November 2021

Your Private Company Equity Compensation Valuations Just Got Easier

---

A new accounting standard update makes it easier for private companies to value share-based employee compensation. However, there are important nuances to consider, which we detail in this alert.

On October 25, 2021, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update 2021-07 (ASU 2021-07), which aims to reduce the effort and cost of valuing employee equity awards issued by private companies. The update impacts only private companies and does not change current valuation techniques and methodologies used by public businesses, nor does it apply to equity awards classified as liabilities.

The FASB has recently taken initiatives to reduce the cost and complexity required to conform with all aspects of Generally Accepted Accounting Principles (GAAP) in the U.S., with an emphasis on alleviating these burdens for private companies. Equity awards are a popular component of employee compensation for private companies and require various inputs to calculate the fair value required by the accounting guidance. This accounting update addresses the grant date stock value input, which is one of the more complex inputs for private companies to calculate. While public companies can obtain this information freely through the stock markets, private companies must calculate the grant date stock price input using a business valuation methodology.

ASU 2021-07 provides a practical expedient for private companies to expand the allowable calculation methodologies for the current price input to valuation models. For entities that elect to use the practical expedient, the grant date stock price may be calculated using a “reasonable valuation method.” The FASB identifies four characteristics of a reasonable valuation methodology, which are consistent with the characteristics of Internal Revenue Code Section 409A valuation. These characteristics are listed below.

Ultimately, ASU 2021-07 loosens the requirements for calculating the grant date stock price for private companies and helps align the tax practice (Code Section 409A) with accounting practice. As a result, companies may determine that a prior calculation of the grant date stock price continues to be a reasonable valuation. Other companies may conclude that one valuation satisfies both Topic 718 and IRC 409A requirements.

ASU 2021-07 is effective for all qualifying awards granted or modified for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. Early adoption is permitted for financial statements not yet issued or made available for issuance as of October 25, 2021. Entities must elect to apply the practical expedient on a measurement date-by measurement-date basis.

The Four Characteristics of Reasonableness

Empower Results®

As mentioned above, the FASB identifies four characteristics of a reasonable valuation methodology. These include:

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:
   - The value of the tangible and intangible assets of the entity.
   - The present value of the anticipated future cash flows of the entity.
   - 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.
   - Recent arm's-length transactions involving the sale or transfer of the stock or equity interests of the entity.
   - 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.
   - 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:
   - The value is updated for any information available after the date of calculation that may materially affect the value of the entity.
   - The value is calculated no more than 12 months earlier than the date for which the value is being used.

Next Steps

Navigating the valuation of share-based compensation at private companies is no small feat. And while this accounting update serves as a practical expedient, we anticipate that some companies will still have questions. Our equity services team can help. Please write to humancapital@aon.com for more information about the accounting update or this topic in general.

Author Contact Information

Conor Buckley, CPA
Senior Consultant, Human Capital Solutions
Aon
conor.buckley@aon.com

Daniel Levine, CEP
Senior Associate, Human Capital Solutions
Aon
daniel.levine@aon.com

Amanda Benincasa, MBA, CEP
Associate Partner, Human Capital Solutions
Aon
amanda.benincasa@aon.com

About Human Capital Solutions

Aon's human capital business provides leaders with a powerful mix of data, analytics and advice to help them make better workforce decisions. Our team, spanning 2,000 colleagues in more than 30 countries, includes the firm's rewards, talent assessment, and performance & analytics practices. To learn more, visit humancapital.aon.com.

About Aon

Aon plc (NYSE:AON) is a leading global professional services firm providing a broad range of risk, retirement and health solutions. Our 50,000 colleagues in 120 countries empower results for clients by using proprietary data and analytics to deliver insights that reduce volatility and improve performance. For further information, please visit aon.com.