ALERT

November 2, 2021

FASB ISSUES ACCOUNTING STANDARDS UPDATE ON SIMPLIFYING THE VALUATION OF SHARE-BASED AWARDS FOR NONPUBLIC COMPANIES

The Financial Accounting Standards Board (FASB) on October 25, 2021 issued Accounting Standards Update (ASU) 2021-07 to the Accounting Standards Codification (ASC) Topic 718-10-30-20, which further simplifies the valuation of equity-classified share-based awards for nonpublic companies made to employees and nonemployees. Prior to ASU 2021-07, ASC Topic 718 provided simplified methods for nonpublic companies to estimate expected term length and expected stock price volatility inputs used for an option pricing model. However, companies without observable market prices (i.e., nonpublic companies) were given limited and vague standards for determining the underlying stock price of a share-based award. Topic 718 only required companies to apply a method consistent with objectives based on established principles of financial economic theory and reflective of all substantive characteristics of the instrument (Topic 718-10-55-11).

As noted in our previous Alert Letter from September 2020 (found here), ASU 2021-07 provides a "practical expedient" that allows nonpublic companies to use any of the following three valuation safe harbors described in the "presumption of reasonableness" under IRC Section 409A to determine the stock price at the date of grant:

1. A valuation determined by an independent appraisal within the 12 months preceding the grant date
2. A valuation based on a formula that, if used as part of a non-lapse restriction with respect to the shares, would be considered the fair market value of the shares
3. A valuation made reasonably and in good faith that is evidenced by a written report that considers the relevant factors with respect to the illiquid stock of a start-up corporation, as defined in the regulations

A practical expedient is defined by the FASB as a more cost-effective way of achieving the same or a similar accounting or reporting objective. The FASB believes an independent appraisal will be the valuation technique most often used by nonpublic companies.

Not included in the previous proposed version, ASU 2021-07 establishes further limitations saying a valuation is not reasonable if:

1. Such valuation fails to reflect information available after the date of calculation that may materially affect the value, such as the resolution of a material litigation or a liquidity event
2. The value was calculated with respect to a date that is more than 12 months earlier than the grant date

The practical expedient for nonpublic companies now provides further guidance on factors to consider as part of a “reasonable” valuation. Importantly, ASU 2021-07 permits nonpublic companies to use the Section 409A safe harbor for up to 12 months prior to the grant date barring any significant subsequent events between the valuation date and grant date. As nonpublic companies are already required by the Internal Revenue Service (IRS) to follow deferred compensation rules under Treasury Regulation Section 1.409A-1(b)(5)(iv)(B) (“Section 409A”), the update allows nonpublic companies to use the same valuation for federal tax and generally accepted accounting principles (GAAP) purposes for determining the current price of the underlying share at the grant date. The Exposure Draft to ASU 2021-07 limited the use of the safe harbor valuation methods prescribed in the Sections 409A to stock options and stock-settled stock appreciation rights (SARs). ASU 2021-07 now explicitly states that the practical expedient may be applied to all equity-classified share-based payment awards, not just stock options and stock-settled SARs.

The ASU becomes effective for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. A company that elects to use the practical expedient prescribed by ASU 2021-07 is required to:

- Apply the method on a measurement-date-by-measurement-date basis; meaning the practical expedient must be applied to all equity-classified share-based awards having the same underlying share and measurement date
- Apply the method using a prospective transition method; meaning nonpublic companies are not required to remeasure the grant-date fair value of existing equity-classified awards
- Disclose in financial statements’ footnotes the use of the practical expedient for each year which an income statement is presented

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General questions about this summary can be addressed to Stafford Schmidt in our New York City office at 212.294.0105 or by email at stafford.schmidt@fwcook.com; or to Thomas M. Haines in our Chicago office at 312.332.0910 or by email at thomas.haines@fwcook.com. Specific questions should be referred to the company’s professional accountants. Copies of this summary and other published materials are available on our website at www.fwcook.com. The Alert Letter on the Proposed Version of ASU 2021-07 can be found here. A complete summary of Topic 718 can be found here.