What is the population of private companies that would need the expedient?
    - Would private companies that strive for a change in control/liquidity event (including the potential for an Initial Public Offering) want to apply a PE or, rather, perform a valuation that complies with Topic 820?
    - Companies that plan to remain private may provide employees with the ability to put their awards to the company at fair value upon a specified date(s). Alternatively, the employer may have the ability to call the shares at a specified date at fair value. This seemingly would require a valuation as of the liquidation date. Therefore, would these companies already have the sophistication to perform a valuation at grant date?

# Appendix B – Preliminary List of Issues to be Addressed

**Issue 1 – Scope of PE**

- Only equity-classified awards issued to employees as defined in Topic 718 (includes a company's Board of Directors)
- All equity-classified awards (employee and nonemployee)

**Issue 2 – Management assertion that award is not in the money**

- Should assertion be explicitly required by PE guidance?
- If yes, what level of effort is required of management to prove awards are not in the money? In other words, what documentation is sufficient to substantiate the assertion?
- Can definitive language representing the facts and circumstances necessary to substantiate that awards are not issued in the money be developed? If so, what are those facts and circumstances?

**Issue 3 – Application of PE: a broad policy election or on an award-by-award basis**

**Issue 4 – Awards issued near or at the same time**

- Should PE be allowed when multiple awards with the same underlying shares but different strike prices are issued near or at same time?
- If yes, which strike price would be used?
    - Highest (most conservative as price would seemingly be an out-of-the-money price)
    - Lowest (requires substantiation that lowest price is not in the money)

**Issue 5 – Disclosures**

- The fact that PE has been elected
- The number of awards issued during the year for which the PE has been applied
- Other?

**Issue 6 – Transition**

- Prospective
- Retrospective