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Technology Spotlight
March 28, 2025

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Consideration of Draft Updates to the AICPA Guide on Valuing Equity Securities

The Bottom Line

- When estimating the fair value of equity securities underlying share-based compensation awards, entities should consider the working draft of two chapters released by the AICPA's Financial Reporting Executive Committee (FinREC) as part of a forthcoming update to its *Accounting and Valuation Guide: Valuation of Privately-Held Company Equity Securities Issued as Compensation* (the "AICPA Valuation Guide"). The working draft places more emphasis on secondary transactions than does the current edition of the AICPA Valuation Guide, which was released in 2013.
- The working draft addresses the increase in secondary transactions and share repurchases, which are common in technology companies, since the 2013 edition was released.
- FinREC recommends that entities apply the market-based measurement guidance in ASC 820[1] to estimate the fair value of equity securities underlying share-based compensation awards. To meet the objectives of such guidance, reporting entities must maximize the use of relevant observable inputs and minimize the use of unobservable inputs.
- Information related to both primary and secondary transactions can be used as relevant observable inputs for estimating the fair value of equity securities underlying share-based compensation awards. Primary transactions involve issuing equity directly from a company to an investor, often including preferred stock with negotiated rights and preferences. These transactions may provide relevant pricing information even

[1] FASB Accounting Standards Codification (ASC) Topic 820, *Fair Value Measurement*.

if they do not involve the same securities underlying the share-based compensation awards. Secondary transactions, such as those involving the purchase or sale of existing equity interests between investors, employees, or third parties, offer market-based indications of fair value that reflect prices agreed upon by willing buyers and sellers.

- Entities must exercise judgment in determining the weight to place on secondary transactions and company repurchases relative to other indications of value. By carefully considering all relevant inputs and calibrating valuation models, entities can ensure that their fair value measurement of the equity securities underlying share-based compensation awards aligns with the principles in ASC 820.
- Identifying and quantifying compensatory elements in secondary transactions can be challenging. Entities need to assess whether the transaction price includes a compensatory element and how to treat the transaction in the valuation of the equity securities.

Beyond the Bottom Line

This publication highlights the importance of considering the working draft when measuring the fair value of equity securities in share-based compensation awards. It discusses market-based assumptions and the hierarchy of inputs for valuation and emphasizes the need for entities to use judgment when assessing secondary transactions and company repurchases, particularly those involving multiple elements, such as compensatory or strategic agreements. Further, it outlines the implications of ASC 718[2] on the recognition of compensation costs for equity securities that are repurchased from grantees in excess of fair value. It also provides decision trees that may help entities navigate the complexities of fair value measurement and appropriately apply the guidance in ASC 820 and ASC 718.

Background

Since the 2013 release of the AICPA Valuation Guide, the volume of secondary transactions and share repurchases by emerging growth companies has significantly increased. While these transactions occur in multiple industries, they are particularly common in technology companies because such organizations typically have equity-heavy compensation structures, which can create a demand for the sale of shares before an initial public offering. In addition, venture-backed technology companies attract new investors that, as part of investing in the company, may offer liquidity to existing shareholders, including employees.

In June 2024, as the first step in a planned comprehensive update to the 2013 edition of the AICPA Valuation Guide, FinREC released a working draft of the following two chapters:

- Chapter 8, "Inferring Value From Transactions in a Private Company's Securities."
- Chapter 9, "Selected Accounting and Disclosure Matters."

Developed by FinREC's Equity Securities Task Force (the "Task Force"), the working draft consolidates best practices for applying the fair value measurement guidance in ASC 820 and the share-based compensation guidance in ASC 718. Although nonauthoritative, the working draft provides interpretive guidance for private companies that grant share-based compensation awards.

Connecting the Dots

At the 2024 AICPA & CIMA Conference on Current SEC and PCAOB Developments, the FinREC chair noted that feedback during the comment period on the working draft was relatively minor and that the Task Force therefore does not expect to make significant additional changes to the chapters. Accordingly, although the working draft

[2] FASB Accounting Standards Codification Topic 718, *Compensation — Stock Compensation*.

has not yet been finalized, entities should consider it when evaluating the implications of secondary transactions on estimating the fair value of their equity securities and determining whether a compensatory element exists. The Task Force believes that companies have historically placed less weight on secondary transactions than other indications of fair value and that the working draft provides leading practices for an entity's consideration of such transactions in estimating the fair value of equity securities underlying share-based compensation awards.

Primary Versus Secondary Transactions

It is crucial for an entity to distinguish between primary and secondary transactions when determining the fair value of equity securities held by private companies. Primary transactions involve the issuance of equity or debt directly from a company to an investor, typically to raise capital or form strategic agreements. These transactions often include preferred stock with negotiated rights and preferences. Although primary transactions usually do not involve the same equity securities as those granted as share-based compensation awards, they can still provide relevant pricing information about the valuation of the award's underlying equity securities.

A secondary transaction involves the buying or selling of an existing equity interest in a privately held company between investors, employees, or third parties. Unlike primary transactions, secondary transactions do not create new shares; instead, they transfer ownership of previously issued equity securities. Common examples include:

- Purchases by new or existing investors.
- Tender offers.
- Private investor transactions.
- Trades facilitated through secondary exchanges.

Such transactions often serve as market-based indicators of fair value for the equity securities underlying share-based compensation awards because they reflect prices agreed upon by willing buyers and sellers.

Connecting the Dots

As discussed above, both primary and secondary transactions can provide important inputs for an entity's estimation of the fair value of privately held company equity securities. The framework in Chapter 8 of the working draft helps valuation specialists apply the fair value measurement principles in ASC 820 when assessing observed transactions.

Measurement of Share-Based Compensation Awards

Share-based compensation awards (e.g., stock options, restricted stock units, profits interests that represent a substantive class of equity) are classified as liabilities or equity instruments in accordance with ASC 718. Regardless of how an award is classified, ASC 718 requires entities to use a "fair-value-based" method to measure the award rather than the fair value guidance in ASC 820.

A fair-value-based method excludes the effects of specific features that (1) are sometimes included in share-based compensation awards (e.g., contingent clawback provisions, reload features, or performance conditions) and (2) would typically be included in a fair value measurement under ASC 820. However, the Task Force recommends that unless ASC 820 is inconsistent with the requirements in ASC 718, entities should apply ASC 820 to share-based compensation awards because such guidance provides a framework for the valuation of the underlying equity security (e.g., the equity instrument underlying the award), which is often an input into the valuation of the share-based compensation award.

Connecting the Dots

The Task Force believes that while ASC 718 provides guidance on performing a fair-value-based measurement, an entity would determine the fair value of the underlying equity security itself in accordance with the requirements in ASC 820 unless those requirements conflict with the guidance in ASC 718.

ASC 820 Principles

ASC 820 establishes the principles for performing a market-based measurement of fair value. ASC 820-10-05-1B states:

> Fair value is a market-based measurement, not an entity-specific measurement. For some assets and liabilities, observable market transactions or market information might be available. For other assets and liabilities, observable market transactions and market information might not be available. However, the objective of a fair value measurement in both cases is the same — to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions (that is, an exit price at the measurement date from the perspective of a market participant that holds the asset or owes the liability).

In addition, ASC 820 discusses the following key concepts related to the objective of a fair value measurement:

- *"Exit price"* — Fair value is based on an "exit" price (i.e., the price a party receives to sell an asset or is paid to transfer a liability).
- *"An orderly transaction"* — Transactions that occur under normal market conditions (not in a forced liquidation or distressed sale).
- *"Between market participants"* — Fair value is determined on the basis of the perspective of market participants, which include buyers and sellers in the principal market that:
  - Are independent of each other.
  - Have a reasonable understanding of the asset or liability on the basis of available information obtained through usual and customary efforts.
  - Can enter into the transaction and are willing to do so.
- *"In the principal (or most advantageous) market"* — Fair value is measured in the principal market[3] even if the price in a different market is potentially more advantageous on the measurement date.[4] If no principal market exists, the entity must develop a hypothetical (assumed) transaction as of the measurement date in accordance with the fair value objective in ASC 820.
- *"On the measurement date"* — Fair value is determined on the basis of market conditions as of the measurement date.

Because fair value measurement is a market-based measurement based on an exit price notion, it must be determined in accordance with the assumptions that market participants would use in pricing the asset, liability, or equity instrument, regardless of whether those assumptions are observable or unobservable. A measurement based on "true value," "economic value," or management's perception of value is inconsistent with a fair value measurement. ASC 820-10-35-16B specifies that an entity should measure the fair value of liabilities and instruments classified in equity "from the perspective of a market participant that holds the identical item as an asset at the measurement date."

[3] ASC 820-10-20 defines "principal market" as "[t]he market with the greatest volume and level of activity for the asset or liability."
[4] See ASC 820-10-35-6.

In addition, the fair value of liability and equity instruments should be measured by maximizing observable inputs and minimizing unobservable inputs.[5] ASC 820-10-35-16BB prescribes the following hierarchy for such measurement:

1. Use "the quoted price in an **active** market for the identical item held by another party as an asset, if that price is available" (emphasis added). Otherwise, proceed to the next step.
2. Use "the quoted price in a market that is **not active** for the identical item held by another party as an asset" if that price is available (emphasis added). Otherwise, proceed to the next step.
3. Use a valuation approach to measure the fair value of the identical item held by another party as an asset such as:
   a. "An income approach (for example, a present value technique that takes into account the future cash flows that a market participant would expect to receive from holding the liability or equity instrument as an asset . . .)."
   b. "A market approach (for example, using quoted prices for similar liabilities or instruments classified in shareholders' equity held by other parties as assets . . .)."

Sometimes, an entity must adjust the quoted price of an asset to properly reflect factors that do not apply to the fair value of a liability or instrument classified in equity. As discussed in ASC 820-10-35-16D, the need for such an adjustment could arise because the observed price is related to a similar, but not identical, asset used to measure the fair value of a liability or equity instrument.

Principal Market

The principal market for an entity's equity securities is the market with the greatest volume and level of activity. ASC 820 does not require that the principal market be organized (such as an exchange or dealer market) or active.[6] In some instances, secondary transactions may occur with an intermediary's assistance (e.g., a brokered market that matches buyers and sellers but does not trade on its account). In other cases, such transactions may be negotiated independently without an intermediary (a principal-to-principal market). Regardless, the principal market will be the market that has the greatest volume or level of activity that an entity can access. An entity does not need to have access to the secondary market on the measurement date for the market to be the principal market.

A reporting entity is not required to perform an exhaustive search to identify all markets that could be the principal market. Unless contradictory evidence exists, it is presumed that the market in which a market participant normally transacts is the principal market. The concept of the "most advantageous market" is only relevant when there is no principal market for the equity security subject to the fair value measurement. In such a case, an entity would need to determine the price that would be paid or received in a "hypothetical" transaction in the principal-to-principal market.[7] The Task Force stated the following related to how companies would make this determination:

> In such a case, companies would need to consider the likely types of market participants such as financial investors, strategic investors, private individuals, or other employees, that would be willing and able to negotiate independently — and what considerations and assumptions they would make about the value of the company's equity securities underlying the stock-based compensation awards, as well as what level of information they would expect to examine in order to be willing to

[5] The ASC master glossary defines observable inputs as "[i]nputs that are developed using market data, such as publicly available information about actual events or transactions, and that reflect the assumptions that market participants would use when pricing the asset or liability." It defines unobservable inputs as "[i]nputs for which market data are not available and that are developed using the best information available about the assumptions that market participants would use when pricing the asset or liability."

[6] The ASC master glossary defines an active market as "[a] market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis."

[7] The ASC master glossary defines a principal-to-principal market as "[a] market in which transactions, both originations and resales, are negotiated independently with no intermediary. Little information about those transactions may be made available publicly."

execute a transaction as a knowledgeable buyer or seller, having a reasonable understanding about the security and the transaction.

Considerations Related to Primary and Secondary Transactions

Secondary transactions for equity securities underlying share-based compensation awards may not take place in the principal (or most advantageous market), on the measurement date, or in an active market (which is often the case for private-company transactions). However, companies should still consider these transactions because they provide observable pricing information about the value of the equity securities underlying the share-based compensation awards. ASC 820 requires entities to maximize the use of observable inputs and minimize the use of unobservable inputs. Thus, observable transactions, even in an inactive market, should be prioritized because they reflect actual market activity. At the same time, unobservable information (e.g., assumptions in valuation models) should be minimized in the determination of fair value.

Connecting the Dots

A single secondary transaction — even one that occurs on the measurement date — may not be sufficient as an indication of fair value. The Task Force stated:

> Even when there are observable transactions, if the market is not active, FASB ASC 820 does not require that the observed transaction price would be given 100% weight.

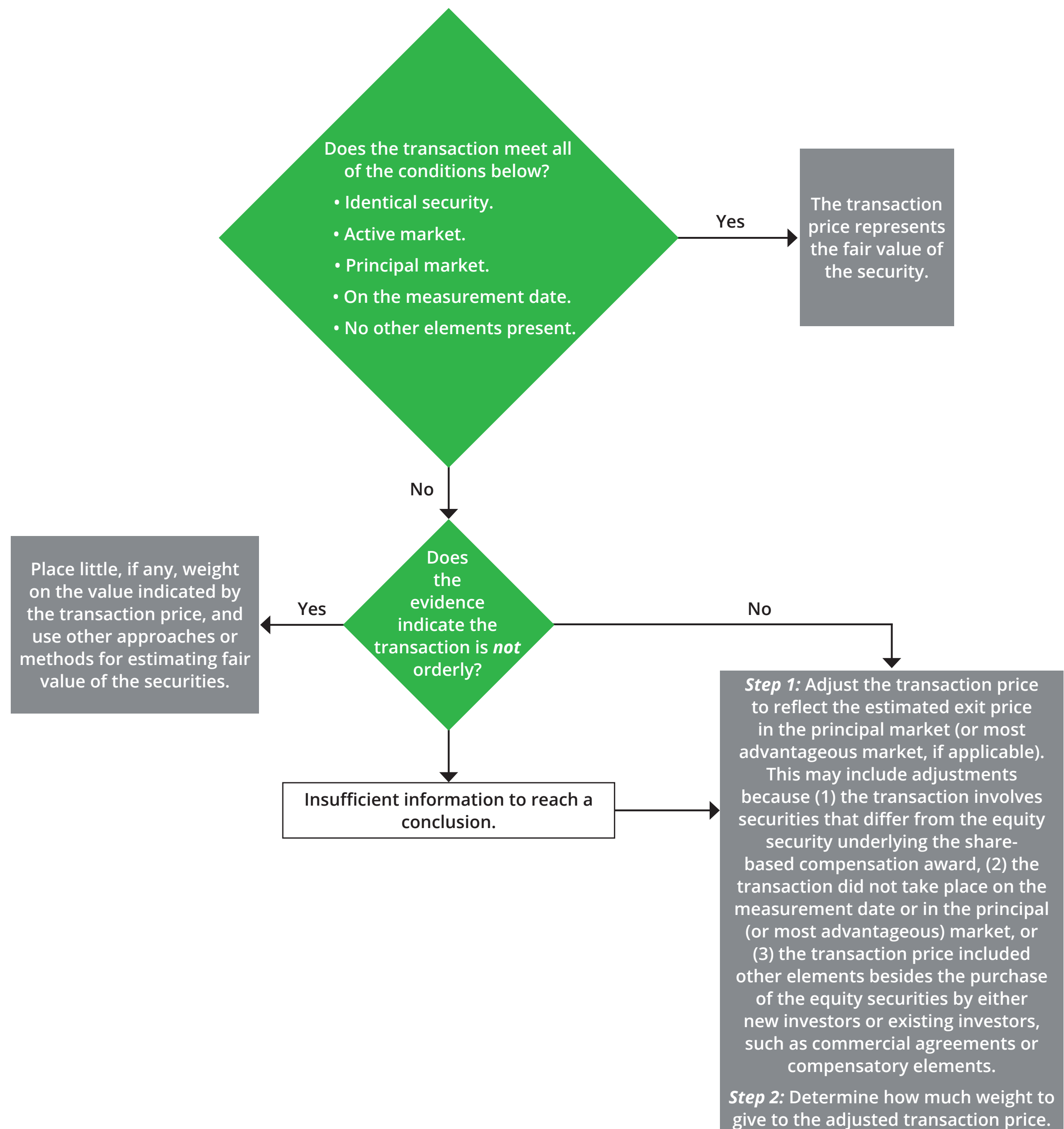
However, if the number of secondary transactions increases and they are closer to the measurement date and their pricing remains consistent, it would be less appropriate to weigh other indications of value, including those based on primary transactions and valuation models. This view is consistent with the principles in ASC 820, which require an entity to maximize the use of all observable inputs and minimize the use of unobservable inputs.

In addition, while a primary transaction, such as the issuance of newly created preferred stock, would represent an entry price rather than an exit price under ASC 820, it can often be observable and thus provide relevant information about the unobservable inputs to the valuation model(s) used to estimate the fair value of the equity securities underlying the share-based compensation award. However, primary transactions should be adjusted to properly reflect factors that do not apply to the fair value of the equity security (e.g., liquidation preferences and other rights), provided that any such adjustments are consistent with a market participant's perspective.

Lastly, while transactions between related parties (e.g., employees selling shares back to the company or to existing investors) are common, an entity would not be precluded from considering them when estimating the fair value of its equity securities. For example, ASC 820-10-30-3A(a) states that "the price in a related party transaction may be used as an input into a fair value measurement if the reporting entity has evidence that the transaction was entered into at market terms."

Framework for Evaluating Primary and Secondary Transactions

The decision tree below is based on the framework in Chapter 8 of the working draft and on the principles in ASC 820. It is intended to help entities evaluate primary and secondary transactions when estimating the fair value of equity securities underlying share-based compensation awards.



The Task Force believes that most entities will navigate to the bottom right corner of the decision tree since private-company transactions typically occur in inactive markets. Further, the Task Force believes that it is rare for secondary transactions to be classified as "not orderly" since specific knowledge of transaction dynamics and an evaluation of the indicators in ASC 820 are required for an entity to make this determination.

Weighting Considerations Related to Secondary Transactions and Company Repurchases

While secondary transactions and company repurchases may not be the sole basis for fair value estimates, entities must determine how much weight to assign them *relative* to other indications of fair value. To make this decision, an entity must apply significant judgment and consider its specific circumstances.

Before evaluating the weight of a secondary transaction relative to other indications of fair value, an entity should assess whether the transaction involves multiple elements. ASC 820-10-35-16D requires that an entity adjust the asset's quote price if there are factors specific to the asset that do not apply to the fair value measurement of the equity instrument. This is because the objective is to measure the fair value of the equity securities underlying

the share-based compensation award, not the fair value of a combined package that includes multiple elements. For example:

- Transactions linked to compensation (e.g., the repurchase of shares at a favorable price to reward employees) may indicate that the transaction price does not solely reflect the fair value of the equity security. When repurchasing shares from a grantee, an entity should assess (1) whether the repurchase was based on preexisting features in the original arrangement with the grantee, such as a call feature in a stock-based compensation award, and (2) how the repurchase price was defined. As stated in Chapter 8 of the working draft, "a repurchase price based on a preexisting formula would likely not be indicative of an observable transaction price."
- Transactions involving strategic agreements (e.g., an investor's purchase of shares upon entering into a commercial partnership or licensing agreement) may reflect pricing influenced by other economic arrangements.

The Task Force noted that the intent to compensate may be evident:

> In some situations, it may be clear that the intent of the purchase was to compensate the grantees (for example, a situation in which the purchase price paid by the company was significantly in excess of the price of a recent preferred stock financing transaction and the intent of the company was to pay the grantees a bonus). In those situations, it may be inappropriate to incorporate the secondary transaction in determining the fair value of the equity securities underlying stock-based compensation awards, as the purchase does not represent an observable transaction reflecting solely the fair value of the equity security.

Chapter 9 of the working draft includes the following example of how an entity may conclude that a transaction contains a compensatory element:

> Consider Entity A, a private company, which is negotiating with new investors (New Investors) to purchase a new series of preferred stock in Entity A. The New Investors did not previously hold an economic interest in Entity A. To participate in the preferred stock offering, the New Investors must purchase a minimum number of vested Entity A common shares held by grantees through a tender offer organized by Entity A. Entity A specifies that only grantees that have provided service to Entity A for more than two years are eligible to participate in the tender offer. Through the tender offer, the New Investors acquire 1 million vested Entity A common shares held by grantees at $15.00 per share (the same price paid per share for the new series of preferred stock). A contemporaneous valuation of the Entity A common shares at the time of the tender offer resulted in a fair value of $5.00 per share, which is broadly in line with other secondary transactions that took place in reasonable proximity to the new financing round. Because the sale price of each share of common stock exceeds the fair value of the common stock, Entity A considers whether the transaction is compensatory. Entity A was significantly involved in facilitating the tender offer and concludes that the New Investors should be considered economic interest holders of Entity A and the difference between the tender offer price and the fair value of the common stock represents compensation to the grantees for prior services rendered.

In the above example, Entity A can confirm that the price of the common shares as a result of the valuation, which was performed at the same time as the tender offer, was generally consistent with the price observed in other recently conducted secondary transactions. On the other hand, the occurrence of secondary transactions in the principal market that were more consistent with the entry price for the preferred financing (i.e., $15 per share) would indicate that market participants value the company on a common-stock-equivalent basis and do not place significant value on the liquidation preferences and other features of the primary transaction. In that situation, an entity may view the $15 price as an observable secondary transaction without a compensatory element. This approach is consistent with the Task Force's views that a market participant may not place value on the liquidation preference in situations in which "an investor participating in a preferred stock primary financing concurrently repurchases common stock from grantees at the preferred stock price and there is an indication at the time of the repurchase that market participants place value on the liquidation preferences present in the preferred stock and no such liquidation preferences are present in the common stock purchased from grantees."

However, in most instances, the analysis will not be straightforward. For example, the Task Force stated:

> [B]ecause it may not be possible for a company to independently determine the amount of compensation expense paid to recipients, it may be difficult to determine the stand-alone value of the shares based upon the overall transaction price in these types of transactions.

In addition, the Task Force observed the following:

> If there is significant uncertainty regarding the adjustments needed to the observable transaction (e.g., if the transaction included multiple elements and the value of each element is not clear), then it may be appropriate to give the transaction less weight.

Thus, entities should carefully evaluate whether the transaction price includes a multiple-element arrangement because such an arrangement may indicate that the transaction price does not represent an observable price for the underlying equity share. This evaluation often involves determining whether the arrangement has a compensatory element. When making this determination, entities should consider Tables 1 and 2 below, which are based on language adapted from the working draft and provide indications of a transaction price that may include a compensatory element.

Table 1: Considerations Related to Transactions — Compensatory Elements

Indications That the Transaction Price May Not Represent an Observable Price for the Securities	Indications That the Transaction Price Represents an Observable Price for the Securities
• Compensation expenses are recorded for financial reporting purposes (see discussion in the Recognizing Compensation Expense section below). • The company reported ordinary income as compensation for tax purposes for the sale of shares that otherwise would have been subject to capital gain tax on the basis of the difference between the transaction price and the estimated fair value. • A favorable price was established primarily or partially for compensatory purposes.	• No compensation expense was recorded for financial reporting purposes. • The company concluded that there was no intent to compensate and did not report ordinary income as compensation on the employee's tax reporting documents for the sale of qualified shares. • The company was limited in its involvement in the transaction and did not establish the price, which may indicate that it had no intent to compensate.

Table 2: Indications of Compensatory Elements

Indications That a Compensatory Element Exists	Indications That a Compensatory Element Does Not Exist
• The company determines the purchase price or directly negotiates the purchase without negotiating with the investors or grantees. • The company identifies the investors, sets the parameters for employee sales (e.g., only certain employees can sell), and limits sales to current or former employees. • The transaction is limited to a select group of executives, such as C-suite executives or founders. • There is evidence that the transaction is intended to provide the employees with favorable pricing to help the company with recruiting, retention, or a severance agreement.	• The transaction is initiated at an investor's request to prevent dilution (rather than to compensate) in connection with a new financing transaction. • The primary transaction is oversubscribed, and the investor's primary purpose for purchasing common stock is to increase its equity ownership rather than compensate the employees. • There is little or no difference between the purchase price and a concurrent or recent primary transaction, and the facts and circumstances indicate that market participants place little to no value on the liquidation preferences and other rights present in the primary transaction.

Table 2: Indications of Compensatory Elements (continued)

Indications That a Compensatory Element Exists	Indications That a Compensatory Element Does Not Exist
• A portion of the proceeds reported by the entity is classified as compensation for tax purposes. • There is little or no difference between the purchase price and a concurrent or recent primary transaction, and the facts and circumstances indicate that market participants value liquidation preferences and other rights present in the primary transaction. • The investor or investors participating in the transaction have more than a de minimis interest.	• The entity reports the transaction as a capital transaction for tax purposes. • The company's involvement is limited to waving its right of first refusal. • Many sellers are financial investors.

As noted in the above tables, one indication is related to the entity's treatment of the transaction for tax purposes. Stock repurchases are generally considered to be either (1) capital (e.g., capital gain) or (2) dividend-equivalent redemptions (e.g., ordinary dividend income to the extent of earnings and profits). If repurchases are from current or former service providers (i.e., current or former employees or independent contractors), additional questions arise related to whether any proceeds should be treated as compensation for tax purposes. In the assessment of whether a portion of the payment is compensation, it is critical for a nonpublic entity to calculate the appropriate value when determining the effect of the capital redemption. That is, the nonpublic entity must decide whether some portion of the consideration for the repurchase represents something other than fair value for the common stock (i.e., compensation cost). Given the complexity of making this determination, including evaluating existing tax law, companies should consult with their tax specialists.

In addition, Table 1 notes that the transaction price may not represent an observable price for the securities when an entity recognizes compensation expense for financial reporting purposes. This interplay creates a circular dependency because the entity must consider the transaction when estimating fair value; however, the entity cannot recognize compensation expense without first determining the fair value of the underlying equity security. In acknowledging this interplay, the Task Force stated:

> While chapter 8 describes this assessment sequentially (first determining if there is a compensatory element of the transaction and then determining whether and how that transaction should be considered when determining the fair value of the underlying equity security subsequent to the transaction), significant judgment is required in assessing the interplay between whether there is a compensatory element related to a secondary transaction and how, or if, that transaction should be incorporated in determining the fair value of the underlying equity security . . .

Generally, entities should first evaluate the indications of compensation discussed in Table 2 when determining whether the transaction includes a compensatory element. If a company concludes that a transaction includes a compensatory element, it will need to use judgment to determine how to weigh the transaction when calculating the fair value of the underlying equity security.

The decision tree below illustrates how an entity would evaluate a transaction that may be part of a multiple-element arrangement.

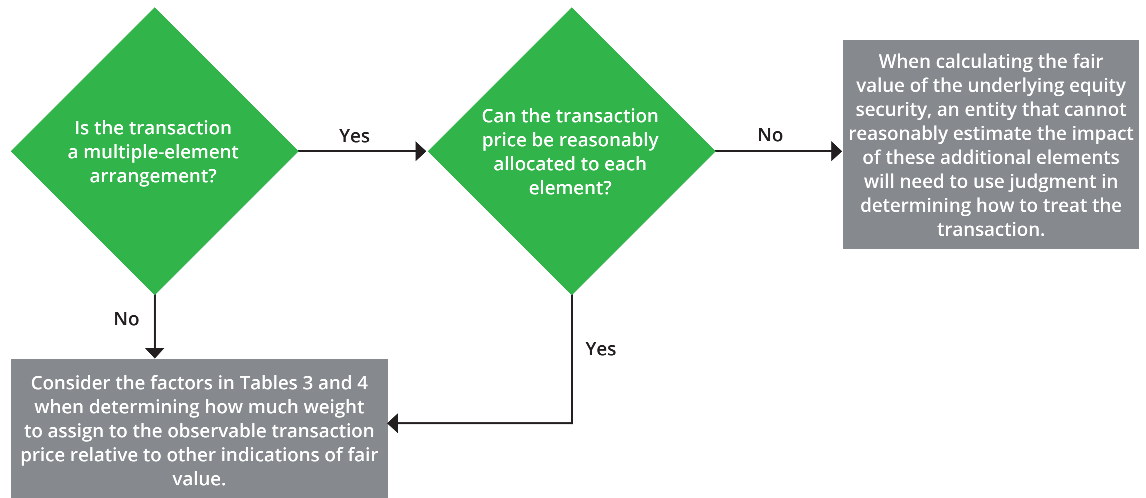


Table 3 below summarizes considerations related to the weight to give transactions with multiple elements when an entity *can* reasonably allocate the transaction price between the multiple elements in the arrangements. Entities should consider the factors below, along with the factors in Table 4, when determining how much weight to assign to the transaction relative to other indications of fair value. The tables are based on language adapted from the working draft.

Table 3: Considerations Related to Transactions With Multiple Elements — Other Elements in the Transaction

Indications of Less Weight (After Consideration of Price Allocation)	Indications of More Weight
• The transaction involves additional commercial agreements (e.g., partnerships and licensing). • There are indications of compensation (e.g., the company structured the transaction to provide liquidity at a favorable price).	• The transaction was a stand-alone transaction, no compensation was intended, and the buyer was entering into no other commercial arrangements. • The transaction involves diverse sellers with no compensatory intentions (e.g., financial investors and broad employee participation).

Weighting Considerations Related to Observable Secondary Transactions

In addition to evaluating whether a transaction involves compensatory or other elements, an entity must determine how much weight to place on observable secondary transactions when estimating the fair value of equity securities underlying share-based compensation awards. The working draft of Chapter 8 identifies several factors that may influence how an entity would make this determination, and Table 4 below summarizes considerations related to the weighting of observable secondary transaction prices or adjusted transaction prices for an arrangement that has multiple elements. Table 4 is not intended to be all-inclusive, and when considering each factor, entities must use judgment and take into account their specific facts and circumstances. No single factor is determinative.

Table 4: Weighting Observable Secondary Transactions

Factor	Indications of Less Weight to Place on Secondary Transactions	Indications of More Weight to Place on Secondary Transactions
Consistency of prices	Transaction prices are inconsistent and do not provide a reasonable basis for estimating fair value.	Multiple transactions with consistent pricing, or pricing that aligns with developments at the company or in the market.
Information available	Buyers and sellers lack relevant information that participants in the principal (or most advantageous) market would consider.	Buyers' and sellers' access to information was similar to that of participants in the principal (or most advantageous) market.
Significance of the transaction	The transaction was de minimis (e.g., too small to involve negotiations or be influenced by other factors).	The transaction was substantive to both parties.
Nature of buyers	Buyers do not represent participants in the principal (or most advantageous) market.	Buyers represent participants in the principal (or most advantageous) market.
Timing of the transaction	Participants in the principal (or most advantageous) market know that significant changes have occurred in the company or market since the last observable transaction.	The transactions were recent, with no significant subsequent changes in the company or the markets. If changes in the company or the market occurred between the transaction date and the measurement date, it is possible to calibrate to the original transaction price and then adjust for these changes.

The following are additional considerations related to certain of the factors listed above:

- *Consistency of prices* — If there have been multiple transactions as of the measurement date, consistent pricing or pricing that aligns with the company's performance or broader market trends will indicate that more weight should be placed on the secondary transactions than on other indications of fair value. For example, a company's recent announcement of significant milestones (e.g., product launches or new contracts) and pricing that is consistent with these announcements would suggest that greater weight should be placed on these indications. However, transaction prices that vary widely without logical explanation (e.g., unrelated to announced company developments or known market conditions) may indicate that less weight should be placed on them because the transactions may be influenced by other factors (e.g., multiple-element arrangements).
- *Information available* — Buyers and sellers in secondary transactions often have access to less information than investors in primary transactions; however, this does not indicate that less weight should be given to secondary transactions relative to other indications of fair value. Instead, companies should consider the level of information that is usual and customary in the principal (or most advantageous) market. In secondary transactions, market participants may not have access to information about significant events at the company, historical or projected financial information, details about capital structures, or other nonpublic information that could significantly affect the price if it were known to the parties transacting.

Connecting the Dots

For secondary transactions, access to limited (or even minimal) information may be usual and customary and therefore should not be used as a basis on which to conclude that less weight should be given to these transactions. For example, an entity should not place less weight on secondary transactions because it has nonpublic information unknown to market participants, even if that information would affect the equity securities valuation.

- *Significance of the transaction* — Companies should evaluate whether the transaction was de minimis from the buyers' and seller parties' perspectives. Even small transactions can be substantive if they represent meaningful liquidity events for the parties transacting. Entities should be careful not to dismiss transactions or assign less weight to secondary transactions solely because they represent a small percentage of the entity's overall equity. This is consistent with the Task Force's views:

  > The volume of the transaction may be considered as an indication of its relevance, but it would not be appropriate to use the volume of the transaction as a percentage of the total shares outstanding as a proxy for the percentage weight to apply. Even for securities that are traded in an active market, it is typical that only a small percentage of the outstanding shares are transacted in a given timeframe.

- *Timing of the transaction* — Recent transactions are generally more reliable indications of fair value than older ones provided that there have been no significant changes in the company or market conditions since the transaction date. For example, secondary transactions conducted two weeks before the measurement date are most likely more relevant than those conducted six months earlier if significant milestones, risk, or market shifts have occurred during the interim. The point at which transactions become "stale" depends on an entity's facts and circumstances. If changes have occurred, companies should consider whether it is possible to calibrate to the original transaction price and adjust for these changes. The adjusted transaction price would then be considered in the valuation.

Weighting Considerations Related to Other Indications of Fair Value

If the factors in Tables 3 and 4 above indicate that it is appropriate to place less weight on secondary transactions, entities will often use an indicator from other valuation models as one of the inputs to estimate the fair value of their equity securities. The selected weighting of secondary transactions and other indications of value would take into account the relevance of the two estimates relative to each other as well as the factors in Tables 3 and 4 above and in Table 5 below. Indicators from valuation models often use unobservable inputs and should reflect the best estimate of what a participant in the principal (or most advantageous) market would use. It is important that entities appropriately calibrate these models by using relevant observable pricing information, including primary and secondary transactions. The Task Force stated the following related to the importance of adjusting valuation models that appropriately reflect market participant perspective:

> [T]here may be circumstances where certain types of valuation models or assumptions do not appropriately reflect the extent to which market participants in the principal (or most advantageous) market for the security underlying the stock-based compensation award (e.g., common stock) would place value on the liquidation preferences or other features for the securities issued in primary transactions (e.g., preferred stock), or where the valuation model was not appropriately calibrated to the prices observed in the most recent primary transactions to reflect the price that market participants in the principal (or most advantageous) market would pay for the securities underlying the stock-based compensation awards. In such circumstances, it would be appropriate to adjust the valuation model to more appropriately reflect market participant perspectives before deciding on a weighting between the indications of value inferred from the secondary transactions and the indications of value inferred from the primary transactions. In particular, it is important to ensure:
>
> a. The valuation model calibrated to the primary transactions captures the extent to which market participants are considering the company on a common stock equivalent basis: for example, using a common stock equivalent method if the observable transactions indicate that market participants in the principal (or most advantageous) market assign no

value to the liquidation preferences or other features, or using a debt-like preferred plus upside method or a hybrid method including a common stock equivalent scenario if market participants in the principal (or most advantageous) market would place some value on the liquidation preferences or other features.

b. The valuation model is appropriately calibrated to a relevant recent transaction and captures the changes in the company and the markets between the transaction date and the measurement date . . .

Table 5 below provides considerations for weighting other indications of fair value. The table, which is based on language adapted from the working draft, is not intended to be all-inclusive, and when considering each factor, entities must use judgment and take into account their specific facts and circumstances. No single factor is determinative.

Table 5: Weighting Other Indications of Fair Value

Factor	Indications of Less Weight	Indications of More Weight
Is there a relevant recent transaction that provides a basis for calibrating the valuation model?	• The company has not recently completed a relevant transaction. • The company cannot reliably quantify significant differences between securities issued in previous transactions and securities underlying the share-based compensation award. • The information available to the parties in previous transactions differs significantly from that available to the participants in the principal market for the securities underlying the share-based compensation awards.	• There is a relevant recent transaction, and the company can reliably quantify differences between securities issued in previous transactions and securities underlying the share-based compensation award. • Market participants are aware that changes in the company or market occurred between the transaction date and the measurement date, and it is possible to calibrate to the original transaction price and then adjust for these changes.
What is the predictability and confidence in unobservable inputs (e.g., cash flows, key performance indicators)?	• The company is an early-stage entity (R&D; pre-revenue).	• The company is a later-stage entity with more predictable cash flows.
What is the degree of confidence in the unobservable inputs to the valuation model?	• The company does not have sufficient data or processes to prepare reliable forecasted information.	• The company has sufficient data or processes to prepare reliable forecasted information.

Recognizing Compensation Expense

In certain situations, individuals or entities that provide goods and services to a company or are customers of the company and hold its equity securities may sell those securities to other investors, to unrelated third parties, or back to the company itself. Entities should evaluate these transactions to determine whether there is a compensatory element and, if so, how to quantify it.

Under ASC 718-20-35-7, compensation cost must be recognized if an entity repurchases equity securities from grantees to the extent that the amount paid to the grantee exceeds the fair value of the equity securities repurchased on the repurchase date. In addition, ASC 718-10-15-4 requires an entity to recognize compensation costs if an *economic interest holder*[8] repurchases equity securities from grantees in an amount that exceeds the fair value of the

[8] In accordance with the ASC master glossary definition of an economic interest in an entity, an economic interest holder would include any party that holds equity securities in the entity.

equity securities unless the transaction "is clearly for a purpose other than compensation." The Task Force observed that "it will . . . be difficult to demonstrate that the excess paid over fair value is 'clearly for a purpose other than compensation for goods or services.'" In addition, the Task Force stated that "a company should also apply judgment to determine whether a new investor that purchases equity securities directly from grantees would also be considered an economic interest holder for purposes of applying FASB ASC 718."

In Chapter 9 of the working draft, the Task Force discussed a scenario in which a new unrelated third party might not be viewed as an economic interest holder:

> In some cases, an unrelated third party with no existing ownership in the entity may independently identify and negotiate the purchase of a limited number of equity securities from an existing shareholder with no involvement of the entity and not as part of a broader series of transactions with the entity. Similarly, a new unrelated third party may purchase a limited number of shares from an existing shareholder on an established secondary exchange . . . again with no other involvement with or by the entity. In those cases, such new investors might not be considered to be economic interest holders for purposes of applying the above guidance. However, as described above, there are many instances involving the purchase of equity securities by new investors where the task force believes it may be appropriate to view such an investor as an economic interest holder for purposes of evaluating the secondary transaction. . . .
>
> When a company is involved in a secondary transaction, and such involvement is limited to the company's waiver of its right of first refusal to purchase such shares, then the task force believes such involvement by itself would not necessarily result in the secondary transaction being viewed as within the scope of FASB ASC 718.

Thus, determining whether a new investor is viewed as an economic interest holder under ASC 718 is primarily based on the entity's involvement in facilitating the transaction. The Task Force believes that a key consideration related to making this judgment is "whether the company (including management, such as if they are the ones negotiating with an investor while also holding equity securities that will be purchased) benefited from the purchase (which could include direct benefits such as completing a concurrent primary financing round with the investor, or indirect benefits such as improved employee morale and retention by enabling grantees to obtain liquidity) or actively facilitated the transaction." [Footnote omitted]

In performing this assessment, an entity should also refer to Table 2 above. If the entity concludes that there is a compensatory element in the arrangement, the transaction will be within the scope of ASC 718. Further, entities will need to apply judgment to determine how much weight to apply to the secondary market transaction when quantifying the fair value of the underlying equity securities in calculating the amount that is the excess paid over the fair value of the equity securities on the transaction date.

Documentation Considerations

It is essential that companies appropriately document how they reached their conclusions related to the considerations discussed in this publication. This includes describing:

- How they evaluated whether a transaction includes a multi-element arrangement, such as a compensatory element, and how much weight they gave that secondary transaction relative to other indications of fair value.
- The reasons for excluding transactions that did not represent fair value or to which they gave limited weight in estimating the fair value of the equity securities underlying the share-based compensation award.
- The key judgments management applied when assessing the weight assigned to secondary transactions relative to other indications of fair value.

- The relevance and quality of the data used in each valuation method, including the data's relevant strengths and the company's confidence in one approach versus another.
- The completeness assessment performed to identify all potential secondary transactions that may indicate fair value.

Conclusion

The working draft of revised Chapters 8 and 9 of the AICPA Valuation Guide provides comprehensive interpretive guidance for private companies that grant share-based compensation awards. The Task Force believes that by understanding the distinctions between primary and secondary transactions, applying the principles of ASC 820, carefully evaluating the compensatory elements in secondary transactions, and documenting their conclusions, companies can ensure accurate and fair valuation of their equity securities.

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