

SEC Provides Interpretative Guidance Regarding Share-Based Accounting for Spring-Loaded Equity Awards

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Introduction

From time to time, the Securities and Exchange Commission (SEC) provides interpretative accounting guidance, referred to as staff accounting bulletins (SABs), to public companies. On November 24, 2021, the SEC released SAB 120, which addresses the estimation of the fair value of share grants such as stock options, restricted shares, performance awards, and other equity awards when a company issues an equity award just prior to the release of *positive* non-public information. This type of equity award is referred to in SAB 120 as a “spring-loaded” award. If the award is spring-loaded, the SEC believes the company may need to value the award for accounting and proxy purposes at an amount greater than the reported share price at the date of grant.

It is important to note that the statements of SEC staff in accounting bulletins are not rules or interpretations of the SEC nor are they published as bearing the SEC’s official approval. Such statements represent interpretations and practices followed by the Division of Corporate Finance and the Office of the Chief Accountant in administering the disclosure requirements of the federal securities laws.

Spring-Loaded Share Awards/Grants

Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 718 (ASC 718) is based on the premise that compensation costs resulting from share-based payment transactions are to be recognized in company financial statements at fair value. ASC 718 specifies the accounting treatment of a wide range of share-based compensation arrangements including stock options, restricted share plans, performance-based awards, stock appreciation rights, and employee stock purchase plans.

The SEC acknowledges that a company generally possesses non-public information when entering share-based transactions. The SEC notes that an observable market price on the grant date is generally a reasonable and supportable estimate of the current price of the underlying share in a share-based payment transaction in the event of “a routine annual grant to employees that is not designed to be spring-loaded.”¹ The SEC further opines, however, that when share-based payment arrangements are entered into in contemplation of or shortly before the planned release of material non-public information, and such information is expected to result in a material increase in share price, the company should consider whether an adjustment in the observable market price is warranted. According to the SEC, “determining whether an adjustment to the observable market price is necessary, and if so, the magnitude of any adjustment, requires significant judgment,”¹ which leaves it up to companies to determine the fair value that should be used for accounting and proxy reporting purposes.

SAB 120 provides an obvious example of a spring-loaded share transaction:

*“**Facts:** Company D is a public company that entered into a material contract with a customer after market close. Subsequent to entering into the contract but before the market opens the next trading day, Company D awards share options to its executives. The share option award is non-routine, and the award is approved by the Board of Directors in contemplation of the material contract. Company D expects the share price to increase significantly once the announcement of the contract is made the next day. Company D’s accounting policy is to consistently use*

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the closing share price on the day of the grant as the current share price in estimating the grant-date fair value of the options.

“[Question:] Should Company D make an adjustment to the closing share price to determine the current price of shares underling [the] share options?”

“Interpretative Response: Prior to awarding share options in this fact pattern, the staff [(i.e., SEC)] expects Company D to consider whether such awards are consistent with policies and procedures, including the terms of the compensation plan approved by shareholders, other governance policies, and legal requirements. The staff reminds companies of the importance of strong corporate governance and controls in granting share options, as well as the requirements to maintain effective internal control over financial reporting and disclosure controls and procedures.

“In estimating the grant-date fair value of share options in this fact pattern, absent an adjustment to the closing share price to reflect the impact of Company D’s new material contract with a customer, the staff believes the closing share price would not be a reasonable and supportable estimate and, without an adjustment the valuation of the award would not meet the fair value measurement of FASB ASC Topic 718 because the closing share price would not reflect a price that is unbiased for marketplace participants at the time of the grant.”¹

Additional Accounting Guidance in SAB 120

In addition to the guidance above pertaining to spring-loaded share awards, SAB 120 provides additional miscellaneous guidance to companies regarding the application of ASC 718. This guidance includes such applications of ASC 718 regarding:

- The transition from non-public to public entity status;
- The financial statement footnote disclosure of valuation methods used for equity awards including assumptions such as expected volatility, expected term, and current price of the underlying share (particularly when valuing spring-loaded awards); and
- The accounting for certain redeemable financial instruments issued under share-based payment arrangements, the classification of compensation expense, and capitalization of compensation cost related to share share-based payment arrangements.

Closing Remarks

Pay Governance recommends that corporate management ensure members of the Board’s compensation committee be made aware of this latest SEC development — especially if the Company is contemplating making any off-cycle equity grants prior to the close of the fiscal year. We also recommend that the company consult with their legal and accounting advisors to determine if additional documentation is needed to demonstrate that annual and/or off-cycle awards were not made in contemplation of the release of positive non-public information. Because Pay Governance LLC is a management consulting firm, we are prohibited from providing an official opinion regarding accounting, corporate tax, or SEC reporting issues that may be rendered by either qualified legal or tax counsel or a certified public accounting firm.

General questions about this Viewpoint can be directed to John Ellerman at john.ellerman@paygovernance.com or Mike Kesner at mike.kesner@paygovernance.com.

¹ “Staff Accounting Bulletin No. 120: 17 CFR Part 211.” U.S. Securities and Exchange Commission. November 24, 2021. <https://www.sec.gov/oca/staff-accounting-bulletin-120>