FASB FINANCIAL ACCOUNTING STANDARDS BOARD

MEMO		Memo No.	**05**
		Issue Date	**November 30, 2018**
		Meeting Date(s)	**PCC December 11, 2018**

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Project	**PCC – Share-Based Payments**
Project Stage	**Private Company Pre-Agenda Research**
Issue(s)	**Agenda Decision**

Memo Purpose

1. The December 11, 2018 Private Company Council (PCC) meeting is a decision-making meeting. The PCC will decide whether to add a project on share-based payment accounting for private companies to the PCC technical agenda. If not, the PCC could also recommend that the FASB add a project to the FASB technical agenda. This memo provides the following:
   - A summary of pertinent background information relating to the history of the FASB's research project on share-based payment accounting and the area of that accounting stakeholders identified as especially problematic for private companies
   - An analysis to assist PCC and Board members in determining whether a project should be added to an agenda to make improvements to share-based payment accounting for private companies, and, if so, whether the project should be added to the PCC or the FASB agenda.
   - An analysis and discussion of a potential practical expedient that would provide relief to some private companies if a project is added to an agenda
   - Next steps.
2. If the PCC or the Board adds this project to its agenda, the staff will return to the PCC or the Board to address any follow-on technical issues generated from this meeting, recurring disclosure requirements, transition and transition disclosure, and an analysis of the benefits and costs of the changes.

Questions for the PCC
1. Does the PCC wish to add a project to its technical agenda to consider a practical expedient in measuring the fair value of equity-classified awards under Topic 718?
2. If not, does the PCC recommend that the Board add this project to its technical agenda?

Issue: Measuring grant-date fair value of equity-classified share-based awards

Background and History

3. Since 2013, the accounting for employee share-based compensation (SBC) awards has been discussed by the PCC on several occasions, and extensive outreach has been performed with many different types of stakeholders. PCC members have raised concerns that the permitted methods for valuing share-based awards maybe less appropriate for private company awards as compared to public company awards, or at least those methods present unique challenges to private companies due to their ownership structure.

4. The FASB staff performed outreach in 2013 and 2014 in response to the following developments: a pre-agenda research request from the PCC, Post-Implementation Review (PIR) report findings, and suggestions received in connection with the FASB's Simplification Initiative. The outreach involved multiple professionals from the same or different organizations. Stakeholders included 11 practitioners, 1 human resource consultant, 2 members of the TIC, 4 preparers, 12 financial statement users, and 12 FASB advisory group members (Small Business Advisory Committee [SBAC] and PCC).

5. Additional outreach with practitioners was performed in 2015 to understand their perspective on classifying all private company awards as liabilities, thus potentially measuring them at intrinsic value. Also, outreach was performed in early 2018 with four lenders and users of private company financial statements to assess relevance. In mid- to late-2018 the staff performed outreach with valuation experts, legal experts, and tax experts regarding a potential practical expedient.

Current Requirements under Generally Accepted Accounting Principles (GAAP)

6. Topic 718, Compensation—Stock Compensation, provides authoritative guidance on accounting for compensatory share-based awards, which must be classified as liabilities or equity. The focus of this paper and the research associated with this project are on equity-classified awards, which are initially measured at grant-date fair value (GDFV) and are not subsequently remeasured. Per paragraph 718-10-55-21, if an observable market price is not available for the equity-classified

award, the valuation or estimation of the award's value must take into account, among other things, the following:

1. The exercise price of the option
2. The expected term of the option
3. The current price of the underlying share
4. The expected volatility of the price of the underlying share for the expected term of the option
5. The expected dividends on the underlying share for the expected term of the option
6. The risk-free interest rate(s) for the expected term of the option.

7. While GDFV for equity-classified awards is required, Topic 718 expresses no preference for a lattice model or a closed-form model (for example, the Black-Scholes model) when estimating GDFV. However, for some awards, especially those with certain conditions (for example, vesting upon achieving a certain share price or rate of return on equity), entities may need to use a lattice model or other complex valuation approach (such as a Monte Carlo simulation) to appropriately value the award. While various option pricing models exist, the staff's outreach indicated that the Black-Scholes option pricing model is the most commonly used model by private companies in estimating the fair value of share-based payment awards under Topic 718 because it is generally considered to be the most straight-forward model to use while still providing a reasonable estimate of fair value.

8. Calculating the value of an award using the Black-Scholes model can be completed using online applications or using most stock compensation applications. The inputs to the Black-Scholes model and other models vary in degree of difficulty to estimate. Outreach has indicated that the risk-free interest rate, exercise price, and expected dividend rate are generally not costly to estimate. However, stakeholders have indicated that the following inputs required by Topic 718 can be costly to estimate:

- Expected stock price volatility
- Expected term of the option
- Price of the underlying share.

9. Current guidance provides private company practical expedients for expected volatility and expected term, but not for the underlying share price, which is generally the most costly and complex input to determine and audit.[1]

10. Volatility is an estimate of the amount that a share price is expected to fluctuate during a period. Public entities can observe the market price for their shares and utilize that history to develop an estimate of volatility. However, new public companies and private companies may not have sufficient history to make a reliable estimate. Therefore, the guidance now allows an entity to consider the volatility of similar public entities.[2] The Board also thought that it may be particularly difficult for a private company to obtain sufficient historical information or to identify similar public entities. Therefore, the Board concluded that if it is not practicable for a private company to estimate expected volatility, it can look to the historical volatility of an appropriate industry sector index (paragraph 718-10-55-55). Using this approach to calculate volatility as part of determining the fair value of an option is referred to as the calculated value method.

11. The expected term is an estimate of the period of time that the share-based award is expected to be outstanding (that is, from grant date to the date that the option is exercised). The expected term cannot be longer than the contractual term of the award (that is, the date on which the award expires and the option can no longer be exercised) and cannot be shorter than the vesting period (that is, the date on which the employee can exercise the award). Topic 718 requires that the entity consider the historical exercise behavior, post-vesting termination behavior, stock price, and employee demographics when developing an estimate of expected term. The outreach conducted by the FASB staff in 2013 indicated that estimating the expected term is difficult for private companies because they may not have sufficient history to develop an estimate. For example, the company may be fairly new, may not grant many awards, or may never have granted awards. In response to such concerns, the FASB provided nonpublic entities with a practical expedient to use in determining the expected term of awards under Accounting Standards Update No. 2016-09, *Compensation—Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting*.[3] For example, an entity may estimate the expected term of an award by taking the midpoint between the vesting date and the contractual term when that award is only dependent on a service condition. Other expedients in determining an expected term have also been extended to awards with performance conditions under certain circumstances.

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[1] Many companies estimate the underlying share price for tax purposes, even absent financial reporting requirements. Tax requirements are addressed below.
[2] As detailed in paragraphs 718-10-30-20 and 718-10-55-51 through 55-58.
[3] These amendments are codified in paragraphs 718-10-55-50A and 718-10-30-20A through 30-20B.

Private Company Decision-Making Framework

12. The *Private Company Decision-Making Framework: A Guide for Evaluating Financial Accounting and Reporting for Private Companies* (PCDMF or 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. 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," per paragraph 1.3 of the Guide.

13. 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** may 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.

14. The FASB staff's research and outreach with users of private company financial statements in 2013 through 2014 and 2018, as well as the input the FASB received from the PIR report 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]."[4] Thus, any expedient must still attempt to measure the GDFV of the award. The following sections provide a summary of the PCC and staff outreach with private company stakeholders regarding the relevance of SBC information, the costs of providing SBC information, and the potential alternatives and practical expedients that have been explored to date.

Relevance of information to users of private company financial statements

15. Over the past several years, the PCC and FASB staff have conducted research and performed outreach with stakeholders to understand the relevance of SBC information to users of private

[4] 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]."

company financial statements. According to Chapter 3 of FASB Concepts Statement No. 8, *Conceptual Framework for Financial Reporting*, relevance is one of the fundamental qualitative characteristics of useful financial information. Paragraph QC6 states, "Relevant financial information is capable of making a difference in the decisions made by users. Information may be capable of making a difference in a decision even if some users choose not to take advantage of it or already are aware of it from other sources."

Relevance: 2013-2014 Outreach

16. On August 19, 2014, the Financial Accounting Foundation (FAF) issued its PIR report on FASB Statement No. 123 (revised 2004), *Accounting for Stock-Based Compensation*. The PIR team concluded that Statement 123(R) achieved its expected benefit because the standard resolved the issues that led to its issuance and generally provided users with decision-useful information. The report also noted that it is costlier (more difficult) for private companies to apply in comparison to public business entities (PBEs). Higher costs for private companies were attributed to the complexity of the awards granted, the valuation of underlying shares, and a lack of internal expertise to comply with the requirements.

17. FASB staff performed outreach in the spring of 2013 with five users of private company financial statements (mostly lenders). Those five users were asked about, among other things, the relevance of share-based payment compensation expense for equity-classified awards. Two of the five users noted that the guidance provided relevant information for equity-classified awards. A third user was not sure whether the expense for equity-classified awards should be recognized in the income statement. The other two users did not agree that compensation expense should be recognized for equity-classified awards that cannot be settled in cash, particularly if the option holder will only be paid if a liquidity event occurs. The FASB staff observes, however, that under current guidance, the expense for many awards with a performance condition related to a liquidity event is not recognized until the liquidity event occurs.

18. During 2014, the FASB staff conducted additional private company outreach with three private equity firms, two due diligence professionals, and two debt rating agencies. The feedback provided was mixed.

19. The private equity representatives said that estimating and recognizing expense on the basis of an option pricing model did not provide relevant information. While all the private equity representatives said that equity compensation is an important aspect of incentivizing management, their estimation of the awards' value is not necessarily consistent with GAAP's fair value measurement. The three private equity firms all had different views of share-based compensation, how they estimate its value, and when they choose to recognize it.

20. According to the two firms that provide financial due diligence, share-based compensation is generally excluded from “normalized EBITDA” for the purposes of considering a purchase price. However, the amount of share-based compensation is highlighted to the client as an item to consider if the SBC is disproportionately high and may require increased cash compensation in the future. A human resource consultant noted that, frequently, when a private equity firm acquires a private entity that had previously granted awards to a broad employee base, the firm is likely to replace those options with a profit-sharing type of arrangement for most non-executive employees.[5]

21. The staff discussed the relevance of share-based compensation with two debt rating agencies that provide debt ratings for public and private entities. The representatives from both agencies stated that share-based compensation should be recognized in operating results, and they use that information in their comparative analysis of profitability. A private entity is more likely to have its debt rated as it increases in size and requires access to broader capital markets (for example, a syndicated loan). However, because of proprietary information, the staff was unable to obtain statistics on the number of private entities that obtain a debt rating from the two firms participating in its outreach.

22. The staff learned that bank lenders often rely on credit risk software offered by the rating agencies when making lending decisions about private companies. For example, Moody’s offers financial institutions a private company probability of default software tool called RiskCalc™, which incorporates share-based compensation and other key data points into the software. Over 800 financial institutions use RiskCalc™, very few of which have total assets of $3 billion or less. Financial institutions with more than $10 billion in assets hold 88 percent of industry assets (link). Therefore, the staff thinks that a majority of private companies with complex share-based payment arrangements would not be borrowing exclusively from financial institutions with less than $3 billion in assets. The staff thinks many lenders to private companies not funded by private equity groups (PEGs) or venture capital (VC) funds rely on RiskCalc or something similar.

23. Based on the results of the 2013-2014 FASB staff’s research and outreach with users of private company financial statements and based on the input the FASB received from the PIR report, the FASB staff believes that share-based payment expense provides relevant information to users of private company financial statements because the information is capable of making a difference in the users’ decisions.

[5] The staff believes that it is not uncommon for private companies to issue SBC awards to incentivize their employees. This is especially the case for awards given to high-level and key employees, as well as in start-up companies when cash is limited. Due to the difficulty in identifying such individuals, the research conducted into the relevance of SBC information has not targeted members of this potential user group.

Relevance: 2018 Outreach

24. At the April 2018 PCC meeting, the PCC requested that the FASB staff perform additional outreach with users of private company financial statements regarding the relevance of SBC recognition, measurement, and disclosures currently required under GAAP. The staff, in conjunction with the PCC Share-based Payment (SBP) Award Working Group[6] (Working Group), developed a list of 16 questions to ask stakeholders during outreach. The first nine questions were aimed at ensuring the outreach participant fits the profile sought by the FASB and PCC, while the remaining seven questions were drafted to obtain a better understanding of how the participants view SBP. These questions are included in Appendix A to this memo.

25. Given the outreach performed since 2013 with a variety of stakeholders, the PCC determined that it was best to narrow the focus to lenders to private companies that deal with SBC. The staff was able to conduct outreach with four lending organizations familiar with SBC that primarily lend to PEGs or VC portfolio companies. Each participant uses financial statements for making credit extension and lending decisions with respect to private companies. All four participants saw SBC in almost every private company deal. The focus of the outreach with these users was strictly *employee* share-based compensation.

26. All four participants expressed the importance of financial statements prepared using FASB guidance as a crucial “starting point” or “foundation” to begin their analyses. A financial report prepared in accordance with GAAP is viewed as a common baseline from which each firm can make adjustments for its own analysis and proprietary models. One participant pointed out that if a company under consideration uses a cash-basis or other framework, he will usually hire a third party to convert the financial statements to GAAP. All acknowledged that they generally have some level of access to management.

27. All four participants stated that they do not use RiskCalc™ or any similar externally supported tools as part of their analysis because they have staff and analysts who use internal models, data, and assumptions to make similar risk assessments. In general, the participants indicated that they are the direct users of the financial statements and do not rely heavily on third-party tools to synthesize the financial information they receive to inform their decision-making.

28. The outreach participants explained that they see a variety of SBC arrangements in practice, but the main instruments their clients issue are options, and to a lesser extent, shares of equity. In all cases, however, these SBC instruments were junior to the credit the lenders extend. In the experience of these lenders, vesting conditions for these instruments (again, primarily options) almost always included performance conditions, and often included service (time) conditions as

[6] Composed of PCC Chair Candy Wright; PCC members Tim Curt, Rick Reisig, David Lomax, and David Hirsch.

well. In most cases, option holders cannot exercise their options or cash out their shares until a liquidity event or exit occurs, such as an IPO or funding round.

29. Stakeholders generally indicated that SBC information is relevant to their analyses. Two users were somewhat neutral regarding SBC information with a slight leaning toward current accounting, while the other two users specifically identified SBC at its current measurement of GDFV as being relevant and important to their decision-making processes. Furthermore, the stakeholders explained that the SBC information presented in the financial statements is seen as an indicator; the extent of imprecision is known and expected, but the amount presented is assumed to be a reasonable estimate that is useful for making credit extension and lending decisions.

30. All four outreach participants noted that adjusted EBITDA was the main metric used in their analyses. As lenders, they explained that they are concerned with cash flows and ensuring that outstanding debt can be repaid, and EBITDA provides a good starting point for estimating cash flows. Each participant explained that SBC is almost always added back to EBITDA to arrive at adjusted EBITDA because SBC is a non-cash expense. However, three of the four users specifically noted that while they do add this SBC number back, they still look at SBC, even if only briefly. One user stated that share-based compensation is usually a relatively small number anyway, so it "won't move the needle on [their] evaluation." Other users shared similar sentiments.

31. While SBC is generally backed out, the amount expensed provides users with an idea of the significance of SBC at a private company. For the most part, SBC expense is not a significant part of these users' analysis, but it appears that the information is especially useful when SBC becomes worthless and/or when there is a change in management. The staff interprets this to mean that these users find the information relevant per the conceptual framework definition.

Cost and Complexity of Current GAAP

32. The outreach performed to date and the feedback received from the PCC indicates that valuing the underlying share for purposes of estimating the value of the share-based award is generally costly and requires an independent third-party valuation. Much of the cost is geared toward obtaining a precise value; as user outreach on relevance has shown, such precision is unnecessary for it to still be relevant to users of private company financial statements. To the extent an estimate of share value is also used for tax purposes, however, the incremental financial reporting cost may be mitigated.

Do private companies need further education or clarification of current requirements under GAAP?

33. No. Private company preparers are aware of the current requirements and generally comply with GAAP at a significant cost. Private company practitioners have confirmed this. Users of private

company financial statements generally understand what the information and measurements represent and appear to need no clarification of the current requirements.

Pervasiveness of Issue

34. The requirements under Topic 718 apply to all companies issuing share-based awards, including private companies. Based on feedback received, the staff believes that it is not uncommon for private companies to issue share-based compensation to incentivize their employees. This is especially the case for awards given to high-level and key employees, as well as in start-up companies when cash is limited. While all industries are affected, private companies that are funded by PEGs or VC firms are most affected.

35. While Topic 718 does apply to public companies, the cost and complexity associated with estimating the underlying share price generally does not affect *public entities*, which includes companies with publicly-traded stock. For a company with publicly-traded stock issuing options on its own common stock, this is a straight-forward exercise—the company can simply use the share price on the date the option is granted. Private companies, and public business entities whose stock is not publicly-traded on an established securities market, find this determination to be substantially more difficult. These entities are considered *nonpublic entities* throughout Topic 718 and are currently within the scope of the expected term and historical volatility expedients. Public business entities whose stock is not publicly-traded on an established securities market may face similar challenges as private companies when applying Topic 718 to equity-classified share-based awards. The staff has not received feedback that this issue applies to not-for-profit entities or employee benefit plans.

Previous Consideration by the PCC and the Board

36. Over the past several years, the PCC has considered, researched, and performed outreach on several alternatives and expedients, as explained below.

2014-2015 Alternatives and Expedients

37. At the April 28, 2014 PCC meeting, the PCC requested that the staff perform additional research on the following two alternatives:

    - Alternative 1 (practical expedient): Use the last observable transaction price as the estimate of the per share value
    - Alternative 2 (accounting alternative): Determine compensation expense as the difference between the last observable transaction price and the exercise price (intrinsic

value). That calculation is updated through the settlement date in periods in which there is an observable transaction price.

38. The staff conducted outreach with representatives of two debt rating agencies. Those users were not supportive of either alternative. Alternative 1, a practical expedient, raised concerns because the value of the share used to determine the value of the award may be quite stale and not close to current fair value. Events may have occurred since the last transaction that would have a significant effect on the value. They also were concerned that if the fair value changed significantly, they would have no ability to adjust for the difference. With Alternative 2, a true accounting alternative, the volatility of the expense concerned users because the catch-up adjustments in periods in which there is an observable transaction price would create more volatility. They noted that the volatility may not reflect current economic reality (that is, a current period change in value). One representative commented that if the entity does not assess the fair value of the underlying share, it is difficult to understand how the entity determined how many options to grant and at what exercise price

39. On February 13, 2015, the PCC directed the staff to research other measurement alternatives (in addition to the two alternatives in paragraph 37 above) based on the following:

> Proposed PCC Alternative: all share-based payment awards would be classified as liabilities and measured at intrinsic settlement value, which would be a new concept in GAAP. Intrinsic settlement value would permit a private company to use a pay-out formula in the award, in lieu of the fair value of a private company, when calculating the intrinsic value of an award. The use of a formula is permitted unless another settlement value is probable. If no formula exists within the award, the fair value of the private company would be used to calculate intrinsic value.

40. When asked about this proposed accounting alternative, all practitioners with whom the staff spoke stated that they did not think their clients would elect an alternative that would require all awards to be liability-classified. The practitioners also were concerned that the additional liability could affect their client's existing debt covenants. In addition, the practitioners noted that most private companies did not design their awards in order to obtain a desired financial reporting result nor did they consult their auditors prior to granting those awards. Those practitioners stated that regardless of the alternative implemented, the use of formulas would remain uncommon in practice, and a private company would still have to determine the fair value of the underlying share.

41. Based on its research and outreach, the staff identified the following concerns with the alternatives and expedient considered:

- It appears that most equity-classified awards are granted in a separate class of share from the classes of equity used to raise capital and, therefore, observable transactions would be infrequent for comparable shares.

- Intrinsic value is currently not allowed for equity-classified awards and would not be considered a practical expedient because it would change the approach to recognition and measurement.
- Many entities already perform a valuation to prove that an option was not granted in-the-money to avoid potential tax consequences and, therefore, these entities would likely have to do additional valuation work if applying one of the two accounting alternatives.

42. The PCC concluded that, consistent with the results of the PIR report, share-based compensation expense provides relevant information to the primary users of private company financial statements. Therefore, the Guide would not indicate that a recognition or measurement alternative is appropriate. Furthermore, outreach indicated that with the suggested expedient, the marginal reduction in costs would not justify the reduction in benefits, that is, the decreased usefulness of the information.

2018 Alternative and Expedients

43. In April 2018, the Working Group proposed a potential practical expedient and a potential alternative for measuring an equity-classified award:
    - Alternative A (practical expedient): Measure GDFV of the award by determining **the fair value of the services received** as a proxy for the fair value of the equity-classified awards being granted. For example, if an employee accepts a stock option award plus a $50,000 salary but another employee in the same role or function has an $80,000 salary without a stock option award, then the FV of the award will be deemed $30,000 as a practical expedient, instead of directly estimating the value of the award with an option pricing model.
    - Alternative B (accounting alternative): **Use the intrinsic value of the award at grant date** to determine total compensation cost to be recognized over the expected term. For this alternative, *intrinsic value* will be defined in the same way it is defined in the Master Glossary as "the amount by which the fair value of the underlying stock exceeds the exercise price of an option."

44. Members of the Working Group and the FASB staff indicated that Alternative A, the practical expedient, may often be a reliable estimate of fair value in theory. According to the Master Glossary of the Codification, fair value is "the amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties…." In the case of share-based compensation, one party is accepting the share-based compensation as a form of consideration in an arm's length transaction. The fair value of the services rendered should be the same as the fair value of the compensation, and vice versa.

45. However, Alternative A may not provide relief in certain circumstances in practice and, if used inappropriately, may result in more inaccurate or misleading information than using a current model. Almost anyone in an executive management position provides unique value in their services, and reaching a reasonable range, much less a point estimate, of the value of their services is nearly impossible. Feedback from the Working Group indicates that equity-classified awards in VC- and PEG-backed private companies are granted most often to those senior management positions, rendering the practical expedient less useful. However, for other awards used as compensation for other types of employees, this practical expedient would likely provide substantial relief in a cost-effective manner. Overall, the PCC rejected Alternative A as a practical expedient because it would not sufficiently reduce cost and complexity; rather, it would reduce cost and complexity for valuing the underlying share price while potentially increasing cost and complexity in the overall measurement of share-based awards.

46. Alternative B is a true accounting alternative because it abandons the stated objective for measuring share-based awards—not simply reducing costs for an input. If the PCC and the Board were to find that intrinsic value is relevant to users of private company financial statements, this alternative would be much less complex than current practice because the fair value of the option itself would not need to be measured. While the other costs of determining the fair value of the award would also be eliminated, the underlying shares would still be valued, which, as stated previously, is the costliest aspect of measuring share-based awards.

47. Proponents who support Alternative B often align with the views expressed in Accounting Principles Board Opinion 25, *Accounting for Stock Issued to Employees*, which used intrinsic value to measure SBC. APB 25, along with its basis for conclusions and dissent paragraphs, provides insight into the pros and cons of intrinsic value measurement. APB 25, paragraph 10(a), suggests that the right to receive stock in the future has value primarily stemming from the value of the stock (intrinsic value), but that other factors can also affect value, "some of which tend to diminish its value and some of which tend to enhance it…. The effects of the opposing factors are difficult to measure, and a practical solution is to rely on quoted market price to measure compensation cost…." Thus, APB 25 assumes that other factors that affect the value of the award essentially net to something close to zero, and that intrinsic value of the award can be a close (enough) proxy for fair value of the award.

48. APB 25 also contains information on the dissenting views of the Opinion. Mr. Bows, a member of the APB at the time, dissented from the opinion claiming that intrinsic value is not a proxy for fair value because the value of the other rights and opposing factors do not net to zero and because intrinsic value will often result in no compensation expense:

> Mr. Bows also believes the Opinion [APB 25] is inequitable because grants made under many plans will not result in recognition of compensation costs under this Opinion [APB 25] even though such grants convey valuable rights to officers and employees at the date of

> grant…. He also believes that techniques are available to develop the information needed to estimate the value of all rights.

49. In issuing Statement 123(R), the FASB provided its views on intrinsic value, focusing on the inherent weaknesses and pitfalls of the measurement method. In paragraphs B52 and B56-B57 of Statement 123(R), the FASB noted:

> B52. …Intrinsic value thus excludes the value of the right to purchase the underlying share at a fixed price for a specified future period—its time value….
>
> B56. In reaffirming the conclusion in Statement 123 that equity [awards]… should be measured at fair value, the Board noted that share options and other instruments that have time value are routinely traded in the marketplace at prices that are based on fair value—not on intrinsic value or minimum value….
>
> B57. … The grant date intrinsic value method in [APB] Opinion 25 omits most of the factors that make an option valuable. Thus, it understates the value at the grant date of even those options for which Opinion 25's method does result in recognition of compensation cost. That is, the grant-date intrinsic value of an option fails to reflect the value of the holder's ability to benefit from increases in the price of the underlying share without being exposed to losses beyond the amount of the premium paid for the option....

50. Alternative B is not a practical expedient and will likely result in a share-based compensation expense of zero for most equity-classified awards within its scope. As discussed above, the Guide would support considering a practical expedient that would achieve the same measurement objective as the current guidance but would not support an accounting alternative with a different measurement objective. Alternative B would also require full build-out of a new model.

51. At its June 2018 meeting, the PCC discussed whether pursuing a recognition and measurement *accounting alternative* would be worthwhile. Noting the relevance of the information to users, the PCC decided instead to explore whether a *practical expedient* for determining the value of the underlying share would be a more fruitful option. Initially, the discussion focused on an expedient that would assume that the strike price of the option is equal to the underlying share price. However, upon further discussion with the Board, the PCC decided to pursue an expedient that would rely on the valuation performed for tax purposes rather than an additional valuation for financial reporting purposes. Under the direction of the Working Group, the staff performed outreach to better understand (a) the tax requirements surrounding share-based compensation, and (b) the differences between valuations performed for tax and financial reporting purposes.

Technically Feasible Solution

52. The staff and members of the Working Group performed outreach with the purpose of gathering information to better understand tax valuation requirements, GAAP valuation requirements, the interaction between the two, and what occurs in practice. The staff and the Working Group spoke with two tax experts (a current professor and a current practitioner), two valuation experts from a globally recognized valuation firm (one focusing on Level 3 Topic 820 valuations, specifically private

equity and venture capital investments; and another focusing on Topic 718 and Internal Revenue Code (IRC) Section 409A), and a legal expert on share-based compensation. The staff's and the Working Group's individual research combined with the outreach helped inform the development of a technically feasible solution.

53. IRC Section 409A, enacted in October 2004, regulates taxation of nonqualified deferred compensation. The effects of IRC Section 409A are far-reaching and its requirements were created in response to taxpayers abusing tax-timing and/or structuring accelerated payments through deferred compensation plans. While GAAP does not define share-based payments as deferred compensation, such payments are subject to IRC Section 409A for tax purposes. For example, the issuance of stock options that have an intrinsic value greater than zero at grant date (such as a strike price of $1 when the share is trading concurrently at $200) would generally be subject to Section 409A taxation, including an additional 20 percent income tax plus interest.[7]

54. A PwC guide explains that "Section 409A provides a broad definition of nonqualified deferred compensation and provides rules related to the timing of elections and distributions under deferred compensation arrangements. In addition to affecting deferrals of cash compensation, IRC Section 409A has significant implications for stock-based compensation plans."[8] The Internal Revenue Service (IRS) published Internal Revenue Bulletin (IRB) 2007-19,[9] which describes in great detail how Section 409A should be applied and clarifies how it will be enforced. For discussion purposes, the most common trigger whereby share-based compensation becomes subject to Section 409A with its related penalties is when the strike price is set below the fair value of the underlying share—that is, issuing an option in-the-money. Therefore, to avoid being subject to Section 409A and its related penalties, the strike price should be set at or above the fair market value of the underlying share as of the date of grant. Private companies whose stock is not readily tradable on an established securities market find this determination to be substantially more difficult than for public companies. There are two primary ways in which an entity may meet this requirement to avoid being subject to Section 409A and its related penalties—(a) meeting a rebuttable presumption of reasonableness or (b) proving the deferred compensation is *not* in-the-money.

55. When deferred compensation qualifies for the presumption of reasonableness, it essentially means that the valuation of the underlying share is presumed to be reasonable. The IRS can "rebut such a presumption upon a showing that either the valuation method or the application of such method was grossly unreasonable." If a company qualifies for the presumption of reasonableness, the

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[7] When a plan failure is triggered, all deferred compensation related to the plan for the current taxable year and all previous years generally must be included in gross income, subject to taxation in the current taxable year. The penalties include (a) a 20 percent additional income tax on all deferred compensation (which could result in a total income tax of up to 57 percent on that income), and (b) interest at the underpayment rate plus 1 percent for all taxes owed on deferred compensation from prior years.

[8] PwC's "*Guide to Accounting for Stock-based Compensation*" Second edition, July 2015, page 4-69.

[9] IRB 2007-19 can be accessed at https://www.irs.gov/irb/2007-19_IRB.

burden is on the IRS to prove that the valuation is invalid for some reason. In practice, “grossly unreasonable” is understood to be a fairly high threshold and very difficult for the IRS to prove. The IRS says that “the use of any of [three specified] methods of valuation” will qualify for the presumption of reasonableness, the most common of which is an external, independent valuation. The presumption of reasonableness does not technically guarantee that a company’s assessment of the fair value of the underlying stock will be accepted by the IRS, but it shifts a heavy burden of proof away from the company and its employees.

56. The second approach does not deal with a strict valuation but, instead, focuses on the guidance included in IRB 2007-19, which says, “An option to purchase service recipient stock does not provide for a deferral of compensation if… (1) The exercise price may never be less than the fair market value of the underlying stock… on the date the option is granted.” Whereas the presumption of reasonableness focused on determining a precise fair value, this approach simply requires that the exercise price is not less than the underlying share’s fair value. For example, the exercise price might be set at a level that makes it clear that the option is out-of-the money upon issuance.

57. A firm can prove that deferred compensation is “not in-the-money” at the grant date in many ways, as long as the firm demonstrates through sufficient evidence that the share’s fair value is not greater than the strike price. In certain facts and circumstances, this may be significantly less costly and complex than performing a full valuation.

58. At a conceptual level, a valuation performed to meet the presumption requirements in IRC Section 409A is not too different from a Topic 718 valuation for financial reporting. If two valuations were performed, one to meet the letter and spirit of the Section 409A presumption of reasonableness and one to comply with Topic 718, the methodologies and rigor would be very similar. In practice, companies do not generally obtain or prepare two valuations; instead they arrive at an estimate of value that complies with both Topic 718 and Section 409A. If a company does not need a valuation for financial reporting purposes but gets a valuation solely to satisfy the 409A presumption of reasonableness, those valuations are permitted to be used for up to 12 months after the valuation date, provided that there are no significant milestones, material transactions, or similar events that would alter the fundamental assumptions in the valuation. No such “grace period” exists for purposes of Topic 718. The valuation experts noted that valuations done solely for tax purposes tend to be much less rigorous. However, the difference in rigor is not driven by differing valuation requirements but, rather, by differences in audit risk and other external factors. In other words, there is a small chance of an IRS audit but 100 percent chance of a financial reporting audit if the company produces audited financial statements.

59. For this reason, the valuation experts with whom the staff conducted outreach are under the impression that if the financial reporting valuation requirements said something to the effect of “as a practical expedient, a valuation performed for tax purposes is assumed to be sufficient for financial

reporting purposes," auditors would likely hold the tax valuation to the same standard as a Topic 718 valuation when share-based compensation is material to the company. This would not reduce costs.

60. The valuation experts reported that their experience has been that companies almost always issue options with the intention of the option being at-the-money, meaning they aim to set the strike price equal to fair value. Occasionally, companies may grant a compensatory option with a strike price above fair value (that is, out-of-the money options) to further incentivize the employee to achieve stretch goals, but these instances are rare, purposeful, and almost always for C-level executives. The outreach participants reported rarely—if ever—seeing options granted in-the-money. In the few instances in which this has occurred, it was generally the result of a mistake; the options were not intended to be issued in-the-money. Outreach with the tax expert and legal expert also confirmed that most options are structured to have the strike price equal to the fair value of the underlying share.

61. The staff and Working Group also learned that non-GAAP-related, non-financial-reporting, external factors drive the strike price. In fact, companies often grant options and set a strike price without consulting their professional accountants or auditors, and yet the options still are not issued in-the-money. Granting options in-the-money is not advisable from a tax perspective, which is a primary deterrent to setting the strike price below the underlying share price. Also, options granted in-the-money dilute the equity interest of current shareholders. The terms of an option plan often specify that options granted under the plan must not be granted "in-the-money." Because options are granted to incentivize employees to participate in the financial success of the firm, employees and prospective employees generally do not accept deeply out-of-the-money options. These and other external economic factors help drive the strike price to a point at which it is equal to the underlying share price on the date of grant. In fact, valuation experts reported cases in which the strike price (in dollars) of an option is not set; these options generally include a provision that states that the strike price will be set to equal the fair value of the underlying share at grant-date, per a subsequent valuation yet to be performed.

62. The overall theme of these conversations was that absent an audit or financial reporting requirement, companies would still strive to issue their options at-the-money. Also, companies generally exert some effort to value the underlying share in order to set an appropriate strike price. It may not be a Topic 718- or Topic 820-compliant valuation, and it may not even be a valuation qualifying for the Section 409A presumption of reasonableness, but some effort is expended in order to avoid issuing in-the-money options.

63. Based on this most recent research and the discussion at the October 2018 PCC meeting, the PCC would like to pursue a practical expedient that would say that an entity may assume, for purposes of estimating the GDFV of a stock option, that the strike price of the award has been set at the price

of the underlying share, subject to certain guardrails. These guardrails would effectively disallow the practical expedient if it is obvious that the awards were issued in-the-money.

64. Outreach with subject matter experts on SBC suggests that substantially all awards granted by private companies are granted at-the-money. If that is the case, then the practical expedient would be successful in providing a more cost-effective way of achieving the same or similar accounting objective and would produce an identical result as current guidance for a majority of private companies. Admittedly, this practical expedient would over-value out-of-the-money awards (because the assumed input would be higher than the true fair value of the underlying share). However, as stated above, deeply out-of-the-money awards are not common because these awards are less effective in incentivizing employees. Furthermore, a private company is not likely to elect this practical expedient if it intentionally issues out-of-the-money awards and knows that its financial statement users focus on share-based compensation expense.

65. Under the direction of the Working Group, the staff drafted the following proposed wording of a practical expedient:

> If the current price of the underlying share (per paragraph 718-10-55-21(c)) is not readily observable at the grant date of the share-based award, a company may elect, as a practical expedient for purposes of calculating the grant date fair value of an equity-classified award, to assume that the current price of the underlying share is equal to the exercise price of the option.
>
> However, the practical expedient may not be applied if the company is aware of any facts or circumstances that would indicate, on a qualitative basis, that the award is probable of being in-the-money at grant date. Facts or circumstances that may indicate that an award is probable of being in-the-money at grant date include, but are not limited to, the following:
>
> (a) A valuation is performed near the grant date pricing the underlying share above the exercise price
>
> (b) The company has taken a position for purposes other than financial reporting that indicates the value of the underlying share is above the exercise price (for example, a tax position)
>
> (c) A significant economic event near the grant date (for example, significant research breakthrough or the resolution of material litigation).

66. Between the October 2018 and December 2018 PCC meetings, the staff has discussed this possible wording with external practitioners and received feedback in response to the following three questions that address operability:

- What evidence would an auditor need from a client as part of an audit procedure if the private company was using this expedient?
- Do you think this practical expedient will provide significant cost savings in applying Topic 718?
- How would you improve this practical expedient?

67. Some of the large practitioners that the staff spoke with had a fundamental disagreement with the premise of the expedient. However, their major operability concerns were with criterion (c) due to the extensive number of unlisted categories of economic events that could affect a valuation. Even if all possible events were considered, converting them into a threshold of "probable" would be difficult. Also, the expedient will not work for other types of awards, such as restricted stock units, stock appreciation rights, and, potentially, profits interests. One of these large practitioners noted that a full audit of a Topic 718 valuation may be required in certain circumstances if there is a significant uncertain tax position related to share-based compensation.

68. The remaining outreach participants, most of whom primarily serve private companies, noted that based on the draft language, the expedient would provide significant cost savings in terms of preparing and auditing the input used as the underlying share price. The audit evidence required would be minimal, such as review of board and compensation committee meeting minutes, a statement in a management representation letter, a copy of the Section 409A valuation report (if applicable), and management inquiry. This view is consistent with the staff's thinking. Also, these participants noted that auditors generally should be aware if the indicators listed and others that may be relevant are present from their general knowledge of the company and its operations.

69. These remaining outreach participants, while supportive of the practical expedient, did share some of the following concerns and suggestions:

- Clarification around "readily observable"
- Clarification around "near the grant date"
- Additional implementation guidance or sufficient explanation in the basis to communicate intent of criterion (c), specifically regarding what a significant event may be
- Private companies that eventually go public will have to unwind this expedient, like other private company expedients, which may result in incremental costs
- Clarification around how to address subsequent valuations near the grant date that may indicate, with hindsight, that a previous grant applying the practical expedient was issued in-the-money.

Cross-Cutting Issues

70. This project does not overlap with any other project, with the possible exception of the FASB research project, *Disclosure Review—Intangibles, Share-based Payment, and Foreign Currency*. Because this project would involve a practical expedient, there should be little impact to the disclosure review project.

71. The Board recently issued Accounting Standards Update No. 2018-07, *Compensation—Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting*. The amendments in that Update align the accounting for share-based compensation to employees with the accounting for share-based payments to nonemployees by expanding the scope of Topic 718 to include SBP transactions for acquiring goods and services from nonemployees. Consequently, any proposed practical expedient would impact SBP to nonemployees as well as employees. While the practical expedient could be limited to only employee SBC awards, this would create a difference between employee and nonemployee SBP transactions soon after significant effort was expended to remove differences.

72. In addition, the Board recently added a project to address codification improvements to clarify the accounting for share-based payments made to a nonemployee who is a customer of the entity under a master supply agreement. The Board decided to measure these payments consistent with the GDFV guidance in Topic 718 instead of at contract inception under Topic 606. Thus, any amendments related to the practical expedient in this project would apply to and reduce costs associated with measuring equity-classified share-based payments to customers, as addressed in this nonemployee SBP codification improvement project.

73. The progress or outcome of this project may also affect the PCC's or the Board's work on addressing profits interests. However, research regarding profits interests is a component of the ongoing broader PCC research on SBC and is not currently a separate project.

Next Steps and Recommendation

74. The *Responsibilities and Operating Procedures of the Private Company Council* (Operating Procedures)[10] outlines the steps necessary to add a project to the PCC technical agenda and move it forward to a final Accounting Standards Update. Those steps include:

- "The PCC Technical Agenda Consultation Group will discuss potential projects to be added to the PCC's technical agenda…. This group will discuss whether it is more efficient and effective for the PCC or the FASB to take the lead on a potential project (that is, add the project to its respective technical agenda)." [11]

- "After considering input from stakeholders and consulting with the PCC Technical Agenda Consultation Group, [the PCC will] vote on whether to add a project to the PCC's technical agenda during a public meeting…. A supermajority (defined as two-thirds of all

[10] The PCC Operating Procedures are publicly available online: https://www.fasb.org/cs/ContentServer?c=Document_C&cid=1176166265645&d=&pagename=FASB%2FDocument_C%2FDocumentPage

[11] Composed of PCC Chair Candy Wright; PCC members Tim Curt, Rick Reisig, and David Lomax; FASB members Marsha Hunt and Christine Botosan; and FASB Technical Director Sue Cosper.

sitting PCC members) must approve any additions, significant modifications, or deletions to the PCC's technical agenda."

- The PCC may also recommend that the FASB add a project to its own agenda.

75. The staff believes that SBC information is relevant to users of general-purpose financial statements of private companies. The staff believes that the most difficult issue encountered when estimating the value of equity-classified awards for private companies is determining the price of the underlying share. The Guide supports exploring a practical expedient to reduce the costs associated with valuing the underlying share while maintaining the objective of estimating the GDFV of the award. The staff is convinced that this issue is sufficiently pervasive and unique to private companies and their stakeholders. While the issue has been discussed previously, the staff believes that the solution presented in this paper is technically feasible and would address the issue identified. Therefore, the staff recommends that the project be added to either the PCC's or the FASB's technical agenda. The concerns raised by stakeholders about the language in this memo can be addressed and resolved prior to an exposure draft.

76. If the PCC adds the project to its own technical agenda, any resulting proposed amendments must be approved by a supermajority (two-thirds) of the PCC members and then endorsed by a simple majority of the FASB members and exposed by the FASB for comment. The PCC will then redeliberate the amendments in light of comments received, after which the amendments will be approved by a supermajority of the PCC members, endorsed by a simple majority of the FASB members, and issued as a final Accounting Standards Update. These final Updates are distinguished from other FASB Updates as "a consensus of the Private Company Council," although the amendments themselves aren't distinguished as such when incorporated into the Codification. This process was used for other PCC projects that resulted in Updates 2014-02, 2014-03, 2014-07, 2014-18, and 2016-03. If the FASB adds this project to its technical agenda, the PCC will act as an advisory body, similar to any other project on the FASB Technical Agenda. In the past, one project originated with the PCC and was added to the FASB Technical Agenda; that project was recently completed with the issuance of Accounting Standards Update No. 2018-17, *Consolidation (Topic 810)—Targeted Improvements to Related Party Guidance for Variable Interest Entities*.

77. Per the Guide, a business entity is not within the scope of the PCC if it meets any one of the five criteria included in the definition of a public business entity. *Private Company* was later added to the Master Glossary as a result of Accounting Standards Update No. 2014-02, *Intangibles—Goodwill and Other (Topic 350)*, and defined consistent with PCC's scope as "An entity other than a public business entity, a not-for-profit entity, or an employee benefit plan within the scope of Topics 960 through 965 on plan accounting." If the PCC were to add the SBC project discussed in this memo to its technical agenda, the scope of the expedient would be limited to private companies and not to

other nonpublic entities (that is, entities with nonpublic equity) that issue public debt. Any expansion of the expedient to all nonpublic entities would have to be done by the FASB. The FASB could address this either by adding the project to its own technical agenda or, if added to the PCC technical agenda, by conducting research in parallel or during the endorsement process.

78. Because the FASB meets weekly and the PCC meets quarterly, a project may progress faster on the FASB Technical Agenda than on the PCC Technical Agenda. The following presents examples of project plan timelines if added to each agenda. The plans assume a 60-day comment period, assume sufficient time for the staff to summarize and analyze comment letters received, but do not assume extra time if substantial revisions to the amendments are necessary that would require re-exposure.

Milestone	PCC Technical Agenda	FASB Technical Agenda
Initial review of amendments by PCC	April 2, 2019 PCC meeting	N/A
FASB Public Endorsement / FASB Initial deliberations	April 24, 2019 FASB Board Meeting	February 13, 2019
Vote by written ballot for issuance of Proposed Update	May 24, 2019 (by endorsement)	March 13, 2019
Exposure Draft Issued	June 24, 2019	April 16, 2019
Comment period ends	August 23, 2019	June 15, 2019
Redeliberations of amendments by PCC	December 17, 2019 PCC meeting	N/A
FASB Public Endorsement / FASB Redeliberations	January 15, 2020 FASB Board Meeting	July 31, 2019
Vote by written ballot for issuance of Final Update	February 15, 2020 (by endorsement)	September 1, 2019
Issuance of Final Update	March 15, 2020	October 1, 2019

79. Of course, depending on PCC discussions, Board discussions, further outreach, and comment letter feedback, the timeline could be delayed.

Appendix A: Outreach Questions

Private Company Council
SBP-related Outreach to Lenders
Questions for Participants in Outreach

Introductions
Thank you for your participation.

1. Can you please describe your role in evaluating an enterprise's financial position in a decision-making process for loan originations or buy, sell, hold decisions for existing debt positions.

2. Approximately what percentage of the companies you evaluate are public companies versus private companies?

3. What industries do you focus on (e.g., consumer products, manufacturing, technology, financial institutions, etc.)?

4. What is the approximate size (in terms of revenue or some better measure) of the private companies that you invest in?

5. Do a significant number of the private companies that you invest in issue share-based payments in exchange for goods or services?

6. Please describe how you use GAAP financial statements in your evaluation and decision-making process.

7. Do you use any outside services (e.g., RiskCalc™) to provide summarized financial data regarding the subject company or its industry peers?

8. How would you estimate the relative weight you place on the various sources of information you receive and the order of importance in your evaluation process?

9. What type of share-based payment arrangements do you see? (e.g., actual shares of equity, options on equity, profits interest, management units, SARs, etc.)

For the remaining questions, please consider them in the context of share-based grants that are <u>strictly equity-classified and equity-settled</u>. These questions do not apply to other liability-classified or cash-settled awards.

10. What type of vesting conditions usually exist?
    - For example, *3 years of service, sales target, EBTIDA target, change in control event, obtaining regulatory approval, share price must exceed $X, return to existing shareholders must equal 15%, etc.*

11. Current GAAP generally requires share-based payments issued in exchange for goods or services to be expensed at fair value. Do you make any adjustments to that expense in your analysis? If so, why do you make such adjustments?

12. Assuming stock-based compensation is a significant portion of the company's compensation package, how sensitive is your evaluation of the company's creditworthiness to the precision of the amount of the accounting charge related to SBC? If the amount of the charge were

understated by as much as 50% or overstated by 100% how much of an impact could that difference have on your evaluation?

13. To what extent do you consider the disclosures in the notes to the financial statements related to stock-based compensation as being relevant to your decision-making process? What are the most relevant aspects of these disclosures, if any? (If you are not specifically familiar with the required disclosures, just indicate what you might want to see disclosed)?

14. Would you support an alternative where private companies generally record $0 or no expense when share-based compensation is issued? Would you prefer additional disclosures in the GAAP financial statements if this were the case?

15. Is there anything else about these topics that you think it would be helpful for us to know?

16. Would you be willing to participate in future outreach efforts should there be other topics for which we could use your input?

Thank you .