Private Company Council Accounting Standards Update: Overview of Practical Expedient for ASU Topic 718—Stock Compensation

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Efforts to simplify private company financial accounting standards under U.S. generally accepted accounting principles ("GAAP") have progressed, thanks in part to the work of the Private Company Council ("PCC"). The PCC serves as an advisory board to the Financial Accounting Standards Board ("FASB"). The PCC was established in 2012 by the Financial Accounting Foundation to provide guidance on an alternative reporting framework within GAAP for private companies—in response to concerns about the cost and complexity of compliance with GAAP. In August 2020, the PCC proposed a practical expedient for private companies to determine the current share price for stock-based compensation awards under FASB Accounting Standards Update Topic 718—Stock Compensation. This discussion summarizes the history and function of the PCC. And, this discussion describes the recent guidance for the practical expedient proposed by the PCC for private company equity-based share awards.

Introduction

For decades, private company owners and managers have debated the need for different accounting standards for private companies and public companies. One concern expressed by this group was the amount of time and resources required to comply with reporting requirements that may not be relevant to private companies or helpful in company owner decision making.

Many private company financial statement preparers feel the reporting and compliance requirements of U.S. general accepted accounting principles ("GAAP") are primarily intended to keep public company investors informed about the complex financial statements issued by public companies. Such public company financial statements may have little in common with the financial statements of private companies.

In January 2011, a panel of experts submitted a report to the trustees of the Financial Accounting Foundation ("FAF") with recommendations to create a new, separate, and authoritative standard-setting board. That board would establish exceptions or modifications to GAAP for private companies. The recommendations were based on the panel's

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findings that "the U.S. accounting standard-setting process has insufficient understanding of the needs of users of private company financial statements."[1]

The panel further proposed that the current accounting standards-setting process should recognize and address the needs of users and preparers of private company financial statements in a cost-effective manner.

The Private Company Council ("PCC") initiative was intended to help standard setters consider alternative accounting treatments with respect to the following:

1. The recognition of transactions and events
2. The structure and content presented in private company financial statements
3. Information disclosures
4. The effective dates for applying new reporting requirements

PCC Private Company History and Decision-Making Framework

During 2012, the PCC was established by the FAF as an advisory council (1) to work with the Financial Accounting Standards Board ("FASB") and (2) to provide guidance on an alternative reporting framework within GAAP for private companies. The PCC now plays a more integrated role, with a higher degree of involvement for the overall accounting standards-setting process for private companies.

One of the primary responsibilities assigned to the PCC was to develop a framework, now referred to as the *Private Company Decision-Making Framework*.[2] That framework serves as a guide in determining whether alternatives to existing nongovernmental GAAP are necessary to address the needs of users and preparers of private company financial statements.

In efforts to ensure the framework served its intended purpose, the PCC and the FASB formed a working group of 10 members to advise the PCC and the FASB during the development of the decision-making framework. That working group included (1) private company financial statement users, (2) preparers and auditors, (3) an academic representative, and (4) the Chairman of the Private Company Financial Reporting Committee.

The final version of the *Private Company Decision-Making Framework* guide was issued in December 2013. This final version remained consistent with a focus on the needs of *both* users and preparers of private company financial statements.

The framework addressed five specific areas where financial reporting and guidance may differ between private and public companies. These five areas include the following:

- Recognition and measurement
- Disclosures
- Display (or presentation)
- Effective date
- Transition method

Recognition and Measurement

In evaluating alternative recognition and measurement guidance for private companies, the PCC and the FASB consider the benefits and the costs of possible alternatives after (1) research, (2) outreach to stakeholders, and (3) a public comment period.

In their assessment of private company alternatives for recognition and measurement, the PCC and the FASB also recognized that many alternative methods of recognition and measurement may require modification to current presentation or disclosure requirements.

Disclosures

In determining whether to provide disclosure alternatives for private companies within GAAP, the PCC and FASB consider whether any proposed alternative provides relevant information to the typical users (lenders, other creditors, and investors) of private company financial statements at a reasonable cost.

Presentation

The PCC and FASB believe that, in general, both private companies and public companies should apply the same financial statement presentation guidance. If the presentation is not applicable or relevant to typical private company users, the PCC and the FASB should consider whether private companies are already permitted an exception under existing guidance before providing alternatives. Such existing exceptions included earnings per share and segment reporting disclosures.

Effective Date

When determining the effective date of adopting amended guidance in an Accounting Standards Update ("ASU"), the PCC and the FASB recognized the resource limitations and learning curve implications for private companies. Based on this, they decided the effective date for private companies should be one year after the first annual period when public companies are required to adopt the amendments.

Method of Transition

In determining the transition method for applying accounting guidance and after evaluating practical expedients, the PCC and the FASB considers whether there is sufficient basis to allow private companies to apply a modified retrospective method.

After the evaluation of practical expedients and the costs and benefits of modified retrospective method alternatives, the FASB and the PCC assess whether the prospective method of transition for private companies will be permitted or required.

The PCC and the FASB believe a private company should be required to disclose in the notes to the financial statements the fact that it has applied an alternative transition method. That disclosure should include qualitative information about how the amendments affect the comparison of its current period financial statements with its prior-period financial statements.

Additional Factors and Observations

In developing the private company decision-making framework, the PCC and the FASB further considered factors that differentiate the financial reporting considerations of private companies from those of public companies.

These factors included (1) the number of primary users, (2) the primary users' access to management, (3) the investment strategies of primary users, (4) the ownership and capital structure of the private company, and (5) the number of accounting resources.

These differentiating factors were developed based on input from private company stakeholders and the FASB's research on private company financial reporting. The FASB concluded that, while the types of financial statements do not vary significantly between private and public companies, the number of primary users of private company financial statements is smaller when compared to the number of users of public company financial statements.

Access to company management is considered easier for most users of private company financial statements. These users primarily include lenders.

In contrast, public company financial statement users include a multitude of investors, securities analysts, lenders, and creditors.

The PCC decision-making framework acknowledges two possibilities for recognition and measurement differences between private companies and public companies. The possibilities include (1) an accounting alternative or (2) a practical expedient.

An "accounting alternative is a different method for recognizing or measuring a transaction or an event, whereas a practical expedient is a more cost-effective way of achieving the same or a similar accounting or reporting objective." [3]

Since its establishment, the PCC has released alternative private company accounting guidance with respect to ASUs for the following topics:

- FASB ASU No. 2014-02, Intangibles—Goodwill and Other (Topic 350): Accounting for Goodwill
- FASB ASU No. 2014-03, Derivatives and Hedging (Topic 815): Accounting for

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Certain Receive-Variable, Pay-Fixed Interest Rate Swaps—Simplified Hedge Accounting Approach

- FASB ASU No. 2014-07, Consolidation (Topic 810): Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements
- FASB ASU No. 2014-18, Business Combinations (Topic 805): Accounting for Identifiable Intangible Assets in a Business Combination
- FASB ASU No. 2018-07, Stock Compensation (Topic 718): Accounting for Compensation—Stock Compensation

These updates were all considered as cost-effective accounting alternatives for private companies. These alternatives are not expected to negatively affect the usefulness of the financial information presented.

In particular, although the guidance in ASU 2018-07 Stock Compensation was generally viewed as an improvement and simplification to employee share-based payment accounting, many private company stakeholders continued to express concerns about the cost and complexity of this ASU.

The remainder of this discussion focuses on the implications of the recent practical expedient issued with regard to ASU 2018-07.

Private Company Council Guidance Topic 718—Stock Compensation

In response to private company concerns about the updated and simplified accounting guidance for stock compensation in ASU 2018-07, in August 2020, the PCC issued an exposure draft entitled *Determining the Current Price of an Underlying Share for Equity Classified Share-Option Awards*.

This exposure draft was issued for public comment on the practical expedient proposed for private companies and the accounting treatment for employee stock compensation. The public comment period for the exposure draft remained open through October 1, 2020.

Since most private company equity shares are not actively traded, determining the current share price is more complicated than it is for public companies. Most public companies have observable market prices for their equity shares which trade on an established securities market.

Because the fair value of stock-option awards is most often estimated using an option pricing model, many private companies require outside assistance from a qualified appraiser to estimate a current share price for the equity shares underlying the stock awards. The practical expedient proposed in the exposure draft provides some relief to private companies.

According to the practical expedient outlined in the exposure draft, a nonpublic entity can 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 Internal Revenue Code Section 409A. The Section 409A regulations provide guidance with regard to valuation methods to comply with the presumption of reasonableness requirements.

The valuation methods prescribed in Section 409A regulations for stock not readily tradeable on an established securities market include the following:[4]

- A valuation of a class of stock determined by an independent appraisal that meets the requirements of Section 401(a)(28)(C) and the related regulations as of a date that is no more than 12 months before the relevant transaction to which the valuation is applied.
- A valuation based on a formula that, if used as part of a nonlapsing restriction (as defined in regulation section 1.83-3(h)) with respect to the stock, would be considered to be the fair market value of the stock pursuant to regulation section 1.83-5.
- A valuation made reasonably in good faith and evidenced by a written report that considers the relevant factors (described in paragraph (b)(5)(iv)(B)(1) of Section 409A) of illiquid stock of a start-up corporation at a time that the corporation did not otherwise anticipate a change in control event or a public offering of the stock.

In the exposure draft, the PCC also concluded that the proposed accounting standards update is not applicable for liability-classified awards. This was because liability-based awards must be remeasured at the end of each reporting period.

Section 409A also contains significant tax penalties for share-option awards that are issued in the money (the current price is greater than the exercise price). To alleviate some of this risk, many private companies obtain independent valuations prepared in compliance with Section 409A when share options are awarded or when stock-option awards are modified.

It should be noted that the measurement objective for the current share price defined in ASU Topic 718, is fair value. The practical expedient proposed by the PCC involves using a Section 409A valuation method to conclude fair market value.

Although the valuation methods used to measure fair value and to estimate fair market value are similar (and many times the same), the definitions of fair value and fair market value are different.

ASC Topic 820 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.[5]

The definition of fair market value frequently applied in the tax-related valuation of private companies is defined in Revenue Ruling 59-60 which states that fair market value is the price at which property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.[6]

Summary and Conclusion

The PCC has made significant progress in addressing concerns raised by private companies about the cost and complexity of compliance with GAAP.

This discussion summarized (1) the history of the PCC (2) its role in the accounting standards-setting process as an advisory body to the FASB, and (3) the PCC decision making framework for determining whether (and in what circumstances) alternatives within GAAP are warranted for private companies.

This discussion also described the recent accounting standards update from the PCC and the FASB regarding the use of a practical expedient for private companies to determine the current price of an underlying share for equity classified share-option awards. The FASB and the PCC have taken a big step forward to provide cost-saving alternative accounting treatment for private companies.

Notes:

1. Financial Accounting Foundation Board of Trustees, Establishment of the Private Company Council (Norwalk, CT: May 30, 2012).
2. *FASB In Focus* (December 2013): 1.
3. FASB Exposure Draft Compensation—Stock Compensation (Topic 718) Determining the Current Price of an Underlying Share for Equity-Classified Share-Option Awards (August 2020).
4. Internal Revenue Code Section 409A
5. FASB ASC Topic 820.
6. Revenue Ruling 59-60, 1959-1 CB 237.

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