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To the Point

AICPA — Draft updates to the Accounting and Valuation Guide

AICPA issues draft updates to its accounting and valuation guide on privately held equity securities

Companies should consider the draft updates in valuing share-based compensation when there have been secondary market transactions in their securities.

What you need to know

- The AICPA's FinREC recently released a draft of two updated chapters of the AICPA's *Valuation of Privately-Held-Company Equity Securities Issued as Compensation* guide that companies should consider in valuing share-based compensation when there have been secondary market transactions in the company's securities.
- The draft updates, which reflect what are viewed to be best practices, enhance the frameworks for determining the impact of secondary market transactions on the value of the equity securities underlying share-based compensation awards and for assessing whether compensation cost should be recognized for these transactions.
- Comments are due by 20 September 2024.

Overview

The Financial Reporting Executive Committee (FinREC) of the American Institute of Certified Public Accountants (AICPA) released in June 2024 a **draft** of two updated chapters of the AICPA's Accounting and Valuation Guide, *Valuation of Privately-Held-Company Equity Securities Issued as Compensation*, to provide guidance on calibrating a company's valuation of shares underlying share-based compensation arrangements to secondary market transaction prices (Chapter 8) and on recognizing compensation cost for secondary market transactions in accordance with Accounting Standards Codification (ASC) 718, *Compensation — Stock Compensation* (Chapter 9).

Building a better working world

There has been significant growth in secondary market transactions since the AICPA last updated the guide in 2013. The updated guidance defines a secondary transaction as "any purchase or sale, other than the original issuance, of an equity interest in or debt instrument of a privately-held company." Such transactions have become a popular way for holders of private company shares (e.g., founders, employees, former employees) to monetize their shares before the entity is sold or goes public. Secondary market transactions also often involve direct purchases of the shares by the entity, related parties, other economic interest holders of the entity or new investors.

The release of these draft updates is the first step in significant enhancements to the guide, which includes a framework for preparers of financial statements, valuation specialists and independent auditors related to the accounting for, valuation of and disclosures related to share-based payments issued by privately held companies.

While the AICPA guide is non-authoritative, the guidance reflects the consensus of the AICPA's Equity Securities Task Force (the Task Force) on best practices. The AICPA said future updates to the guide will address valuation methodologies, including valuations in complex capital structures. A timeline for release has not yet been disclosed.

Key considerations

The draft updates to Chapter 8, *Inferring Value from Transactions in a Private Company's Securities*, enhance the guidance for calibrating the valuation of a company's equity securities underlying share-based compensation awards to secondary market transaction prices. The revisions follow the principles in ASC 820, *Fair Value Measurement*, which requires valuations to maximize the use of relevant observable inputs.[1]

The draft updates discuss prioritizing observable transactions and provide factors to consider when assessing their relevance. The guidance, which is based on ASC 820 principles, addresses the determination of the unit of account, the identification of the principal (or most advantageous) market and the calibration of a model to observable transaction prices.

In addition, the draft updates provide various factors to consider when determining the relevance and appropriate weighting of secondary market transaction prices, as well as the relevance of other indications of fair value (including those based on primary transactions[2] and valuation models, such as a discounted cash flow model).

How we see it

Companies with secondary market activity should consider the draft updates when valuing any current and future share-based compensation awards. Although the updates are in draft form, the views of the Task Force are considered to be best practices for considering secondary market transactions in the valuation of private company securities underlying share-based compensation arrangements.

Under the draft guidance, the weight placed on secondary market transaction prices as compared to other indications of fair value will depend on the facts and circumstances. However, we believe that the application of the draft updates may result in heavier weighting of secondary market transactions compared to past practice.

The draft updates to Chapter 9, *Selected Accounting and Disclosure Matters* (Chapter 14 in the 2013 guide) provide a framework for assessing whether a secondary market transaction has a compensatory element. ASC 718 states that when an entity repurchases an equity award from a grantee, any excess of the repurchase price over the fair value of the award is recognized as compensation cost.

Similarly, the Task Force believes this guidance should be applied when the purchasing party is a related party or economic interest holder in the entity, which may include a new investor. The Task Force believes an entity should consider whether it benefited from the purchase (either directly or indirectly) or actively facilitated the transaction when determining whether a secondary market transaction includes a compensatory element.

How we see it

The draft updates to Chapter 9 are consistent with the interpretive guidance on the accounting for secondary market transactions in Chapter 9 of our Financial Reporting Developments publication, *Share-based payment*.

Endnotes:

[1] The Task Force recommends following the ASC 820 measurement guidance unless it is inconsistent with the fair value-based measurement framework in ASC 718.

[2] Paragraph 8.01 of the updated guide defines a primary transaction as "a transaction involving the original issuance of an equity interest or debt instrument of a privately-held company directly by the company to an investor, other than a public offering."