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FASB proposes a practical expedient for valuing nonpublic entity share option awards

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KPMG reports on the FASB's proposed ASU[1], which provides a practical expedient for nonpublic entities to determine the fair value of their share option awards.

Applicability

Nonpublic entities that provide share option awards to employees and nonemployees.

Key Facts and Impacts

The FASB's Private Company Council (PCC) proposal would give nonpublic entities a practical expedient to determine the value of share-based payment option awards. As a result, under the proposal, the current price input of share option awards could be obtained using a valuation in accordance with the 'presumption of reasonableness' provisions of Section 409A of the US Internal Revenue Code (Section 409A).

Background

Under Topic 718, the use of an option pricing model (e.g. Black-Scholes-Merton, lattice, etc.) is required to value share option awards. In applying an option pricing model, various inputs are required for consideration including the current market share price, exercise price, expected volatility, expected term, and the risk-free interest rate. While nonpublic entities are subject to the same general fair value measurement principle as public entities, certain alternative measurement methods are made available to nonpublic entities in order to estimate expected volatility and expected term in the event that it is not practicable for them to make a reasonable estimate.

Despite these alternative measurement methods, determining the fair value of share option awards at grant date or upon a modification can be challenging for nonpublic entities due to the fact that they are not traded on an active market and, therefore, observable market prices are not available. In response, the PCC developed an optional practical expedient for nonpublic entities with the intent to reduce the complexity and the cost associated with determining the current market price of share option awards.

Proposed guidance

Optional practical expedient for nonpublic entities

As a practical expedient, and on an award-by-award basis, nonpublic entities would be allowed under the proposal to use a valuation performed in accordance with the 'presumption of reasonableness' provisions of

[1] Proposed ASU, Determining the Current Price of an Underlying Share for Equity-Classified Share-Option Awards, August 17, 2020

Section 409A[2] to determine the current price of their underlying shares for purposes of determining the fair value of a share option at grant date or upon a modification. The proposal limits the practical expedient to equity-classified awards and could not be used for other types of awards provided under share-based payment arrangements (e.g. restricted share awards). Under these regulations, the following valuation methods are acceptable to meet the presumption of reasonableness provisions:

- 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 nonlapse restriction with respect to the share, would be considered the fair market value of the share; or
- A valuation made reasonably and in good faith and evidenced by a written report that considers the relevant factors of the illiquid stock of a start-up corporation (as defined in the regulations).

KPMG observation

The practical expedient is intended to provide relief to private entities due to the complexity surrounding the required valuation methods under Topic 718 and the costs incurred to perform and audit those valuations. However, while the intent of the FASB and the PCC is to reduce costs incurred to prepare the valuations, unless an entity has historically obtained both a 409A and a Topic 718 valuation for the same awards, the application of this practical expedient likely would not significantly reduce costs for the following reasons:

- There is not a corresponding proposed amendment to the AICPA auditing standards on the auditing of accounting estimates[3]. As a result, if an entity elected to apply the proposed practical expedient, the same level of audit evidence would be required to validate the reasonableness of the estimated share price value; audit procedures would include an evaluation of the valuation method applied and validation of the specific data inputs and assumptions used by management to develop the estimate[4].
- The scope of the practical expedient under the proposal is limited and could only be applied in determining the fair value of equity-classified share option awards at grant date or upon a modification. The practical expedient as proposed would not be applied in determining the fair value of other equity transactions commonly executed by nonpublic entities including, but not limited to, warrants and restricted stock awards. In addition, as proposed, the practical expedient would not be applied to share option awards that are liability-classified. As a result, an entity that elected to apply the practical expedient to its equity-classified share option awards would still be required to perform a valuation under Topic 718 to determine the fair value of these other types of instruments or transactions for financial reporting purposes.

The expectation of the FASB and the PCC is that the majority of nonpublic entities would elect to use a valuation determined by an independent appraiser, based on their research of current common practices in the market. In addition, in accordance with the provisions of Section 409A, valuations are valid for 12 months unless subsequent information (e.g. equity financings, secondary market transactions, financial growth of the entity, etc.) becomes available that would have a material effect on the estimated market price of the entity's shares. The proposed ASU indicates that the Section 409A valuations would not be updated with the 12-month period unless the valuation is determined to be 'grossly unreasonable'.

[2] Treasury Regulation Section 1.409A-1(b)(5)(iv)(B)(2)

[3] AU-C Section 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures

[4] AU-C 540.13

KPMG observation

After a Section 409A valuation is obtained, determining whether there is subsequent information that materially affects the value of an entity's equity may be difficult and require judgment. In addition, determining whether a valuation is 'grossly unreasonable' also would require judgment. Therefore, if the proposal is finalized as proposed, it will be important to continue to identify any secondary market transactions, other financial transactions, or other executed agreements which may affect the valuation's validity, and to consider whether the valuation is 'grossly unreasonable.'

Furthermore, the proposed ASU does not address when there are manual adjustments to a prepared 409A valuation, either at the time of the 409A valuation or at a subsequent date, (e.g. adjustments due to grants issued between valuation dates, secondary sales weightings, etc.). As a result, we believe that if there are manual adjustments to a prepared 409A valuation, the provisions of the practical expedient would no longer apply, and a valuation under Topic 718 would be needed. Any adjustments also would require further audit consideration.

Effective dates and transition

The proposed ASU would be effective prospectively, for all qualifying awards, in interim and annual periods in the year of adoption. The effective date will be determined after the PCC considers stakeholder feedback on this proposed ASU, and entities would be permitted to early adopt the proposed ASU.

Next steps

Comments on the proposed ASU are due October 1, 2020.

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