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Pay Versus Performance: What's New in Year 2?

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Executive Summary

1. The 2024 proxy season marks Year 2 under the SEC's new Pay Versus Performance disclosure framework for public companies.
2. The SEC issued additional guidance over the last year which clarified the requirements and commented upon registrants' proxy filings from 2023. We discuss several of these items pertaining to valuation and equity-based compensation in this article.
3. Newly public companies and those private companies aspiring to list in the future should be aware of the disclosure and valuation requirements related to Compensation Actually Paid for senior executives.
4. With respect to equity-based awards such as stock options and performance shares with market conditions, the rules continue to point to alignment with ASC 718 and require the disclosure of any significant change in valuation techniques and assumptions.
5. Registrants and their advisors should pay particular attention to the impact of changes in key assumptions on the fair value of equity awards, including volatility, realized performance, and changes in the composition of total shareholder return (TSR) peer groups.

Introduction

The SEC's Pay Versus Performance disclosure rules introduced significant new valuation requirements related to equity-based compensation paid to company executives. As the 2024 proxy season gets underway, what lessons have been learned and what guidance has the SEC provided to registrants? We discuss some of the SEC's recent Compliance & Disclosure Interpretations and share some best practices as companies gear up for Year 2 of the new Pay Versus Performance framework.

To recap how we got to this point, the new disclosures were mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act and were originally proposed by the SEC in 2015. These rules added a new item 402(v) to Regulation S-K and are intended to provide investors with more transparent, readily comparable, and understandable disclosure of a registrant's executive compensation. The new provisions apply to all reporting companies other than (i) foreign private issuers, (ii) registered investment companies, and (iii) emerging growth companies.

The rules apply to any proxy and information statement where shareholders are voting on directors or executive compensation that is filed in respect of a fiscal year ending on or after December 16, 2022. As such, the vast majority of registrants were required to include these disclosures in their 2023 proxy statements, with scaled-down disclosures for smaller reporting companies.

For a more technical discussion of the rules, see our earlier article ***5 Things to Know About the SEC's New Pay Versus Performance Rules.***

Valuation-Related Takeaways from the SEC Guidance

The Pay Versus Performance rules require registrants to disclose the fair value of equity awards to certain senior executives in the year granted and to report changes in the fair value of the awards until they vest. Practically speaking, this means that it is necessary to measure the year-end fair value of all outstanding and unvested equity awards under a methodology consistent with what the registrant uses in its financial statements (e.g., ASC 718, Compensation – Stock Compensation).

In 2023, the SEC issued a series of **Compliance & Disclosure Interpretations (C&DIs)** relating to the Pay Versus Performance disclosure requirements. The roughly 30 C&DIs issued in 2023 are structured in a question-and-answer format. While the questions address many different aspects of the requirements, we focus our summary on those that pertain to valuation-related issues. In the sections that follow, we summarize each question and answer for clarity.

Question 128D.14 (Treatment of Awards Granted Prior to a Restructuring or Spin-Off)

Should awards granted in fiscal years prior to an equity restructuring, such as a spin-off, that are retained by the holder be included in the calculation of executive compensation actually paid?

> **Answer**: Yes. All stock awards and option awards that are outstanding and unvested at the beginning of the covered fiscal year or are granted to the principal executive officer and the remaining named executive officers during the covered fiscal year should be included in the CAP table.

Question 128D.15 (Using Private Company Prices for Newly Public Companies)

For a newly public company (e.g., IPO or SPAC) complying with the proxy statement rules for the first time, should the change in fair value of awards granted prior to IPO be based on the fair value of those awards as of the end of the prior fiscal year for purposes of determining executive compensation actually paid?

> **Answer**: Yes. For outstanding stock awards and option awards, the calculations required by Regulation S-K should be determined based on the change in fair value from the end of the prior fiscal year. The fair value of these awards should not be determined based on other dates, such as the date of the registrant's IPO. This means that prior private company valuations (such as for 409A or ASC 718) could come into play when preparing future Pay Versus Performance disclosures.

Questions 128D.16-17 (Inclusion of Market Conditions in Fair Value)

How should awards with a market condition consider that condition in determining whether the applicable vesting conditions have been met in performing the CAP calculations?

Answer: The effect of a market condition should be reflected in the fair value of share-based awards with such a condition. Until the market condition is satisfied, registrants must include in executive compensation actually paid any change in fair value of any awards subject to market conditions. Similarly, registrants must deduct the amount of the fair value at the end of the prior fiscal year for awards that fail to meet the market condition during the covered fiscal year if it results in forfeiture of the award. However, awards that remain outstanding and have not yet vested should not be considered forfeited.

Question 128D.20 (Use of a Different Valuation Technique)

Can a registrant use a different valuation technique for Pay Versus Performance calculations than what was used for grant date fair value?

Answer: Yes, as long as the valuation technique would be permitted under ASC 718, including that it meets the criteria for a valuation technique and the fair value measurement objective. For example, another valuation technique might provide a better estimate of fair value subsequent to the grant date. The rules require disclosure about the assumptions made in the valuation that differ materially from those disclosed as of the grant date. A change in valuation technique from the technique used at the grant date would require disclosure of the change and the reason for the change if such technique differs materially.

Question 128D.21 (Use of Non-GAAP Methods or Shortcuts)

Is it ever acceptable to value stock and/or option awards as of the end of a covered fiscal year based on methods not prescribed by GAAP?

Answer: No. The fair value of equity awards must be computed using methodology and assumptions consistent with ASC 718. For example, the expected term assumption to value options should not be determined using a "shortcut approach" that simply subtracts the elapsed actual life from the expected term assumption at the grant date. Similarly, the expected term for options referred to as "plain vanilla" should not be determined using the "simplified" method if those options do not meet the "plain vanilla" criteria at the re-measurement date, such as when the option is now out-of-the-money.

Assumptions to Watch in Year 2 Fair Value Disclosures

The procedures used to calculate fair value vary depending on the type of equity award. For stock options and stock appreciation rights (SARs), fair value is often calculated using a Black-Scholes or lattice model. When rolling prior grant valuations forward, care should be taken to ensure that the expected term appropriately considers moneyness of the options at the new date.

Performance shares and performance share units often include a performance condition (e.g., the award vests if revenues increase by 10%) or a market condition (e.g., the award vests if the registrant's total shareholder return over a three-year period exceeds its peer group by at least 5%). The performance condition will require updated probability estimates at year-end and at the vesting date. Awards with market conditions are typically valued using Monte Carlo simulation and so a reassessment at subsequent dates using a consistent simulation model with updated assumptions will be necessary. For awards with market conditions, key assumptions to watch in Year 2 updates include:

- **Volatility –** The volatility input should be updated to match the remaining term of the award. If the award is benchmarked to an index or group of peer companies, then the volatility (and correlation factor) for the benchmark should also be reevaluated. Shorter terms might also mean that forward-looking option-implied volatility could be more appropriate than historical approaches.

- **Realized Performance –** When updating the fair value of a three-year award after one year of performance, one-third of the ultimate return (and potential payoff) is already locked in. For companies whose stocks have performed well (either individually or against their peer group), this could lead to a substantial increase in the fair value of the award. On the other hand, a company whose stock price has lagged its peer group could see the value of the award decline drastically, with little likelihood of favorable outcomes possible in the simulation model.

- **Relative TSR Peer Group Changes –** For awards that link payouts to the performance of a group of peer companies or an index, some of the peers may have been acquired or merged since the grant date. The plan documentation will often describe the steps to be taken when the composition of the peer group changes or there is a change in the benchmark index. A different group (or number) of companies will affect the correlation assumption as well as the percentile calculations in a ranked plan.

These are just a few of the assumptions used in the **valuation of equity awards**. Ultimately, the valuation professional should assess the concluded values for reasonableness and be able to explain why the fair value moved as it did. This understanding provides the link to the calculation of Compensation Actually Paid (and the company's explanation for it) in the Pay Versus Performance disclosures.

Summary and Next Steps

With Year 2 of the Pay Versus Performance framework underway, registrants and their advisors now have an understanding of what is expected. Further, the SEC's additional guidance clarified several areas of potential confusion around the valuation of equity awards with market conditions and situations faced by newly public companies. Companies should pay particular attention to the impact of changes in key assumptions on the fair value of equity awards, including volatility, realized performance, and changes in the composition of total shareholder return (TSR) peer groups.

The complexity of implementing the Pay Versus Performance rules in Year 2 will vary by firm. We have already assisted clients with the transition from the initial Year 1 implementation to a roll-forward of previously-valued equity awards. And we certainly understand how the disclosure rules can seem daunting for those new firms who will be complying with the rules for the first time. Ultimately, the individual equity award characteristics will determine the complexity of the valuation process and the number of valuations that need to be performed.

If you have questions about the valuation of equity awards and how they are incorporated into the Pay Versus Performance disclosure framework, please contact a Mercer Capital professional.

Financial Reporting Valuation Services

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