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FASB Offers Practical Expedient to Nonpublic Entities for Measuring Equity-Classified Share-Based Payment Awards

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Background

On October 25, 2021, the FASB issued ASU 2021-07,[1] which allows nonpublic entities to use, as a practical expedient, "the reasonable application of a reasonable valuation method" to determine the current price input of equity-classified share-based payment awards issued in exchange for goods or services. The ASU notes that a valuation performed in accordance with specified U.S. Treasury regulations related to Internal Revenue Code (IRC) Section 409A[2] is an example of a reasonable valuation method under the practical expedient.

Key Provisions of the ASU

In accordance with ASC 718[3] before the adoption of ASU 2021-07, nonpublic entities estimate their share price as of the grant date to determine the grant-date fair-value-based measure of an issued award. However, because of the nature of nonpublic entities, observable market prices generally do not exist for their equity shares. Accordingly, such entities often use either a market approach or an income approach (or both) to estimate this amount, which may be costly and complex.

[1] FASB Accounting Standards Update (ASU) No. 2021-07, *Compensation — Stock Compensation (Topic 718): Determining the Current Price of an Underlying Share for Equity-Classified Share-Based Awards* — a consensus of the Private Company Council.

[2] Internal Revenue Code Section 409A, "Inclusion in Gross Income of Deferred Compensation Under Nonqualified Deferred Compensation Plans."

[3] FASB Accounting Standards Codification (ASC) Topic 718, *Compensation — Stock Compensation.*

Under the ASU's practical expedient, a nonpublic entity may estimate its share price by using the "reasonable application of a reasonable valuation method." ASC 718-10-30-20D specifies that factors to be considered under such a method include the following, as applicable:

a. The value of tangible and intangible assets of the nonpublic entity

b. The present value of anticipated future cash flows of the nonpublic entity

c. The market value of stock or equity interests in similar corporations and other entities engaged in trades or businesses substantially similar to those engaged in by the nonpublic entity for which the stock is to be valued, the value of which can be readily determined through nondiscretionary, objective means (such as through trading prices on an established securities market or an amount paid in an arm's-length private transaction)

d. Recent arm's-length transactions involving the sale or transfer of stock or equity interests of the nonpublic entity

e. Other relevant factors such as control premiums or discounts for lack of marketability and whether the valuation method is used for other purposes that have a material economic effect on the nonpublic entity, its stockholders, or its creditors

f. The nonpublic entity's consistent use of a valuation method to determine the value of its stock or assets for other purposes, including for purposes unrelated to compensation of service providers.

In addition, ASC 718-10-30-20E notes that such a valuation method must take into account "all available information material to the value of the nonpublic entity." Further, ASC 718-10-30-20F states that if either of the following conditions is met, the "use of a value previously calculated under a valuation method is not reasonable as of a later date":

a. The calculation fails to reflect information available after the date of the calculation that may materially affect the value of the nonpublic entity (for example, the resolution of material litigation or the issuance of a patent).

b. The value was calculated with respect to a date that is more than 12 months earlier than the date for which the valuation is being used.

The characteristics above are the same as those in IRC Section 409A that describe the reasonable application of a reasonable valuation method under U.S. Treasury regulations. The ASU also explicitly refers to other valuation approaches under IRC Section 409A that are presumed to be reasonable.[4]

The ASU further clarifies that an entity that wishes to apply the practical expedient must do so on a measurement-date-by-measurement-date basis. That is, the entity must apply the expedient to all equity-classified awards that have the same underlying share and the same measurement date.[5] An entity that elects the practical expedient is also required to disclose that election.[6]

Connecting the Dots

Audit Considerations

On the basis of our experience with clients, entities almost always obtain a single valuation to use for compliance with the requirements of both IRC Section 409A and ASC 718. While ASU 2021-07 codifies that practice, because there have been no corresponding amendments to AICPA SAS 122, Section 540,[7] the requirements related to auditing estimates have not changed.[8] Therefore, the extent of audit evidence needed in the assessment of the estimated share price in the valuation of an equity-classified award remains the same. An entity's use of the share price valuation from its

[4] See ASC 718-10-30-20G.

[5] See ASC 718-10-30-20H.

[6] See ASC 718-10-50-2(f)(2)(vi).

[7] AICPA Statement on Auditing Standards (SAS) No. 122, Section 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures." Note that SAS 143, "Auditing Accounting Estimates and Related Disclosures," supersedes SAS 122 and is effective for audits of financial statements for periods ending on or after December 15, 2023. However, ASU 2021-07 makes no changes to the requirements for auditing estimates under either SAS 122 or SAS 143.

[8] In paragraph BC22 of the ASU, the Board observed that "the practical expedient would not change the fair value measurement objective for the current price input and does not affect existing audit requirements."

IRC Section 409A reporting is not a safe harbor; rather, the auditor must still evaluate whether such an amount represents a reasonable application of a reasonable valuation method by considering the facts and circumstances as of the valuation date.[9] Accordingly, we believe that the audit procedures and associated audit costs related to such valuations are unlikely to change as a result of the practical expedient.

Entities That May Become Public Entities

Certain other practical expedients are available to nonpublic entities[10] under ASC 718 related to the use of the calculated value and intrinsic value methods. In SAB Topic 14.B,[11] the SEC provides transition guidance for entities that elect those practical expedients and are changing from nonpublic to public entity status. However, there is no similar transition guidance in ASU 2021-07 on the use of the practical expedient. Therefore, an entity that no longer meets the criteria to be a nonpublic entity would have to reverse the practical expedient's effect in its historical financial statements. Consequently, before electing the practical expedient in the ASU, nonpublic entities that could become public entities should carefully consider the potential future costs of having to reverse the effect of this relief.

Effective Date and Transition

The guidance in ASU 2021-07 is effective for nonpublic entities for fiscal years beginning on or after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. Entities must apply the ASU's provisions prospectively and may early adopt them for interim and annual financial statements that have not yet been issued or made available for issuance as of October 25, 2021.

[9] See ASC 718-10-30-20C.

[10] As defined in ASC 718-10-20.

[11] SEC Staff Accounting Bulletin (SAB) Topic 14.B, "Transition From Nonpublic to Public Entity Status" (reproduced in part in ASC 718-10-S99-1).

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