

September 18, 2020

Ms. Hillary H. Salo
Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

By e-mail: director@fasb.org

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)


(File Reference No. 2020-200)

Dear Ms. Salo:

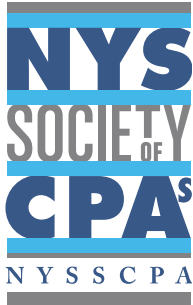
The New York State Society of Certified Public Accountants (NYSSCPA), representing more than 22,000 CPAs in public practice, industry, government and education, welcomes the opportunity to comment on the above-captioned exposure draft.

The NYSSCPA's Business Valuation & Litigation Services and Financial Accounting Standards Committees deliberated the proposed accounting standards update and prepared the attached comments. If you would like additional discussion with us, please contact Mitchell Chosak, Chair of the Business Valuation & Litigation Services Committee, at (212) 331-7256, or Ernest J. Markezin, NYSSCPA staff, at (212) 719-8303.

Sincerely,


Edward L. Arcara
President

Attachment



**NEW YORK STATE SOCIETY OF
CERTIFIED PUBLIC ACCOUNTANTS**

COMMENTS ON

**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)

(File Reference No. 2020-200)

September 18, 2020

Principal Drafters

From the Business Valuation & Litigation Services Committee:

**Mitchell Chosak
Michael Guthammar
Frank Kiepura
Pasquale Rafanelli
Jonathan Tang**

From the Financial Accounting Standards Committee:

**Orumé A. Hays
Jeffrey A. Keene**

NYSSCPA 2020–2021 Board of Directors

Edward L. Arcara, <i>President</i>	Darcy Aldous Carnet A. Brown	Michael E. Milisits Steven M. Morse
Rumbidzai Bwerinofa- Petrozzello, <i>President-elect</i>	Christopher G. Cahill Kelly R. Capron	John A. Mourer Maria L. Petrollese
Thomas S. Pirro, <i>Secretary/Treasurer</i>	Catherine Censullo Orumé A. Hays	Jennifer Pickett Ita M. Rahilly
William H. Dresnack, <i>Vice President</i>	Elliot L. Hendler William C. Huether	Alexander Resnick Sharon Sica-Costanzo
Lynne M. Fuentes, <i>Vice President</i>	John B. Huttlinger, Jr. Jennifer A. Kartychak	Denise M. Stefano Maria E. Suppa
Timothy J. Hammond, <i>Vice President</i>	Edward N. Lee Philip London	Mark M. Ulrich Liren Wei
Robert M. Rollmann, <i>Vice President</i>	Gerard J. LoVerde Kevin Matz	Charles J. Weintraub David G. Young
Joanne S. Barry, <i>ex officio</i>	Patricia A. McGrath Mitchell J. Mertz	Craig A. Zellar

NYSSCPA 2020–2021 Accounting and Auditing Oversight Committee

Margaret A. Wood, <i>Chair</i>	Richard C. Jones	Ilene L. Persoff
Jennifer L. Biundo	Diane L. Jules	Robert M. Rollmann
Jennifer R. George	Jeffrey A. Keene	Lenore Sanchez
Stephanie Gigliotti	Bonnie S. Mann Falk	Christopher J. Zingalli
	Renee Mikalopas-Cassidy	

NYSSCPA 2020–2021 Business Valuation and Litigation Services Committee

Mitchell H. Chosak, <i>Chair</i>	James Guberman	D. Edward Martin
Christopher D. Aglio	Michael Guthammar	Elliot D. Metelka
Michael J. Angerhauser	Jean J. Han	Johnathon Miles
Jeffrey H. Bain	Jeffrey F. Harrison	Alban J. Miranda
Lorraine A. Barton	Edward B. Heben	Cristina Misa
David M. Beckman	Timothy T. Heck	James R. Nelkin
S. David Belsky	Noam Hirschberger	Lawrence Palaszynski
Stephen H. Berardi	Marissa K. Hoffmann	Andrew M. Park
John M. Bonora	Kimberly Hunter	Brian K. Pearson
Rumbidzai N. BwerinofaPetrozzello	Richard E. Hurley	Ronald D. Phillips
Richard J. Bylott	Thomas A. Hutson	Joel R. Podgor
Michael A. Castillo	Ajit K. Jain	Barry L. Pulchin
Margaret Chen	Karl H. Janhsen	Pasquale Rafanelli
Ting-Wei Chen	Stefanie A. Jedra	Richard T. Ranucci
Fred E. Chilkowitz	Patricia A. Johnson	Yigal Rechtman
Clara M. Cohen	Philip H. Kanyuk	M. Jacob Renick
	Belayet Khan	Paul M. Ribauda

Steven I. Crabbe
Robin A. Cramer
John F. Craven
Ciro V. Cuono
David W. Daly
Harold L. Deiters III
Marianne L. DeMario
Mark DiMichael
Edward G. Donnelly
Anthony G. Duffy
Edward F. Esposito
Jared Feldesman
Howard M. Fielstein
JoAnn Fleming
Michael J. Garibaldi
Jeffrey F. Gibraltar
Emily B. Gilbert
Anthony J. Girard
Mark S. Gottlieb
Martin Greene

Frank C. Kiepura
Yaroslav F. Kim
Max Kirsch
Jonathan Kirschner
Hubert Klein
Michael R. Koepfel
Russell J. Kranzler
Jeffrey J. Kravitz
Dennis B. Kremer
Muued Kumandan
Rosalia M. Labate
Keith J. Lazarus
Thomas P. Lee
Elliot A. Lesser
Moshe S. Levitin
Frank Fazhan Li
Martin Lieberman
Stephen A. Linker
Paul C. Marquez
Sheila R. Marshall

Stewart W. Robinson
Sam Rosenfarb
David N. Rudman
Robert I. Schindler
Joshua S. Sechter
David R. Silversmith
Ernest P. Smith
Jason H. Soman
Andrew Taffurelli
Sunny Tam
Jonathan J. Tang
Steven W. Tartaglia
Patrick M. Trask
Sean Umlauf
Mark S. Warshavsky
Nannette Watts
Ian S. Weininger
Jonathan A. Weinstein
Robin L. Zone
David S. Zweighaft

NYSSCPA 2020–2021 Financial Accounting Standards Committee

Jeffrey A. Keene, *Chair*
Sean C. Prince, *Vice Chair*
Agwu Agwu
Brian M. Aledort
Kwame Ampeh
Olga Bashkatova
Christina K. Catalina
Ramona Cedeno
Sara C. D'Agostino
Muneeb Danish
Timothy P. Demetres
Deepak K. Doshi
William Epstein
Roseanne T. Farley
Sharon Sabba Fierstein
Christopher Gagliardi
John F. Georger Jr.
Jo Ann Golden
Fred R. Goldstein

Mukul Gupta
Emily D. Hache
Abraham E. Haspel
Orumé A. Hays
Jean-Pierre Henderson
Edward P. Ichart
Min Jung Kang
Michael D. Kasperski
Angela V. Katehis
Muued Kumandan
Chi Lam
Joseph A. Maffia
Sean Martell
Sean D. Matthews
John J. McEnerney
Mark Murray
Lingyun Ou
Michael A. Pesce
Pedro D. Pile

Richard M. Posen
Laura C. Prevratil
Renee Rampulla
Collette E. Richards
Robert M. Rollmann
Timothy Schroeder
Troy P. Segar
Ahmed Shaik
Daniel Shea
Mark Springer
Fatou Kine Thiam
A'Isha Torrence
Ross A. Trapani
Joshua D. Verni
Priyanka K. Vig
Rosemarie E. Whyte
Margaret A. Wood
Yan Zhang

NYSSCPA Staff
Ernest J. Markezin

New York State Society of Certified Public Accountants

Comments on

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)

(File Reference No. 2020-200)

We welcome the opportunity to respond to the Financial Accounting Standards Board’s (FASB or the Board) invitation to comment on Proposed Accounting Standards Update—*Compensation—Stock Compensation (Topic 718): Determining the Current Price of an Underlying Share for Equity-Classified Share-Option Awards* (proposed Update).

General Comments

We agree that it is an acceptable practical expedient to use a reasonably determined Internal Revenue Code Section (Section) 409A valuation, according to accounting requirements, as the current price input into an option model for Accounting Standards Codification (ASC) 718 purposes. However, we believe there are significant differences between generally accepted accounting principles (GAAP) and Section 409A requirements and enforcements. Codifying Section 409A concepts into current accounting practice while “presuming reasonableness”, without identifying quality safeguards and audit assessment, may result in providing outdated and unreliable financial information to investors.

The history of accounting for equity options has been filled with controversy ever since the issuance of Accounting Principles Board (APB) 25 in 1972. It took FASB over a decade of discussions and reviews to issue Statement of Financial Accounting Standards (SFAS) 123 and a decade more and the bursting of the “dot-com bubble” before wide adoption of expensing for employee stock options. For private companies, the uncertainties related to the value of their equity instruments present special challenges for both tax and accounting determinations. Today, with private equity investments becoming a larger part of overall portfolios, stock options being an increasingly larger part of employee compensation, and large private companies staying private for much longer time horizons, the issues related to Section 409A and ASC 718 have become more important than ever.

Current Best Practice

The current best practice for private companies issuing “plain-vanilla”¹ options under Section 409A and ASC 718 is as follows. For “non-plain-vanilla” options, a separate valuation for ASC 718 is usually warranted.

- 1) The private company obtains a valuation report from an independent appraiser for Section 409A purpose.
- 2) The private company should assess the report and valuation conclusion for reasonableness.
- 3) The private company’s auditor reviews the Section 409A report and determines its reasonableness.
- 4) After receiving feedback from management and its auditor, and approval from its board, the company issues options with strike prices based on the Section 409A report’s fair market value, and calculates compensation expense using the same fair market value as both the current price and the strike price inputs into an option pricing model.
- 5) The company continues to issue stock options and calculate compensation expenses at the same fair market value within the safe harbor period, i.e., a period of 12 months after the valuation date or until an event occurs indicating a material change in company value (such as signing a large new client, closing a new financing round from venture capital investors, or achieving an important technical milestone).
- 6) After expiration of the safe harbor period (again, either 12 months after the previous valuation, or upon an event that would indicate a material change in value), a new valuation is required for both Section 409A and ASC 718 purposes.

We are not aware of any wide adoption of the practice of requiring private companies to separately estimate a different current price input for ASC 718 purposes if the Section 409A safe harbor is in place. That is because if the company determines, under accounting principles, that the value of the company has changed enough to warrant a new current price input, then the same should be applied to the Section 409A safe harbor determination, at which time a new Section 409A valuation is needed. We note that this very subjective determination is often the main point of contention between private companies issuing stock options and auditors reviewing Section 409A and ASC 718 valuations.

¹ “Plain vanilla” options refers to equity share options issued to employees with the following basic characteristics: (1) The options are granted at-the-money; (2) Exercisability is conditional on performing service through the vesting date; (3) If an employee terminates service prior to vesting, the employee would forfeit the share options; (4) If an employee terminates service after vesting, the employee would have a limited time to exercise the share options (typically 30-90 days); and (5) The share options are nontransferable and nonhedgeable. The term appears in “SEC Codification of Staff Accounting Bulletins, Topic 14: Share-Based Payment”, “Question 6” and “Footnote 75”. It is a standard term used by people performing ASC 718 valuations.

Section 409A Presumption of Reasonableness

As summarized in the proposed Update, Section 409A allows for three methods to meet the presumption of reasonableness requirements (below language from the proposed Update):

- 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 nonlapse restriction with respect to the share, would be considered the fair market value of the share
- 3) 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).

A comparison of these descriptions with AICPA Statement on Standards for Valuation Services (SSVS) No. 1 and other valuation standards such as Uniform Standards of Professional Appraisal Practice (USPAP) Standards 9 and 10 raises questions on whether the last two “valuation” methods prescribed by Section 409A qualify as acceptable valuation methods. It would appear that the results of these two methods would fall well short of the fair-value-based requirements of ASC 718.

The proposed Update does state “Because of the requirements associated with, and limiting the availability of, the second and third methods listed above, it is expected that an independent appraisal will often be the method used by nonpublic entities electing the practical expedient in this proposed Update.” However, the proposed Update does not require the use of the first method to elect the practical expedient. This leaves room for use of the second and third methods which may lead to an interpretation that auditors should not question the use of such methods if they are performed within the context of Section 409A, and thus, for ASC 718 as well. We believe that the necessity of an effective audit assessment should be clearly stated, especially if the first method is not used.

Additionally, we note that the summary in the proposed Update is a simplified paraphrase of the Section 409A regulation which includes more qualifiers for all three methods. For example, method 2 has specific limitations on the types of transactions for which the formula is applied and requirements in consistency in applying this formula. Further, method 3 has specific description of the applicable start-up business as well as requirements on the qualification of the person performing this method. These limitations and requirements can be subjective and necessitate expert judgement from, for example, auditors, to determine reasonableness. Accordingly, these important qualifying factors are not clearly noted in the new procedure.

Section 409A Facts and Circumstances

The language in the proposed Update does not include the part of the Section 409A regulations that state:

The determination of whether a valuation method is reasonable, or whether an application of a valuation method is reasonable, is made based on the facts and circumstances as of the valuation date.

The regulation then provides a list of examples of these facts and circumstances. Importantly, Section 409A states:

The use of a valuation method is not reasonable if such valuation method does not take into consideration in applying its methodology all available information material to the value of the corporation. Similarly, the use of a value previously calculated under a valuation method is not reasonable as of a later date if such calculation fails to reflect information available after the date of the calculation that may materially affect the value of the corporation (for example, the resolution of material litigation or the issuance of a patent) or the value was calculated with respect to a date that is more than 12 months earlier than the date for which the valuation is being used.

We note that the aforementioned facts and circumstances, as described in Section 409A are largely subjective and misapplication of Section 409A prescribed methods under certain facts and circumstances can lead to exceptionally unreasonable values. Again, due to the subjective nature of these issues, expert judgement from auditors are often necessary to determine their reasonableness.

Section 409A Use of Alternative Methods

Section 409A, in the *Use of alternative methods* section, states:

[A] different valuation method may be used for each separate action for which a valuation is relevant, provided that a single valuation method is used for each separate action and, once used, may not retroactively be altered. For example, one valuation method may be used to establish the exercise price of a stock option, and a different valuation method may be used to determine the value at the date of the repurchase of stock pursuant to a put or call right.

The use of different valuation methods for different actions, especially in the example listed above, can lead to significant issues under GAAP and careful reconciliation between the methods may be necessary. Therefore, use of alternative methods under GAAP would often require expert judgement from financial statement preparers and auditors to determine if they are acceptable.

Section 409A Rebuttal of Presumption of Reasonableness

Section 409A, in the *Presumption of Reasonableness* section, states:

[T]he use of any of the following methods of valuation is presumed to result in a reasonable valuation, **provided that the Commissioner may rebut such a presumption upon a showing that either the valuation method or the application of such method was grossly unreasonable** [.] (*emphasis added*)

Section 409A, through use of this paragraph, reserves the right to review and rebut the presumption of reasonableness. However, in practice, due to budget and priority reasons, the IRS rarely reviews Section 409A valuations. Further, any IRS review could take several years, allowing possible highly unreasonable valuations to stand in the intervening period. While this delay may be acceptable for tax purposes where a later-date adjustment or penalty would suffice to address the necessary tax consequences, it is entirely inappropriate in financial reporting where an investor may have relied on highly unreasonable numbers to make investment decisions.

The proposed Update, does not clearly state the necessity of company management and the auditors to review and confirm the presumption of reasonableness, which is largely dependent on subjective judgement. This would appear to minimize management's responsibility and reduce the auditor's responsibility to ensure reliability and usefulness of the financial information presented, thus delegating the task of assessing reasonableness to a largely non-existent and delayed IRS review process.

Section 409A Compliance

From our own experience and discussions with others, it is our assessment that compliance with Section 409A regulation is generally inadequate for private companies, primarily because the IRS rarely reviews Section 409A issues. It is not uncommon to encounter companies that issue options outside of the 12-month safe harbor period or not accounting for information after the previous valuation that may have significantly changed the value of the company. It is often left up to the auditors, who cannot fully rely on preparers and management, to review ASC 718 valuations to ensure that companies are complying closely with Section 409A regulations. The proposed Update may reduce or remove, rather than enhance, management and the auditors' commitment to reviewing such issues.

Summary

To summarize, we note:

- 1) The current best practice typically does not require companies to separately determine the current price input for ASC 718 within the Section 409A safe harbor period, if the period is properly determined (i.e. within 12 months and no information indicating material change in value).
- 2) Two of the three "valuation" methods under Section 409A Presumption of Reasonableness may not qualify as valuation methods under SSVS 1 and their results appear to fall far short of the fair-value-based requirements of ASC 718.
- 3) While the proposed Update states that "it is expected that an independent appraisal will often be the method used by nonpublic entities electing the practical expedient in this proposed Update", the proposed Update does not require the use of independent appraisals, thus allowing questionable valuation methods to become a part of FASB Codification.

- 4) Section 409A's limitations and requirements, facts and circumstances and use of alternative methods all require significant subjective judgement to determine their reasonableness.
- 5) The proposed Update does not clearly give management and the auditors the impetus to closely assess and as needed, rebut the presumption of reasonableness because Section 409A reserves this right for the IRS.
- 6) Due to limited oversight from the IRS, it is often the responsibility of the auditors to ensure timely compliance with both Section 409A and ASC 718. This should be clarified and stated as a requirement.

Based on the previous reasons, we believe that the practical expedient, as proposed, would have a negative impact on the reliability and usefulness of the financial information. We believe two changes, if incorporated, can mitigate the above concerns:

- 1) Instead of "expecting" an independent appraisal to "often" be used, it should be recommended as a Best Practice. The practical expedient should only be selected if an independent appraisal was used; and
- 2) The responsibility of management and the auditors to closely assess the issues related to using the Section 409A valuations, should be clearly stated to provide sufficient support for the "presumption of reasonableness."

As noted at the beginning of this response letter, with the growth in private equity, more employee options issued, and larger private companies, it is now more important than ever to ensure that the accounting for equity compensation provides useful and reliable information for investment decisions.

Specific Comments

We have the following responses to the questions posed in the proposed Update.

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

Response: Yes, the practical expedient as drafted is operable. However, as discussed in the general comments section, we believe the proposed Update, as it currently reads, is inconsistent with the goal of providing reliable and useful financial information, unless the described improvements are implemented.

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.

Response: Nonvested shares do not require valuation for tax purposes until they become vested, which can be years after the grant date. Therefore, a Section 409a valuation

would not be required at grant date and as such, this practical expedient could not be applied.

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.

Response: We do not believe the proposed practical expedient will reduce costs in most cases as it is rare for auditors to require a separate determination of current price input if the Section 409A safe harbor period is in effect. We believe that most frequent requirement of separate determination of current price input stems from misapplication of the Section 409A safe harbor period. Audit assessment should remain a necessary component of the valuation process.

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

Response: For “plain-vanilla” stock option grants, it is very uncommon to obtain separate valuations for ASC 718 and Section 409A. For other types of grants such as profit interests, options not granted at fair market value, or options with market-based vesting schedules, a separate ASC 718 valuation is often necessary.

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

Response: Yes, discretion should be left up to the company and its auditor.

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.

Response: Yes. As detailed in the General Comments section above, we believe the proposed practical expedient, as it currently reads, will compromise the decision usefulness of information related to equity-classified share-option awards by utilizing less than reliable valuation techniques and reducing audit assessment.

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

Response: Yes, provided the issues we raised are adequately addressed.