Private Companies

Practical expedient for valuing share-based payment awards

October 26, 2021

New ASU provides a practical expedient to determine the fair value of private company share-based payment awards.

Applicability

ASU 2021-07, Determining the Current Price of an Underlying Share for Equity-Classified Share-Based Awards, a consensus of the Private Company Council

Applies to private companies that provide share-based payment awards to employees and nonemployees.

Fast facts, impacts, actions

Under Topic 718, entities value their share-based payment awards at fair value. Because private companies often lack observable market prices for their equity securities, they may need to obtain costly or complex valuations to determine the fair value of their awards. Therefore, determining a share price for restricted stock awards or obtaining the share price input when using an option pricing model to value option-based awards can be problematic.

For this reason the FASB has provided a share price practical expedient that allows private companies to determine their restricted share price, or option-based award share price input, using a ‘reasonable application of a reasonable valuation method’.

One example of a reasonable application of a reasonable valuation method is a share award valuation performed under the US Treasury regulations related to Section 409A of the Internal Revenue Code (IRC). If a private company applies the new practical expedient, it can use an IRC Section 409A valuation for up to 12 months, adjusted for any material events subsequent to the valuation date.

The practical expedient applies to both employee and nonemployee awards, is not available for liability-classified share-based payment awards, and is applied on a measurement date-by-measurement date basis. The practical expedient is effective prospectively and early application is permitted (see Effective dates and transition).

> **Action:** A private company should evaluate its current method for determining its restricted share price, or option-based award share price input, in light of this newly available practical expedient, taking into account the observations discussed below.

Background

All entities must value their share-based payment awards at fair value under Topic 718. Although private companies are subject to the same general fair value measurement principles as public entities, there are practical expedients and alternative measurement methods available to private companies. The practical expedients and alternative measurement methods assist private companies in developing the inputs to option pricing models used to estimate their share-based payment awards (e.g. expected volatility and expected term inputs). Until ASU 2021-07, there was no practical expedient for developing the share price input required by the option pricing models when valuing equity-classified share-based payment awards, nor was there one for determining a restricted share price when valuing such awards.

Share price practical expedient for equity-classified awards

The FASB created the share price practical expedient due to the absence of observable market prices for private companies, and in an effort to further reduce cost and complexity of valuing equity-classified share-based payment awards. The practical expedient does not change the measurement objective of Topic 718; all entities must use a valuation model that meets the measurement objective of Topic 718 to determine the fair value of their equity-classified awards. Instead, the practical expedient allows flexibility in determining the restricted share price, or option-based award share price input to an option pricing model, by using a 'reasonable application of a reasonable valuation method'.

A valuation method is considered reasonable if it considers all available information material to the value of the private company. A valuation performed under IRC Section 409A is an example of an application and methodology that would be acceptable under the practical expedient because ASU 2021-07 notes that the measurement objective (fair market value) of Topic 718 and the Treasury Regulations related to IRC Section 409A are similar.

Generally, a value calculated under the Treasury Regulations is considered valid for 12 months after the valuation date unless the value would be considered grossly unreasonable. The ASU clarifies that a value is not reasonable as of a later date, and therefore a new valuation is needed, if it does not reflect information available after the valuation date that materially affects the value of the private company. As a result, while using a reasonable valuation performed in accordance with Section 409A is an example of a way to apply the practical expedient, a private company cannot simply rely on such a valuation without considering whether there are events subsequent to the valuation date that materially affect its value.

Observation: The practical expedient is designed to allow private companies that have historically received both an IRC Section 409A valuation and a Topic 718 valuation to obtain one valuation for both purposes.

Although some private companies may be able to reduce cost or complexity by not obtaining both types of valuations, the fair value measurement objective of Topic 718 has not changed; even post-ASU adoption, private companies are still required to evaluate information available after the date of the valuation that may materially affect the value of the entity. In current practice, our experience is that most private companies obtain an IRC Section 409A valuation and adjust the valuation for subsequent material events to obtain their share price value. As a result, we do not expect the ASU to result in a significant change to current practice unless an entity previously obtained two separate valuations.

In addition, the auditing standards related to fair value have not changed, and therefore we anticipate the same level of audit considerations post-ASU adoption.

The practical expedient is available for both employee and nonemployee awards, must be elected on a measurement date-by-measurement date basis, and is applied to all equity-classified share-based payment awards with the same underlying share and measurement date.

Observation: Because the ASU applies only to equity-classified awards, if an entity grants both equity-classified and liability-classified awards on the same date, it can use the practical expedient only for the equity-classified awards. For such entities, instead of applying the practical expedient, it will likely be better to obtain a Topic 718 valuation for both the equity-classified and liability-classified awards.

Effective dates and transition

	Private companies
Annual periods – fiscal years beginning after	December 15, 2021
Interim periods – in fiscal years beginning after	December 15, 2022
Early application permitted?	Yes, for interim or annual financial statements that have not been issued (or made available for issuance) as of October 25, 2021

Private companies that elect the practical expedient must apply it prospectively.

Observation: Because the fair value measurement objective of Topic 718 has not changed, we would not expect a significant difference in the valuation of share-based payment awards whether or not the practical expedient is elected. However, private companies that are considering going public should evaluate whether using the practical expedient ultimately would be beneficial, given the scrutiny placed on the valuation of share-based payment awards under Topic 718 in the period leading up to an initial public offering.

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