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To the Point

FASB — proposed guidance

FASB proposes nonpublic entity practical expedient for the fair value of equity-classified share options

The proposal addresses concerns expressed by private company stakeholders about the cost and complexity of determining the fair value of share options.

What you need to know

- The FASB proposed a practical expedient that would allow nonpublic entities to determine the current share price input when valuing equity-classified share-option awards by using a valuation method allowed by Section 409A of the Treasury Regulations.
- Nonpublic entities would be allowed to apply the practical expedient prospectively on an award-by-award basis to determine the fair value of a share option on the grant date and upon a modification.
- Comments are due by 1 October 2020.

Overview

The Financial Accounting Standards Board (FASB or Board) proposed amendments[1] to Accounting Standards Codification (ASC) 718, *Compensation — Stock Compensation*, that would provide a practical expedient that nonpublic entities could use to determine the current share price for the purpose of calculating the fair value of equity-classified share-option awards.

In issuing the proposal, the FASB is responding to concerns private company stakeholders expressed to the Private Company Council (PCC) about the cost and complexity of determining the fair value of share-option awards. While ASC 718 already provides nonpublic entities with a practical expedient for estimating expected term and an alternative for estimating expected share price volatility in certain cases, there is currently no expedient for estimating the current share price input in the option pricing model. Determining this input is complex because there is often no observable market price for private company shares.

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Key considerations

The proposal would allow nonpublic entities (as defined in ASC 718)[2] to determine the current share price input to the option-pricing model of equity-classified share-option awards using a valuation method that is performed in accordance with the "presumption of reasonableness" requirements of the Treasury Regulations of Internal Revenue Code Section 409A (Section 409A).[3]

Nonpublic entities would be allowed to prospectively apply this practical expedient on an award-by-award basis to determine the grant date fair value of share options and the fair value of share options when they are modified. The expedient could be applied to equity-classified share options issued to either employees or nonemployees.[4]

The following three methods are acceptable under the presumption of reasonableness requirements of Section 409A to determine the fair market value of a share:

- A valuation determined by an independent appraisal within the 12 months preceding the grant date
- A valuation based on a formula that, if used as part of a non-lapse restriction with respect to the share, would be considered the fair market value of the share
- A valuation made reasonably and in good faith that is evidenced by a written report that considers the relevant factors of the illiquid stock of a start-up corporation (as defined in the regulations)

The Board expects that an independent appraisal would often be the method used by nonpublic entities electing this practical expedient.

How we see it

Many companies already obtain one valuation for both Section 409A and US GAAP reporting, and the proposal would codify that practice. Under Section 409A, a company can use a valuation determined by an independent appraisal for up to 12 months after the valuation date, and the entity would not be required to assess the valuation for changes during this period (as long as the valuation is not "grossly unreasonable"). Accordingly, if the proposal is finalized, nonpublic entities that elect to use the practical expedient and obtain a valuation determined by an independent appraisal would be able to use the Section 409A-compliant valuation to calculate the fair value of awards during that 12-month time period allowed under Section 409A.

The FASB asked respondents to comment on whether it should allow nonpublic entities to use the practical expedient to determine the fair value for other share-based payment transactions (e.g., grants of nonvested shares).

Transition and effective date

The proposal would be effective for nonpublic entities on a prospective basis and would apply to all equity-classified share options granted during fiscal years beginning on or after the effective date and interim periods within the following years. The PCC and the Board will determine an effective date after considering stakeholder feedback. Early adoption would be permitted.

Endnotes:

[1] Proposed Accounting Standards Update (ASU), *Determining the Current Price of an Underlying Share for Equity-Classified Share-Option Awards*.

[2] The Master Glossary in ASC 718 defines a nonpublic entity as "Any entity other than one that meets any of the following criteria: (a) Has equity securities that trade in a public market either on a stock exchange (domestic or foreign) or in an over-the-counter market, including securities quoted only locally or regionally (b) Makes a filing with a regulatory agency in preparation for the sale of any class of equity securities in a public market (c) Is controlled by an entity covered by the preceding criteria. An entity that has only debt securities trading in a public market (or that has made a filing with a regulatory agency in preparation to trade only debt securities) is a nonpublic entity."

[3] Section 1.409A-1(b)(5)(iv)(B)(2) of the Treasury Regulations.

[4] If an entity has adopted ASU 2018-07, *Improvements to Nonemployee Share-Based Payment Accounting*, the practical expedient could be applied to equity-classified share options issued to customers that are in exchange for a distinct good or service. If an entity has adopted ASU 2019-08, *Codification Improvements — Share-Based Consideration Payable to a Customer*, the practical expedient could be applied to equity-classified share options issued to customers that are not in exchange for a distinct good or service.

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