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What U.S. Companies Should Know About New Accounting Rule that Impacts ‘Spring-Loaded’ Stock Awards

A new SEC accounting bulletin says that companies in possession of positive material non-public information must consider adjusting the value of underlying shares of one-time or off-cycle stock awards in calculating the accounting value of the awards.

On November 29, 2021, the Securities and Exchange Commission (SEC) staff released Staff Accounting Bulletin No. 120 (SAB 120), which covers a variety of equity-related topics. While some of the issued guidance simply adjusts language to reflect existing changes to ASC Topic 718 guidance relating to employee and non-employee share-based compensation, the highlight of SAB 120 is the newly issued comments on so-called “spring-loaded” awards.

The SEC uses the term spring-loaded to refer to share-based compensation awards issued while a company is in possession of material non-public information, which may materially affect the price and volatility of the stock underlying the award being issued. Through SAB 120, the SEC staff amended Topic 14 to specifically emphasize that, in cases where stock-based compensation awards are issued when a company possesses positive material non-public information, the company should consider whether adjustments to the stock award are appropriate. Specifically, the amendment says: “[C]onsider whether adjustments to the current price of the underlying share or the expected volatility of the price of the underlying share for the expected term for the share-based payment award are appropriate when applying a fair-value-based measurement method to estimate the cost of its share-based payment transactions.”

While the SEC does not explicitly outline acceptable methods of adjusting the underlying stock price or expected volatility, it does acknowledge that this is an area that will require substantive professional judgment. It also says that considering positive and material non-public information aligns with the overall fair value measurement objective of aligning the assumptions with those that a marketplace participant would use in determining the exchange price for an option.

In Topic 14, the SEC explains that future events should be considered in the estimation of volatility, with consideration given to determine whether material non-public information, such as M&A activity or positive clinical trial data, would be reviewed by a marketplace participant once publicly available. The SEC further states under Topic 14 that the observable market price on the grant date is generally reasonable and supportable for annual grants made in the ordinary course of business under grant practices not designed to be spring-loaded. This

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makes it clear that the adjustment of stock price and expected volatility is not expected in all cases of stock-based compensation grants made while a company is in possession of material non-public information.

What does this mean for my company?

Going forward, both management and third-party valuation specialists should take special care to assess whether they should adjust stock prices and volatility for the potential impact of material non-public information. This consideration is likely to be an added focus by independent audit firms for upcoming grants. However, we expect that in the vast majority of cases an adjustment will not be necessary.

Many companies' annual grant practices are drafted to require annual awards to be made after the annual earnings release or at regular board compensation committee meetings scheduled well in advance of the grant date and should not create any challenges. However, for one-time or off-cycle awards, the existence of positive information — and consideration of its impact on the future share price — should be documented and care should be taken when granting to new hires. This is particularly true for executives who tend to receive larger new-hire grants on their initial hire date.

In cases where a grant is made preceding the news that management believes would impact stock price, the company should consider whether the stock price and expected volatility assumptions need to be adjusted, we encourage you to contact your Aon consultant.

To speak with one of our experts about this topic, please write to humancapital@aon.com.

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