FINANCIAL ACCOUNTING SERIES

FASB ACCOUNTING STANDARDS UPDATE

No. 2021-07
October 2021

Compensation—Stock Compensation (Topic 718)

Determining the Current Price of an Underlying Share for Equity-Classified Share-Based Awards

a consensus of the Private Company Council

An Amendment of the *FASB Accounting Standards Codification*®

Financial Accounting Standards Board

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Summary

Why Is the FASB Issuing This Accounting Standards Update (Update)?

The Private Company Council (PCC) added this issue to its agenda in response to feedback from private company stakeholders indicating that determining the fair value of private company share-option awards at grant date or upon a modification to an award is often costly and complex. When determining the grant-date fair value of those awards, a valuation technique such as an option-pricing model is typically used. An option-pricing model requires various inputs, including the fair value of the equity shares underlying a share-option award (referred to as the current price input). During its research and outreach efforts leading to the amendments in this Update, the PCC received feedback that the current price input is typically the most difficult input for private companies to estimate. This is primarily because private company equity shares often are not actively traded and, thus, observable market prices for those shares or similar shares do not exist.

The PCC decided that the concerns expressed about the cost and complexity of determining the current price input in accordance with existing generally accepted accounting principles (GAAP) indicated that a change to that guidance for private companies was warranted. The *Private Company Decision-Making Framework: A Guide for Evaluating Financial Accounting and Reporting for Private Companies* acknowledges two possibilities for recognition and measurement differences between private companies and public companies—an accounting alternative and a practical expedient. An accounting alternative is “a different method for recognizing or measuring a transaction or event,” whereas a practical expedient is “a more cost-effective way of achieving the same or a similar accounting or reporting objective.” If the information provided by existing GAAP is deemed relevant to the users of private company financial statements, then a practical expedient should be used to lower the cost and complexity of applying the guidance. Outreach with users of private company financial statements indicated that information about share-option awards provided under existing GAAP is relevant; thus, the PCC reached a consensus to provide a practical expedient for private companies for all equity-classified share-based awards within the scope of Topic 718, Compensation—Stock Compensation, leading to the issuance of this Update.

Who Is Affected by the Amendments in This Update?

The amendments in this Update apply to all nonpublic entities (as defined in the Master Glossary of the Codification) that issue equity-classified share-based awards and elect the practical expedient in this Update.

What Are the Main Provisions?

As a practical expedient, a nonpublic entity is allowed to determine the current price input of equity-classified share-based awards issued to both employees and nonemployees using the reasonable application of a reasonable valuation method. The practical expedient describes the characteristics of the reasonable application of a reasonable valuation method including (1) the date on which a valuation's reasonableness is evaluated, (2) the factors that a reasonable valuation should consider, (3) the scope of information that a reasonable valuation should consider, and (4) the criteria that should be met for the use of a previously calculated value to be considered reasonable. The same characteristics are used in the regulations of the U.S. Department of the Treasury related to Section 409A of the U.S. Internal Revenue Code (the Treasury Regulations) to describe the reasonable application of a reasonable valuation method for income tax purposes. A reasonable valuation performed in accordance with the Treasury Regulations is an example of a way to achieve the practical expedient.

How Do the Main Provisions Differ from Current Generally Accepted Accounting Principles (GAAP) and Why Are They an Improvement?

The measurement objective in Topic 718 for share-based awards is fair value based, and the current price input is measured at fair value. This input is used in determining an award's fair value. The practical expedient in this Update allows a nonpublic entity to determine the current price of a share underlying an equity-classified share-based award using the reasonable application of a reasonable valuation method. The practical expedient describes the following characteristics of the reasonable application of a reasonable valuation method:

1. The date on which the valuation's reasonableness is evaluated is the measurement date.
2. The following factors should be considered in a reasonable valuation:
   a. The value of the tangible and intangible assets of the entity.
   b. The present value of the anticipated future cash flows of the entity.
   c. The market value of stock or equity interests in similar entities engaged in trades or businesses substantially similar to those engaged in by the entity for which stock is to be valued.

    d. Recent arm's-length transactions involving the sale or transfer of the stock or equity interests of the entity.
    e. Other relevant factors such as control premiums or discounts for lack of marketability and whether the valuation is used for other purposes that have a material economic effect on the entity, its stockholders, or its creditors.
    f. The entity's consistent use of a valuation method to determine the value of its stock or assets for other purposes.
3. The scope of information to be considered in a reasonable valuation is all information material to the value of the entity.
4. The following criteria must be met for the use of a previously calculated value to be considered reasonable:
    a. The value is updated for any information available after the date of calculation that may materially affect the value of the entity.
    b. The value is calculated no more than 12 months earlier than the date for which the value is being used.

The same characteristics are used in the Treasury Regulations to describe the reasonable application of a reasonable valuation method for income tax purposes. As a result, a reasonable valuation performed in accordance with the Treasury Regulations is an example of a way to achieve the practical expedient.

The population of valuations that would be considered the reasonable application of a reasonable valuation for purposes of the practical expedient is not limited to a valuation by independent appraisal. That is, other valuations, including internal valuations, could have the characteristics described in the practical expedient in this Update. However, it is expected that an independent appraisal will often be the method used by nonpublic entities electing the practical expedient in this Update because of (1) the presumption of reasonableness associated with that method for tax purposes and (2) the requirements associated with, and limiting the availability of, other methods that achieve the presumption of reasonableness.

Currently, some nonpublic entities may obtain separate external valuations to satisfy the requirements of both Topic 718 and the Treasury Regulations. Others may seek to use one formal valuation to serve multiple purposes. The practical expedient in this Update amends certain requirements of Topic 718 to clarify that an acceptable practice is to obtain a single valuation that satisfies both requirements.

The practical expedient in this Update can be elected for equity-classified share-based awards within the scope of Topic 718.

The practical expedient in this Update is not available for liability-classified awards, primarily because those awards may affect an entity's cash balance upon settlement and because outreach with private company financial statement users indicated that the accounting for a share-based award that may affect an entity's cash balance was relevant and should not be changed. Additionally, liability-classified awards are required to be remeasured at the end of each reporting period and it is not expected that nonpublic entities would obtain valuations that satisfy the requirements of the Treasury Regulations at each reporting date.

Nonpublic entities can elect the practical expedient in this Update on a measurement-date-by-measurement-date basis. That means that the practical expedient must be applied to all share-based awards within the scope of the practical expedient that have the same underlying share and the same measurement date.

When Will the Amendments Be Effective and What Are the Transition Requirements?

The practical expedient in this Update is effective prospectively for all qualifying awards granted or modified during fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. Early application, including application in an interim period, is permitted for financial statements that have not yet been issued or made available for issuance as of October 25, 2021.

Amendments to the *FASB Accounting Standards Codification*®

Introduction

1. The Accounting Standards Codification is amended as described in paragraphs 2–5. Terms from the Master Glossary are in **bold** type. Added text is <u>underlined</u>.

Amendments to Subtopic 718-10

2. Add paragraphs 718-10-30-20C through 30-20H and their related heading, with a link to transition paragraph 718-10-65-16, as follows:

Compensation—Stock Compensation—Overall

Initial Measurement

<u>**> Nonpublic Entity—Practical Expedient for Current Price**</u>

<u>**718-10-30-20C** As a practical expedient, a **nonpublic entity** may use a value determined by the reasonable application of a reasonable valuation method as the current price of its underlying share for purposes of determining the fair value of an **award** that is classified as equity in accordance with paragraphs 718-10-25-6 through 25-18 at **grant date** or upon a **modification**. This practical expedient may not be used for awards classified as liabilities in accordance with paragraphs 718-10-25-6 through 25-18.</u>

<u>**718-10-30-20D** The determination of whether a valuation method is reasonable, or whether an application of a valuation method is reasonable, shall be made based on the facts and circumstances as of the **measurement date**. Factors to be considered under a reasonable valuation method include, as applicable:</u>

- <u>a. The value of tangible and intangible assets of the nonpublic entity</u>
- <u>b. The present value of anticipated future cash flows of the nonpublic entity</u>
- <u>c. The market value of stock or equity interests in similar corporations and other entities engaged in trades or businesses substantially similar to those engaged in by the nonpublic entity for which the stock is to be valued, the value of which can be readily determined through nondiscretionary, objective means (such as through trading prices on an established securities market or an amount paid in an arm's-length private transaction)</u>

d. Recent arm's-length transactions involving the sale or transfer of stock or equity interests of the nonpublic entity
e. Other relevant factors such as control premiums or discounts for lack of marketability and whether the valuation method is used for other purposes that have a material economic effect on the nonpublic entity, its stockholders, or its creditors
f. The nonpublic entity's consistent use of a valuation method to determine the value of its stock or assets for other purposes, including for purposes unrelated to compensation of service providers.

718-10-30-20E The use of a valuation method is not reasonable if that valuation method does not take into consideration when applying its methodology all available information material to the value of the nonpublic entity.

718-10-30-20F The use of a value previously calculated under a valuation method is not reasonable as of a later date if either of the following conditions is met:

a. The calculation fails to reflect information available after the date of the calculation that may materially affect the value of the nonpublic entity (for example, the resolution of material litigation or the issuance of a patent).
b. 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.

718-10-30-20G A valuation performed in accordance with Treasury Regulation Section 1.409A-1(b)(5)(iv)(B) having the characteristics described in paragraphs 718-10-30-20D through 30-20F is an example of a valuation that is reasonable under the practical expedient in those paragraphs.

718-10-30-20H A nonpublic entity that elects the practical expedient in paragraphs 718-10-30-20C through 30-20F shall do so on a measurement-date-by-measurement-date basis. That is, the practical expedient shall be applied to all share-based awards within the scope of the practical expedient having the same underlying share and the same measurement date.

3. Amend paragraph 718-10-50-2(f), with a link to transition paragraph 718-10-65-16, as follows:

Compensation—Stock Compensation—Overall

Disclosure

718-10-50-2 The following list indicates the minimum information needed to achieve the objectives in paragraph 718-10-50-1 and illustrates how the disclosure requirements might be satisfied. In some circumstances, an entity may need to disclose information beyond the following to achieve the disclosure objectives:

f. For each year for which an income statement is presented, both of the following (An entity that uses the intrinsic value method pursuant to paragraphs 718-10-30-21 through 30-22 is not required to disclose the following information for awards accounted for under that method):

1. A description of the method used during the year to estimate the fair value (or calculated value) of awards under share-based payment arrangements
2. A description of the significant assumptions used during the year to estimate the fair value (or calculated value) of share-based compensation awards, including (if applicable):
   i. Expected term of share options and similar instruments, including a discussion of the method used to incorporate the contractual term of the instruments and grantees' expected exercise and postvesting termination behavior into the fair value (or calculated value) of the instrument.
   ii. Expected **volatility** of the entity's shares and the method used to estimate it. An entity that uses a method that employs different volatilities during the contractual term shall disclose the range of expected volatilities used and the weighted-average expected volatility. A nonpublic entity that uses the calculated value method shall disclose the reasons why it is not practicable for it to estimate the expected volatility of its share price, the appropriate industry sector index that it has selected, the reasons for selecting that particular index, and how it has calculated historical volatility using that index.
   iii. Expected dividends. An entity that uses a method that employs different dividend rates during the contractual term shall disclose the range of expected dividends used and the weighted-average expected dividends.
   iv. Risk-free rate(s). An entity that uses a method that employs different risk-free rates shall disclose the range of risk-free rates used.
   v. Discount for postvesting restrictions and the method for estimating it.
   vi. Practical expedient for current price input. A nonpublic entity that elects to apply the practical expedient in paragraphs 718-10-30-20C through 30-20F shall disclose that election.

4. Add paragraph 718-10-65-16 and its related heading as follows:

Transition and Open Effective Date Information

> Transition Related to Accounting Standards Update No. 2021-07, *Compensation—Stock Compensation (Topic 718): Determining the Current Price of an Underlying Share for Equity-Classified Share-Based Awards*

718-10-65-16 The following represents the transition and effective date information related to Accounting Standards Update No. 2021-07, *Compensation—Stock*

Compensation (Topic 718): Determining the Current Price of an Underlying Share for Equity-Classified Share-Based Awards:

a. The pending content that links to this paragraph shall be effective for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022.
b. An entity shall apply the pending content that links to this paragraph prospectively.
c. Early application, including application in an interim period, is permitted for financial statements that have not been issued or made available for issuance as of October 25, 2021.

Amendments to Status Sections

5. Amend paragraph 718-10-00-1, by adding the following items to the table, as follows:

718-10-00-1 The following table identifies the changes made to this Subtopic.

Paragraph	**Action**	**Accounting Standards Update**	**Date**
718-10-30-20C through 30-20H	Added	2021-07	10/25/2021
718-10-50-2	Amended	2021-07	10/25/2021
718-10-65-16	Added	2021-07	10/25/2021

The amendments in this Update were adopted by the unanimous vote of the seven members of the Financial Accounting Standards Board:

Richard R. Jones, *Chair*
James L. Kroeker, *Vice Chairman*
Christine A. Botosan
Gary R. Buesser
Frederick L. Cannon
Susan M. Cosper
Marsha L. Hunt

Background Information and Basis for Conclusions

Introduction

BC1. The following summarizes the PCC's considerations in reaching the conclusions in this Update. It includes the Board's basis for endorsing the PCC's conclusions when needed to supplement the PCC's considerations. It also includes reasons for accepting certain approaches and rejecting others. Individual PCC members and Board members gave greater weight to some factors than to others.

BC2. On December 11, 2018, the PCC added Issue No. 2018-01, "Practical Expedient to Measure Grant-Date Fair Value of Equity-Classified Share-Based Awards," to its technical agenda. The PCC added this Issue in response to feedback from private company stakeholders indicating that determining the fair value of private company share-option awards is often costly and complex. When determining the fair value of those awards, a valuation technique such as an option-pricing model is typically used. An option-pricing model requires various inputs, including the fair value of the equity shares underlying a share-option award (referred to as the current price input). The PCC received feedback that the current price input is typically the most difficult input for private companies to estimate. This is primarily because private company equity shares often are not actively traded and, thus, observable market prices for those shares or similar shares do not exist.

BC3. On December 16, 2019, the PCC decided to propose a practical expedient, whereby a nonpublic entity is allowed to determine the current price input of equity-classified share-option awards issued to both employees and nonemployees using a valuation method performed in accordance with the Treasury Regulations, which provide acceptable valuation methodologies to comply with the requirements of Section 409A.

BC4. On February 12, 2020, the Board endorsed the PCC's decision, leading to the issuance of proposed Accounting Standards Update, *Compensation—Stock Compensation (Topic 718): Determining the Current Price of an Underlying Share for Equity-Classified Share-Option Awards,* on August 17, 2020. Comments were due on October 1, 2020, and the Board received 24 comment letters. Overall, respondents supported the amendments in the proposed Update. Some respondents made suggestions to improve the operability and enhance the potential cost savings of the proposed amendments.

BC5. On April 20, 2021, the PCC expanded the scope of eligible instruments by allowing a nonpublic entity to determine the current price input of equity-classified share-based awards issued to both employees and nonemployees using the reasonable application of a reasonable valuation method. The practical expedient describes the characteristics of the reasonable application of a reasonable valuation method including (a) the date on which a valuation's reasonableness is evaluated, (b) the factors that a reasonable valuation should consider, (c) the scope of information that a reasonable valuation should consider, and (d) the criteria that should be met for the use of a previously calculated value to be considered reasonable. The same characteristics are used in the Treasury Regulations to describe the reasonable application of a reasonable valuation for income tax purposes. A reasonable valuation performed in accordance with the Treasury Regulations is an example of how to achieve the practical expedient. Those regulations also describe certain valuation methodologies that are presumed to result in a reasonable valuation, and those methodologies are also examples of how to achieve the practical expedient. Broadly, the Treasury Regulations have significant implications for share-option awards, whereby service providers, such as employees, may be subject to significant tax penalties if the awards are issued in the money (current price is greater than exercise price). Therefore, entities may already obtain valuations that are compliant with the requirements of the Treasury Regulations in conjunction with the issuance of share-option awards to mitigate the risk that those penalties will be imposed on their service providers.

Background Information

BC6. Topic 718 provides guidance on accounting for share-based compensation awards such as share-option awards, which are classified as either liabilities or equity. Equity-classified share-based awards are initially measured at fair value at the grant date (referred to as grant-date fair value) and are not subsequently remeasured unless they are modified and meet certain requirements. If an observable market price is not available for a share-based award, the fair value of those awards is estimated using a valuation technique that would be used for determining amounts at which instruments with similar characteristics would be exchanged. Liability-classified awards are remeasured at the end of each reporting period.

BC7. For share-options and similar awards, a lattice model (for example, a binomial model) and a closed-form model (for example, the Black-Scholes-Merton model) are option-pricing models used for estimating fair value that are accepted under Topic 718. The PCC learned that the Black-Scholes-Merton model is the most commonly used model by nonpublic entities because that model is generally considered to be the least complex for determining a reasonable estimate of fair value if the terms of the option allow it. That model requires all of the following inputs for measuring the fair value of share-option awards:

a. Exercise price
b. Expected term

c. Expected volatility of the price of the share underlying the share-option award for the award's expected term
d. Expected dividends on the share underlying the share-option award for the award's expected term
e. The risk-free interest rate for the expected term
f. The current share price.

BC8. Private company stakeholders indicated that the inputs to the Black-Scholes-Merton model vary in degree of difficulty to estimate. Specifically, they noted that the exercise price, expected dividend rate, and risk-free interest rate are generally easy to obtain. However, those stakeholders indicated that the expected term, expected share price volatility, and current share price can be costly to estimate.

BC9. Topic 718 already provides nonpublic entities with practical expedients for estimating expected share price volatility and expected term. However, no practical expedient currently exists for estimating the current price input. The current price input is often considered the most costly and complex input to determine and audit for nonpublic entities, primarily because an active market for those entities' shares rarely exists. Therefore, readily determinable market prices normally do not exist for nonpublic entity shares. Although the current price input is discussed above in the context of the Black-Scholes-Merton model, other valuation models, such as lattice models, also may require the current price input.

BC10. Since 2013, the PCC has discussed the accounting for share-based compensation on several occasions, and extensive outreach has been performed with all stakeholder types. The objectives of the outreach were to determine (a) whether share-based compensation information in the financial statements is decision useful for users of private company financial statements and (b) whether the accounting for share-based compensation could be simplified for private companies. Broadly, it was determined that share-based compensation information is relevant and decision useful. Therefore, under the Private Company Decision Making Framework, any option provided to nonpublic entities to simplify the guidance would have to achieve a result similar to existing GAAP.

BC11. Specifically, the Private Company Decision Making Framework acknowledges two possibilities for recognition and measurement differences between private companies and public companies—an accounting alternative and a practical expedient. An accounting alternative is "a different method for recognizing or measuring a transaction or event," whereas a practical expedient is "a more cost-effective way of achieving the same or a similar accounting or reporting objective." If the information provided by existing GAAP is deemed relevant to the users of private company financial statements, then a practical expedient should be used to lower the cost and complexity of applying the guidance. If the information is not relevant or if it is relevant but costly and no practical expedient is available, only then should the PCC and the Board consider an accounting alternative for recognition and measurement. Consequently, a practical expedient (as opposed to an accounting alternative) is warranted.

BC12. Between 2014 and mid-2019, the PCC considered the following alternatives to reduce the cost of accounting for share-based compensation (note some alternatives had a scope broader than just share-option awards):

a. Use the last observable transaction price of the share underlying a share-option award as the current price input
b. Determine share-based compensation cost as the difference between the last observable transaction price of the share underlying a share-option award and the exercise price, and update that calculation when there is an observable transaction through the award's settlement date
c. Classify all awards as liabilities and measure them at intrinsic settlement value—which would be a new concept in GAAP
d. Measure grant-date fair value of an award by determining the fair value of the services received as a proxy for the fair value of the equity-classified awards granted
e. Use the intrinsic value of the award at the grant date to determine total compensation cost to be recognized over the expected term
f. Use the exercise price of an equity-classified share-option award as the current price input for purposes of determining grant-date fair value.

BC13. Those alternatives were rejected for various reasons, including, but not limited to:

a. The relevance of share-based compensation information would be compromised.
b. The alternative represented an accounting alternative as opposed to a practical expedient.
c. There were operability concerns.

Basis for Conclusions

BC14. In September 2019, the PCC decided to pursue a practical expedient that would allow a nonpublic entity to use a valuation performed in accordance with the Treasury Regulations to determine its current price input for purposes of determining the fair value of an equity-classified share-option award.

BC15. Section 409A regulates taxation of nonqualified deferred compensation and applies to many share-based compensation arrangements. Share-option awards may be considered nonqualified deferred compensation plans for tax purposes subject to Section 409A. While Section 409A does not discuss share-option awards in detail, the Treasury Regulations provide a robust description of the awards subject to Section 409A and the acceptable valuation methodologies for those awards. To avoid having service providers subject to significant penalties under Section 409A, the exercise price of a share-option award should be set at or above the fair market value of the underlying share as of the grant date. The Treasury Regulations state that an entity with stock that “is not readily tradable on an established securities market” may avoid being subject to Section 409A by obtaining or performing a valuation based on the “reasonable application of a reasonable valuation method.”

BC16. Under the Treasury Regulations, the two primary ways in which an entity may demonstrate to the U.S. Internal Revenue Service (IRS) that the fair value of a share underlying a share-option award was determined using a reasonable application of a reasonable valuation method are by (a) considering certain facts and circumstances as of the valuation date (the “facts and circumstances method”) or (b) meeting a rebuttable presumption of reasonableness. The proposed Update had only allowed the valuation methods meeting the rebuttable presumption of reasonableness to qualify for the practical expedient because the PCC believed that applying the facts and circumstances method was similar to what is currently done in practice to comply with Topic 718 and, thus, would not reduce costs. On the basis of the feedback received on the proposed Update indicating that including the facts and circumstances method would make the practical expedient more operable and improve the cost savings of the practical expedient by specifying when a previously calculated value is considered reasonable, the PCC decided that the facts and circumstances method should also be allowed under the practical expedient.

BC17. Broadly, the facts and circumstances method identifies the characteristics of the reasonable application of a reasonable valuation as being related to (a) the date on which a valuation’s reasonableness is evaluated, (b) the factors that a reasonable valuation should consider, (c) the scope of information that a reasonable valuation should consider, and (d) the criteria that should be met for the use of a previously calculated value to be considered reasonable. When the PCC decided to include the facts and circumstances method, it also decided that the practical expedient should describe the characteristics of the reasonable application of a reasonable valuation method using the same language that the Treasury Regulations use to describe such a valuation method. The PCC also decided that the practical expedient should indicate that a reasonable valuation performed in accordance with the Treasury Regulations is an example of a valuation approach that would be reasonable under the practical expedient—a result of the characteristics of the practical expedient being aligned with the characteristics of the Treasury Regulations. That approach differed from the approach taken in the proposed Update, which only referred to a specific paragraph number within the Treasury Regulations and did not provide any further description of the characteristics of a reasonable valuation. That decision was based on feedback on the proposed Update indicating that changes made to the specific paragraph of the Treasury Regulations directly referred to by the practical expedient would result in automatic changes to GAAP.

BC18. Despite that change from the proposed Update, one PCC member remained concerned that the identification of a Treasury Regulation paragraph (even as an example of a valuation approach that would be reasonable under the practical expedient) would be (a) unnecessary because the practical expedient already mirrors language from the Treasury Regulations and (b) costly from a standard-setting perspective because it would establish a precedent for referencing regulations of the U.S. Department of the Treasury in the Codification and require that the FASB monitor changes to identified paragraphs in the Treasury Regulations. The PCC ultimately decided to keep the example because (a) changes in the Treasury Regulations would make the example obsolete rather than change GAAP, (b) the Treasury Regulations change after a long and deliberative process, which should provide lead time for the FASB to understand such changes, and (c) the example was important to the cost savings of the practical expedient to ensure private company preparers are aware of the practical expedient's intent. The Board further observed that the example was a result of the characteristics of the practical expedient being aligned with the characteristics of the Treasury Regulations as of the issuance date of this Update and that future changes to the Treasury Regulations, as a result of changes to Section 409A or otherwise, would not change the characteristics outlined in the practical expedient unless the Codification was amended.

BC19. The following three methods are acceptable under the rebuttable presumption of reasonableness requirements of the Treasury Regulations to determine the fair market value of a share and, as a result, are examples of ways to achieve the practical expedient:

a. A valuation determined by an independent appraisal within the 12 months preceding the grant date
b. 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
c. 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 Treasury Regulations).

The Treasury Regulations provide a number of conditions that must be satisfied with respect to each of those three methods that achieve the presumption of reasonableness. For example, the regulations define the necessary qualifications for an independent appraiser performing the valuation referenced in the first method. In addition, entities must satisfy other specific attributes to avail themselves of the second and third methods (the third method applies only for eligible start-up corporations). The satisfaction of those requirements would similarly apply to nonpublic entities electing to use one of those three methods to apply the practical expedient in this Update.

BC20. The population of valuations that would be considered the reasonable application of a reasonable valuation for purposes of the practical expedient is not limited to the three methods that achieve the presumption of reasonableness under the Treasury Regulations. That is, other valuations, including internal valuations, could have the characteristics described in the practical expedient. However, it is expected that most nonpublic entities would use a valuation determined by an independent appraisal to determine the current price of a share underlying a share-option award. Outreach indicates that nonpublic entities often seek to achieve the rebuttable presumption of reasonableness for tax purposes and that an independent appraisal is the most common method used by nonpublic entities to achieve that rebuttable presumption. The other methods that achieve the rebuttable presumption of reasonableness are subject to restrictions, which results in those methods being used much less frequently.

BC21. In June 2021, the PCC reached a consensus on the practical expedient in this Update because it will reduce costs associated with determining the current price input associated with a share-based award. The PCC expects that the cost reduction will arise primarily from a potential reduction in the number of valuations that nonpublic entities obtain when a reasonable valuation having the characteristics described in the practical expedient was obtained within the last 12 months and that valuation was updated to reflect information after the date of the calculation that may have a material effect on the value of the entity. The PCC also expects that in more limited circumstances the cost reduction will arise because:

a. Nonpublic entities currently obtaining two independent valuations (one for GAAP and one for tax requirements) will be able to obtain just one to satisfy both purposes.
b. An acceptable practice for determining the current price input using only one valuation will be codified in GAAP.

BC22. The Board endorsed the PCC's consensus in August 2021, observing that while the PCC's expected cost savings may occur among a more limited population of private companies, the decision usefulness of share-based compensation information should be unaffected by the practical expedient. In addition, the Board observed that the PCC's decision to specify attributes of a reasonable valuation rather than directly refer to a paragraph of the Treasury Regulations helped to clarify that the practical expedient will achieve the same or a similar result as the fair value objective for the current price input. The Board noted that the practical expedient would not change the fair value measurement objective for the current price input and does not affect existing audit requirements.

BC23. The PCC decided to require nonpublic entities that elect the practical expedient to disclose that election on the basis that similar requirements exist for other practical expedients in Topic 718.

Scope

BC24. The PCC decided that the scope of the amendments in this Update should be consistent with the scope of the practical expedient that provides for estimating expected term. Therefore, the practical expedient in this Update includes all nonpublic entities as defined in the Master Glossary (second definition). At present, the Board has not considered whether the practical expedient may be appropriate for other entities. However, those entities are less likely to experience the same level of difficulty in determining the current price input because it is more likely that those entities will have observable market prices for their shares.

BC25. The amendments in the proposed Update limited the scope of the practical expedient to equity-classified share option awards. On the basis of the feedback received on the proposed Update, the PCC expanded the scope to include all equity-classified share-based awards within the scope of Topic 718. The PCC decided to expand the scope because the difficulty in estimating the current price of a private company share is not unique to the valuation of share options and because nonpublic entities may have valuations performed in accordance with the Treasury Regulations available to use for other share-based awards when they grant share options on the same day or within 12 months of the grant date of another type of share-based award.

BC26. The PCC decided that the practical expedient in this Update should not be available for liability-classified awards, primarily because those awards may affect an entity's cash balance upon settlement and because outreach with private company financial statement users indicated that the accounting for share-based awards that may affect an entity's cash balance was relevant and should not be changed. Additionally, liability-classified awards are required to be remeasured at the end of each reporting period and it is not expected that nonpublic entities would obtain valuations that satisfy the requirements of the Treasury Regulations at each reporting date.

BC27. Equity-classified share-based awards granted to employees and nonemployees are within the scope of the amendments in this Update. The PCC did not believe that there was a reason to exclude awards issued to nonemployees from the scope of the practical expedient because (a) the accounting for share-based awards issued to employees and nonemployees was aligned by FASB Accounting Standards Update No. 2018-07, *Compensation—Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting*, and (b) the practical expedient uses the same characteristics to describe the reasonable application of a reasonable valuation method as do the Treasury Regulations, which have an underlying measurement objective (fair market value) that is similar to the fair-value-based objective in Topic 718.

BC28. The PCC decided that the practical expedient could be applied on a measurement-date-by-measurement-date basis. That means that the practical expedient must be applied to all equity-classified share-based awards having the same underlying share and the same measurement date. Although a policy election for all qualifying awards would promote consistency, the PCC concluded that it would be illogical to disallow a nonpublic entity from using a valuation method that was otherwise compliant with Topic 718.

Effective Date and Transition

BC29. The PCC decided that the practical expedient in this Update should be applied on a prospective basis. A retrospective or modified retrospective transition would require that a nonpublic entity remeasure the grant-date fair value of its existing awards using the current price input determined by a valuation method having the characteristics described by the practical expedient. Because the practical expedient uses the same characteristics as the Treasury Regulations, which have an underlying measurement objective (fair market value) that is similar to the fair-value-based objective in Topic 718, the benefits of any required remeasurement likely would not justify the related costs.

BC30. The PCC decided that the practical expedient in this Update should be applied prospectively for any qualifying awards granted or modified during fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022, consistent with the Private Company Decision Making Framework. The PCC also decided that early application, including application in an interim period, should be permitted for financial statements that have not yet been issued or made available for issuance as of October 25, 2021.

Effect on User Relevance and Cost under the Private Company Decision-Making Framework

BC31. The objective of financial reporting is to provide information that is useful to present and potential investors, creditors, donors, and other capital market participants in making rational investment, credit, and similar resource allocation decisions. However, the benefits of providing information for that purpose should justify the related costs. The Private Company Decision Making Framework augments the existing conceptual framework for financial reporting to provide additional considerations in making user-relevance and cost-benefit evaluations for nonpublic entities. The Board and the PCC's assessment of the costs and benefits of issuing new guidance is unavoidably more qualitative than quantitative because there is no method to objectively measure the costs to implement new guidance or to quantify the value of improved information in financial statements.

BC32. The Board and the PCC believe that the practical expedient in this Update, if elected by a nonpublic entity, will continue to provide decision-useful information to the users of private company financial statements, while reducing the cost and complexity associated with determining the current price input into an option pricing model. The practical expedient describes the reasonable application of a reasonable valuation method using the same characteristics that are used to describe such methods under the Treasury Regulations. Therefore, a reasonable valuation performed in accordance with the Treasury Regulations is an example of how to achieve the practical expedient. In 2006, the Board had agreed that the definition of fair value used for financial reporting purposes is generally consistent with the definition of fair market value provided by the IRS. At that time, the Board had observed that the definition of fair market value provided by the IRS related principally to assets (property) and had attached to it a significant body of interpretative case law developed in the context of tax regulation that may not be relevant for financial reporting purposes. It is expected that the current price value determined using a valuation method satisfying the requirements of the Treasury Regulations will be similar to the value that would have been determined using a valuation method that is compliant with Topic 718. The Board and the PCC believe that costs will be reduced for nonpublic entities for the reasons identified in paragraph BC21 and BC22.

Amendments to the GAAP Taxonomy

The amendments to the *FASB Accounting Standards Codification*® in this Accounting Standards Update do not require improvements to the GAAP Financial Reporting Taxonomy and the SEC Reporting Taxonomy because the Securities and Exchange Commission requirements to provide financial statements in interactive format using eXtensible Business Reporting Language do not apply to entities that are not public business entities.