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Ms. Hillary H. Salo
Technical Director
File Reference No. 2020-200
Financial Accounting Standards Board
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P.O. Box 5116
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1 October 2020

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:

We appreciate the opportunity to comment on the Proposed Accounting Standards Update, *Compensation — Stock Compensation (Topic 718) — Determining the Current Price of an Underlying Share for Equity — Classified Share-Option Awards*, issued by the Financial Accounting Standards Board (FASB or Board).

We support the objective of the Private Company Council (PCC) to reduce the cost and complexity associated with determining the current price input of equity-classified share-based payment awards in accordance with existing GAAP. However, we do not believe that the proposed practical expedient would significantly reduce cost and complexity for most preparers.

In our experience, most private companies already obtain a single valuation that satisfies the requirements of both the Treasury Regulations of Internal Revenue Code Section 409A (Section 409A) and Accounting Standards Codification (ASC) 718, *Compensation — Stock Compensation*. Further, we do not expect a significant reduction in audit effort when assessing a valuation that is prepared to comply with Section 409A or one prepared for purposes of valuing a share under ASC 718.

However, for companies that issue multiple awards during a 12-month period, we believe that the primary benefit of the proposed practical expedient is the ability to apply Section 409A's provision that allows a valuation performed using an independent appraisal to be used to determine the current share price input for a 12-month period (included in Treasury Regulation § 1.409-1(b)(5)(iv)(B)(2)(i)) unless it is determined to be "grossly unreasonable."

We suggest that the PCC also consider expanding the proposed practical expedient to allow a nonpublic entity that obtains or prepares a valuation report for purposes of complying with ASC 718 to use the valuation for a period of 12 months from the valuation date unless there has been a significant event or transaction that would cause a material change in the valuation, as discussed in further detail in our response to Question 1 in the Appendix. Our responses to other questions in the proposal are also in the Appendix.

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We would be pleased to discuss our comments with the Board or its staff at its convenience.

Very truly yours,

Ernst + Young LLP

Appendix — Responses to *Questions to Respondents* in the PCC's proposal

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

We believe that the practical expedient in this proposed Update would be operable. Furthermore, we believe the approach generally would be consistent with what many entities currently are applying in practice. In our experience, most nonpublic entities already obtain one valuation that is used to support the requirements of both ASC 718 and Section 409A as noted in our response to Question 4 below.

As stated in our cover letter, we suggest expanding the proposed practical expedient to allow nonpublic companies that obtain or prepare a valuation for purposes of valuing an award granted in accordance with ASC 718 (i.e., a valuation that is not obtained solely to satisfy the requirements of Section 409A) to similarly use the valuation for a 12-month period from the report date unless certain significant events or transactions have occurred that would materially change the value of the company. We believe that this would allow all nonpublic companies to take advantage of the primary benefit of the proposed expedient, which is the ability to use a valuation for a 12-month period, regardless of whether the company obtains a valuation performed in accordance with Section 409A.

In addition, we believe that ASC 718 should include examples of significant events or transactions that may lead to a material change in the valuation that would require an updated valuation to be obtained or performed (e.g., an imminent merger or acquisition, disposal of a significant business, a financing transaction, launch of a significant product).

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 believe that the scope of the proposed practical expedient should be expanded to include other equity-classified share-based compensation arrangements. As discussed further in Question 4 below, because the valuation requirements for ASC 718 and Section 409A generally are similar, we expect the valuation under ASC 718 and Section 409A generally to yield similar results. If a valuation is deemed appropriate for the share price input for valuing share-option awards, we believe it would also be appropriate to use it to value other equity-classified awards upon grant or subsequent modification.

Further, we recommend that the PCC consider expanding the practical expedient to allow a nonpublic entity to measure liability-classified awards (including those measured using intrinsic value) on the grant date and to measure such awards on the reporting date using a valuation obtained within the preceding 12 months, unless certain events or transactions have occurred that would materially change the value.

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 believe that the cost reduction (including fees associated with valuation and audit efforts) for entities that elect to apply this proposed practical expedient would be minimal.

In our experience, most nonpublic entities already obtain one valuation to support the requirements of both ASC 718 and Section 409A. Further, companies that issue awards throughout a 12-month period often do so in periods leading up to an initial public offering (IPO), a financing transaction or another event that significantly affects the fair value of the company. These companies may not benefit from the ability to use one Section 409A valuation for awards granted in the 12-month period because such transactions may cause the valuation to be considered "grossly unreasonable" given the new information. Therefore, we do not believe that in these instances there will be a significant reduction in valuation costs.

Additionally, we do not expect the audit effort to determine whether a valuation complies with Section 409A to be reduced in comparison with that to determine whether the valuation is performed in accordance with ASC 718. In fact, we expect there could be an increase in audit effort due to the need to involve tax professionals to determine whether the valuation complies with Section 409A.

Whether the valuation is performed in accordance with ASC 718, or for the purposes of Section 409A, under the standards of the American Institute of Certified Public Accountants, the resulting value to be included in the financial statements constitutes an accounting estimate.[1] AU-C 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures,* stipulates that an auditor's responsibility relating to accounting estimates is to obtain sufficient appropriate audit evidence about whether accounting estimates are reasonable in the context of the applicable financial reporting framework.[2] In addition to other audit performance requirements, AU-C 540 stipulates that if the auditor has assessed a risk of material misstatement related to an accounting estimate, the auditor should perform one or more of the following, while taking into account the nature of the audit estimate:[3]

- Determine whether events occurring up to the date of the auditor's report provide evidence regarding the accounting estimate
- Test how management made the accounting estimate, which includes assessing the appropriateness of the methodology used to measure the estimate, the reliability of the data and the reasonableness of the assumptions used
- Test the operating effectiveness of the associated controls
- Perform appropriate substantive procedures
- Develop a point estimate or range to evaluate management's point estimate

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1 AU-C 540 defines an "accounting estimate" as "an approximation of a monetary amount in the absence of a precise means of measurement. This term is used for an amount measured at fair value when there is estimation uncertainty, as well as for other amounts that require estimation."

2 AU-C 540.06.

3 AU-C 540.13.

Certain valuations, including an independent appraisal, performed in accordance with Section 409A are presumed to result in a reasonable valuation. It is our belief, however, that the proposed practical expedient would not alter the auditor's responsibility to test the valuation by using one or more of the above procedures. That is, an auditor may not rely on Section 409A's presumption of reasonableness to reduce audit effort.

In our experience, these types of estimates are often assessed by testing how management made the accounting estimate and evaluating the data on which the estimate is based. Regardless of the testing method used, the auditor is required to understand how management makes the accounting estimate and understand the data on which the estimate is based.[4] Management frequently engages a valuation specialist to assist with preparing these types of valuations, whether performed in accordance with ASC 718 or in compliance with Section 409A. If the auditor intends to use information prepared using the work of management's specialist as audit evidence, AU-C 500, *Audit Evidence,* stipulates that the auditor should: [5]

- Evaluate the competence, capabilities and objectivity of the specialist
- Obtain an understanding of the work of the specialist
- Evaluate the appropriateness of the specialist's work as audit evidence for the relevant assertion

As contemplated in AU-C 540.14, the auditor may also determine that specialized skills or knowledge with regard to the accounting estimate is required to obtain sufficient appropriate audit evidence. Therefore, the auditor uses the work of an auditor's specialist and determines whether that work is adequate for the auditor's purposes.[6] Among other things, AU-C 620, *Using the Work of an Auditor's Specialist,* requires the auditor to evaluate the competence, capabilities and objectivity of the auditor's specialist and evaluate the adequacy of the work of the auditor's specialist, including evaluating the relevance and reasonableness of the assumptions and methods used by the auditor's specialist.[7]

If the proposed practical expedient is used by a company, the auditor still would be required to comply with the audit requirements discussed above, among others, related to auditing accounting estimates and the use of the work of specialists. Further, if the proposed practical expedient is used by a company, the auditor may need to involve other tax professionals, who would not meet the definition of a specialist, to assist in determining whether the current price input valuation is in accordance with Section 409A. Therefore, we would not expect a reduction in audit effort if a company were to use the proposed practical expedient.

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[4] AU-C 540.08.

[5] AU-C 500.08.

[6] AU-C 620.05; AUC-620 defines an "auditor's specialist" as "an individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence. An auditor's specialist may be either an auditor's internal specialist (who is a partner or staff, including temporary staff, of the auditor's firm or a network firm) or an auditor's external specialist."

[7] AU-C 620.12.

That said, if one Section 409A valuation is used to support multiple grants of awards issued throughout a 12-month period, there may be a reduction in audit effort if multiple valuations would have been obtained without the use of the proposed practical expedient. However, the assessment of whether the Section 409A valuation is "grossly unreasonable" may require assistance from tax professionals and considerable judgment.

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

Based on our experience, most companies obtain one valuation that satisfies both GAAP requirements (ASC 718) and tax regulations (Section 409A). This approach is widely used because the valuation requirements for ASC 718 and Section 409A generally are similar, and we expect the valuation under both generally to yield similar results. However, it is our experience that in the infrequent instances that companies obtain separate valuations for ASC 718 and Section 409A, the ASC 718 valuation is generally performed retrospectively when the Section 409A valuation is determined to be insufficient for purposes of supporting fair value under ASC 718.

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

We don't have any concerns with allowing the proposed practical expedient to be elected on an award-by-award basis. However, we believe an entity would need to use the most recent valuation to value the share price input of an award when it elects to apply the proposed practical expedient when multiple Section 409A valuations were obtained in the 12-month period preceding the grant date of an award.

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.

As stated in our response to Question 4, we generally expect ASC 718 and Section 409A valuations to yield similar results. However, in the few instances where we observed companies obtaining separate Section 409A and ASC 718 valuations, the Section 409A valuation generally results in a significantly lower per-share value. If such a valuation is determined not to be "grossly unreasonable" and, therefore, not subject to challenge under Section 409A, an unintended consequence that results from the application of the proposed practical expedient may be that valuations used for financial reporting purposes are lower than historical valuations obtained to satisfy the requirements of ASC 718. This could affect the comparability of financial information with prior periods and with the financial information of other companies that did not use the proposed practical expedient. This also may affect the decision usefulness of information related to equity-classified share-option awards.

Additionally, in Staff Accounting Bulletin (SAB) Topic 14.B, the Securities and Exchange Commission (SEC) provided guidance on the transition to fair-value-based measurements by nonpublic entities that become public entities. Under the guidance, if a company uses the calculated value method for estimating volatility, it should continue to follow that approach for its previously granted awards when it becomes public, unless those awards are subsequently modified, repurchased or canceled. Similarly, liability-classified awards measured at intrinsic value are not required to be retrospectively remeasured when a company becomes public. In both instances, awards issued before a company becomes public are not retrospectively revalued at the time of its IPO.

Absent clarifying guidance from the FASB or SEC, it is expected that companies would be able to apply SAB Topic 14.B by analogy and would not remeasure awards measured using the proposed practical expedient upon becoming public. Given the SEC's focus on valuations of common stock underlying equity issuances in the periods leading up to a company's IPO, more standard setting may be necessary if the above transition approach is determined not to be reasonable (that is, it is determined that financial statements included in a registration statement should not include compensation cost measured using the proposed practical expedient).

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

We agree with the proposed prospective transition requirements but suggest clarifying that early adoption would be permitted in an interim period.