New Private Company Relief for Share-Based Payments

On October 25, 2021, FASB issued Accounting Standards Update (ASU) 2021-07, *Compensation—Stock Compensation (Topic 718): Determining the Current Price of an Underlying Share for Equity-Classified Share-Based Awards,* which creates a practical expedient for private companies to use a reasonable application of a reasonable valuation method to calculate the fair value of the equity shares underlying a share-option award. The practical expedient uses the same characteristics as Section 409A of the U.S. Internal Revenue Code[1]. A reasonable valuation performed in accordance with §409A is an example of a way to achieve the practical expedient.

A private company that already obtains §409A compliant valuations for tax purposes may save time and money in valuing stock compensation for U.S. generally accepted accounting principles financial statements under this practical expedient.

Background

Private companies have struggled with the cost and complexity of determining the fair value of stock-option awards when granted or modified, primarily because their equity shares often are not actively traded and observable market prices for those shares or similar shares do not exist. Under current accounting guidance in Accounting Standards Codification (ASC) 718, *Compensation—Stock Compensation*, if an observable price is not available, companies must use a valuation technique such as an option-pricing model to determine the grant-date fair value of awards. These models require various inputs, including the fair value of the equity shares underlying a share-option award. This valuation is typically the most difficult input for private companies to estimate and substantiate to auditors, primarily because of the lack of observable prices. ASC 718 already provides private companies with a practical expedient to estimate other option model inputs for expected share price volatility and term.

Relief

The ASU describes the characteristics of the reasonable application of a reasonable valuation method, including:

- The date on which a valuation's reasonableness is evaluated
- The factors that a reasonable valuation should consider:
    - The value of the tangible and intangible assets of the entity
    - The present value of the entity's anticipated future cash flows
    - The market value of stock or equity interests in similar entities engaged in trades or businesses substantially similar to those engaged in by the entity for which stock is to be valued
    - An entity's recent arm's-length transactions involving the sale or transfer of the stock or equity interests
    - Other relevant factors such as control premiums or discounts for lack of marketability and whether the valuation is used for other purposes that have a material economic effect on the entity, its stockholders, or its creditors
    - The entity's consistent use of a valuation method to determine the value of its stock or assets for other purposes

[1] *Section 409A regulates taxation of nonqualified deferred compensation and applies to many share-based compensation arrangements. Treasury regulations include the acceptable valuation procedures for awards subject to §409A. To avoid significant penalties under §409A, the exercise price of a share-option award should be set at or above the fair market value of the underlying share as of the grant date. Section 409A states that an entity with stock that "is not readily tradable on an established securities market" may avoid being subject to §409A by obtaining or performing a valuation based on the "reasonable application of a reasonable valuation method."*

- The use of a valuation method is not reasonable if it does not consider all available information material to the entity's value
- The criteria that should be met for the use of a previously calculated value to be considered reasonable:
    - The value is updated for any information available after the date of calculation that may materially affect the entity's value
    - The value is calculated no more than 12 months earlier than the date for which the value is being used

The reasonable population of valuations is not limited to a valuation by independent appraisal; other valuations, including internal valuations, could meet the above characteristics. However, it is expected that an independent appraisal will often be the method used by nonpublic entities electing this practical expedient to comply with the presumption of reasonableness under the IRS code.

The practical expedient would not be available for liability-classified awards.

Transition & Effective Date

These changes are effective on a prospective basis for qualifying awards granted or modified during fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 21, 2022. Early application, including application in an interim period, is permitted for financial statements that have not yet been issued or made available for issuance as of October 25, 2021. The practical expedient is to be applied on a measurement-date-by-measurement-date basis, *i.e.*, all share-based awards that have the same underlying share and the same measurement date. If the practical expedient is elected, an entity must disclose that information.

Conclusion

If you have questions about these changes, contact your **BKD Trusted Advisor**™ today.

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