Three Ways SAB No. 120 Impacts Stock-Based Compensation in the U.S.

Companies should institute Internal equity award controls and disclosure policies to mitigate new and future financial reporting changes from the SEC.

In November 2021, the Securities and Exchange Commission (SEC) released Staff Accounting Bulletin No. 120 (SAB 120) featuring new comments about "spring-loaded" stock awards. At the time, it was critical for businesses to understand why the SEC wants companies to consider whether stock award adjustments are needed while in possession of material non-public information.

Since then, business leaders have questioned how the new SEC guidance will impact financial reporting. There are three important grant, stock-based compensation and valuation topics that companies must review internally given the potential impact of the new SAB 120 guidance on financial reporting.

1: Annual award grants

The SAB 120 bulletin asserts that the observable market price on the grant date is generally viewed as reasonable when "estimating the grant-date fair value of a routine annual grant to employees that is not designed to be spring-loaded."[1] Therefore, we believe that companies will not need to adjust for annual equity grants in most cases.

Nevertheless, the full content and effects of this bulletin should not be disregarded. We recommend that companies not only document evidence that this bulletin was considered for annual grant cycles, but also conclude whether awards are spring-loaded. This will provide strong audit evidence that the topic was considered. Strong internal controls and disclosure policies over the granting of share-based payments will also reduce the risk for financial reporting errors internally and externally while highlighting any need for adjustments.

Consider these four control functions:

- Assessing whether awards are designed to be spring-loaded (not expected to be the case for annual grants)
- Using internal cross-department inquiries to determine whether positive material non-public information exists that could affect awards assessment (i.e., coordination of HR, Legal and Finance departments)
- Documenting positive and negative factors considered in determining whether an adjustment is appropriate

[1] "Staff Accounting Bulletin No. 120," Securities and Exchange Commission, November 24, 2021, https://www.sec.gov/oca/staff-accounting-bulletin-120.

- Disclosing accounting policies related to the identification of adjustments and significant assumptions

#2: Non-routine off-cycle grants

We recommend companies apply a greater level of scrutiny to non-routine off-cycle grants compared to annual award grants. When considering if adjustments to the stock price or volatility are required, companies need to give specific attention to the intent of the award — is the award design to be spring-loaded and is it granted prior to the release of information that may have a significant effect on stock price. Companies should also pay attention to any material positive non-public information in their possession, even in the absence of such award design intent. In either event, we believe actual adjustments to stock price or anticipated volatility will be rare.

The control considerations for annual award grants applies to non-routine grants as well (particularly grants to executives).

#3: Stock-based compensation expense

The SEC staff did not provide guidance on methodologies to calculate the stock price or volatility adjustments in situations where awards are spring-loaded.

Best practice on this topic remains underdeveloped. As a result, there are a variety of potential supporting sources, both internal and external, that companies can use as inputs to or reference points for the adjustment calculation.

Consider the sources below which may not be appropriate for all companies and their assessments but can act as starting points to guide the process.

- Internal
  - Internal financial forecasts
  - Prospective Financial Information (PFI) used in relation to potential mergers and acquisitions or clinical trials
- External
  - Historical price movement following a comparable event, if applicable
  - Historical price movement of a competitor following a comparable event, if applicable

In performing each adjustment calculation, we recommend that companies document information known as of the grant date, including past performance that can be used to estimate a future change in stock price as a percentage of the grant date stock price, and internal expectations regarding the impact of undisclosed events on the stock price. Both sources can provide information to help estimate the required adjustment.

Assessing volatility adjustments is more complex and should incorporate the same facts and assumptions used in assessing stock price adjustments. However, the impact of a one-time increase in stock price may not be well-defined in long-term volatility calculations.

Next steps

It's important for companies to keep in mind that SAB 120 is an accounting pronouncement only. The potential adjustments are focused on fair value calculations. Therefore, a stock price adjustment applied to the grant date price would not be applied to the strike price of an option without a corresponding change to the award agreement.

Nevertheless, companies will want to consider whether an adjustment to the accounting fair value and the fair value of an executive award disclosed in the proxy statement implicates their grant policies and practices.

Companies that determine award size based on estimated accounting fair value should consider if such adjustments required by SAB 120 should be incorporated into the estimate of fair value for granting purposes. Furthermore, companies that grant options should consider whether to adjust the strike price of a given award to account for changes in the share price used for accounting purposes.

To learn more about this topic from our equity services experts, please write to humancapital@aon.com.

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