

October 12, 2020

Technical Director, Financial Accounting Standards Board

File Reference No. 2020-200

Re: Proposed Accounting Standards Update

Compensation – Stock Compensation (Topic 718) *Determining the Current Price of an Underlying Share for Equity-Classified Share-Option Awards* – a proposal of the Private Company Council

The California Society of CPA’s (“CalCPA”) Accounting Principles and Assurance Services Committee (the “Committee”) is the senior technical committee of CalCPA. CalCPA has approximately 42,600 members. The Committee consists of 54 members, of whom 45 percent are from local or regional firms, 32 percent are from large multi-office CPA firms, 12 percent are sole practitioners in public practice, 6 percent are in academia and 5 percent are in international firms. Members of the Committee are with CPA firms serving a large number of public and nonpublic business entities, as well as many non-business entities such as not-for-profits, pension plans and governmental organizations.

Summary of the Committee’s Views on the Proposed ASU

The Committee appreciates the FASB and PCC efforts to simplify GAAP. Overall, we support the proposed practical expedient. However, the Committee believes the scope of the eligible awards should be expanded to capture equity-classified nonvested stock.

The Committee has set forth its responses to the specific questions in the proposed Update below.

Specific Questions

Question 1: Is the practical expedient as drafted in this proposed Update operable? If not, please explain why.

The Committee believes that the proposed Update as drafted will be generally operable.

We suggest that the Board clarify the proposed language in ASC 718-10-30-20C to note that a valuation performed in accordance with Treasury Regulation Section 1.409A-1(b)(5)(iv)(B)(2) can only be used for purposes of the practical expedient during the period it meets the IRS requirements (which is generally within twelve months after its effective date, unless a material event has occurred that would truncate this period).

Question 2: The practical expedient in this proposed Update is applicable only for equity-classified share-option awards. Should the scope of the practical expedient in this proposed Update be expanded to include other equity-classified share-based compensation arrangements (for example, nonvested shares)? Please explain why or why not.

We strongly believe the practical expedient should at a minimum be expanded to cover equity classified nonvested shares.

The reason we believe the practical expedient should be available for these awards and instruments is to prevent circumstances where an entity would be required to use different measures of the value of a share for different purposes. We illustrate the potential for such circumstances in the following example.

Example. A December 31 year-end company obtains a valuation of its common stock in accordance with Treasury Regulation Section 1.409A-1(b)(5)(iv)(B)(2) (“IRS section 409(A) valuation”) as of June 30, 2021, indicating fair value of its common stock of \$1.00.

The IRS section 409(A) valuation can generally be used for tax purposes for twelve months from the effective date, i.e. in our example, through June 30, 2022. In particular, absent “material events”, the entity will be able to use this valuation for tax purposes for stock options the entity issues on December 31, 2021. However, this entity may also grant equity-classified nonvested common shares in scope of Topic 718 on the same date. As the practical expedient would not apply to these awards, the entity would need to establish fair values of the nonvested common shares using other methods. This may result in a conclusion that different measures of fair value of common stock should be used for valuation of different awards as of the same date, which we believe would be counter-intuitive and not useful to either preparers or users of the financial statements.

In addition, the difference between a nonvested share and a stock option may exist in form only. Many stock options permit early exercise, which private company executives tend to do, to reduce their tax liabilities. An early exercised stock option effectively becomes a nonvested share. Conversely, while many entities issue nonvested shares for no consideration, some entities do issue nonvested shares in exchange for cash consideration equal to the fair value of the shares. There is little if any practical difference between a nonvested share that results from early exercise of a stock option and a nonvested share that is originally issued as a share in exchange for cash consideration. Under the proposed ASU, the practical expedient would apply to the former but not the latter. It is not clear to us that such implications of the narrowed scope are meaningful.

We believe that the Board should further consider expanding the scope of the practical expedient to also include liability-classified stock-based awards in scope of Topic 718, and equity or liability classified stock-indexed financial instruments in scope of Topic 480 and Topic 815-40, such as common (and preferred, if applicable) stock options and warrants. While we do not anticipate that failure to adopt our proposed scope expansion will diminish to any substantive extent the usefulness of the information in the financial statements, we also understand that the Board may need to seek additional input from the stakeholders, which may take a substantial amount of time. If this is the case, we would urge the Board to issue the proposed Update with the scope that is limited solely to equity-classified stock options and nonvested shares in scope of Topic 718.

Question 3: Will the proposed practical expedient reduce costs, including audit costs or fees, associated with the current price input? Please explain why or why not.

We expect the proposed practical expedient may reduce costs including audit costs and fees for some companies, but not others. Some of the companies who elect the practical expedient may also see an increase in costs.

Under the current practice, many entities retain a valuation firm to perform an IRS section 409(A) valuation once a year. The adoption of the proposed practical expedient will not impact this cost. Entity management and auditors, upon receipt of the IRS section 409(A) valuation, then undertake procedures to validate the use of the valuation for stock compensation purposes. This generally includes understanding the methodologies, and verifying inputs and assumptions, underlying the valuation. Under the proposed practical expedient, the focus of the management and auditor procedures will be on whether the valuation is acceptable for IRS purposes. We expect such procedures will include validation of the methodologies, inputs and assumptions similar to that performed today for financial reporting purposes. However, in addition, management and auditors will also need to become comfortable that the valuation will be acceptable for tax purposes. Auditors today are not trained or experienced in understanding the IRS requirements to valuation. Further, there are circumstances when acceptability of such valuation is uncertain. As a result, management preparation and audit costs could increase to document compliance with the IRS regulations, allow involvement of the auditors' tax specialist, and assess and document the effects of the uncertainties.

Of course, one could make an argument that if no cost savings are anticipated, an entity may elect to bypass the practical expedient. However, the incremental costs may not become apparent until after the practical expedient has been elected, and thus be unavoidable.

On the other hand, costs could be reduced when an earlier IRS section 409(A) was already validated in connection with an earlier stock option grant, and another grant is made within 12 months. Under today's practice, the entity would need to assess and document, and auditors would audit, the change in the fair value of the underlying shares during the intervening period. Under the proposed practical expedient, little if any additional validation procedures would be required apart from ascertaining that no "material events" have occurred.

For entities granting share options at various times during the year and obtaining valuations to support accounting valuations at each date, the practical expedient will eliminate the need for interim valuations, and this will result in cost savings.

Further cost savings could be realized if the practical expedient is expanded to awards of nonvested shares, as we recommend. Ultimately, whether there is any meaningful cost reduction will depend on the facts and circumstances of each individual entity.

There is a less quantifiable benefit to use of the practical expedient. There is currently uncertainty as to what is acceptable for GAAP, but an external IRS section 409(A) valuation has become the unofficial "gold standard." If use of an external valuation is, in effect, encouraged by the Board with the proposed practical expedient, it could serve to raise the quality of financial reporting by entities not currently using such valuations.

Question 4: Do you or your clients obtain separate valuations to satisfy GAAP requirements (Topic 718) and tax regulations (Section 409A)?

In our experience, it is uncommon for entities to obtain separate valuations for GAAP and tax purposes. One use case example may include a “cheap stock” assessment by companies during the year preceding their initial public offering. However, these companies would not be allowed to use the practical expedient in any event (or if used contemporaneously, would need to replace it with a subsequent reassessment of fair value based on the existing Topic 718 guidance). Other examples we have seen are highly specific to individual companies’ facts and circumstances.

Question 5: Do you agree with allowing the proposed practical expedient to be elected on an award-by-award basis?

We believe entities should apply the practical expedient on a measurement date by measurement date basis. We do not expect it would be reasonable for entities to use different values to measure awards with the same measurement date.

Question 6: Will the proposed practical expedient compromise the decision usefulness of information related to equity-classified share-option awards? If yes, please explain how.

No, we do not believe it would. Measurement of stock compensation awards is typically not precise enough to have material implications for the users of the private company financial statements. We find this is often the case even if the potential changes in the underlying stock compensation amounts were relatively large and would be seen as material if they are related to cash-based expenses.

Question 7: Do you agree with the proposed prospective transition requirements? If not, please explain why.

Yes, we agree. We believe prospective application, with early application permitted, is the most meaningful approach to dealing with the proposed change.

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We thank you for the opportunity to comment on these matters. We would be glad to discuss our opinions with you further should you have any questions or require additional information.

Sincerely,



Nancy A. Rix, Chair
Accounting Principles and Assurance Services Committee
California Society of Certified Public Accountants