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Snapshot

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'Clawback' of executive compensation Final Rule adopted

On October 26, 2022, the SEC adopted the Final Rule, *Listing Standards for Recovery of Erroneously Awarded Compensation,* to implement Section 954 of the Dodd-Frank Act, which added Section 10D to the Exchange Act. Section 10D requires national securities exchanges and national securities associations to adopt listing standards that require all issuers with a class of securities listed on an exchange or an association to develop and implement a policy for recovering, under certain circumstances, erroneously awarded incentive-based compensation paid to executive officers (commonly referred to as a "clawback" policy).

In June 2023, the New York Stock Exchange and Nasdaq Stock Market adopted these required listing standards, which are effective on October 2, 2023. Each listed issuer is required to adopt a policy relating to the recovery of erroneously awarded compensation no later than December 1, 2023, which is 60 days following the effective date. The incentive compensation received by executives on or after October 2, 2023 is subject to the issuer's recovery policies.

Issuers that do not adopt and comply with the compensation recovery policies or those that do not disclose the policy will be subject to delisting.

'Clawback' policy

The Final Rule amends certain rules and forms to require the issuer to (1) disclose and file its recovery policy as an exhibit to its annual report, (2) indicate by check boxes on its annual report whether the financial statements included in the annual report reflect a correction of an error to previously issued financial statements and whether the corrections are restatements that triggered a recovery analysis, and (3) disclose any actions taken from the recovery analysis.

Restatement determination

Under the new rules, an issuer is required to perform a recovery analysis when it has an accounting restatement that (1) corrects an error in previously issued financial statements that is material to the previously issued financial statements (a "Big R" restatement), or (2) would result in a material misstatement if the error was either corrected in the current period or left uncorrected in the current period (a "little r" restatement).

The Final Rule recognizes that U.S. GAAP permits certain retrospective changes to previously issued financial statements that do not represent error corrections and, therefore, would not trigger a recovery analysis. Examples include:

- Change in accounting principle
- Change in reportable segment information due to a change in the structure of an issuer's internal organization
- Reclassification due to a discontinued operation
- Change in reporting entity
- Adjustment to provisional amounts in connection with a prior business combination
- Stock splits, reverse stock splits, stock dividends, or other changes in capital structure

Date of restatement

The Final Rule requires an issuer to recover the erroneously awarded compensation from the three-year period preceding the date when the issuer is required to prepare an accounting restatement. The Final Rule defines this date as the earlier of when the board of directors, a committee of the board of directors, or officers have concluded, or should have concluded, that an accounting restatement is required,[1] or when a court, regulator, or other legally authorized entity directs the issuer to prepare an accounting restatement.

Executive officers

Section 10D defines an "executive officer" as the issuer's president; principal financial officer; principal accounting officer (or controller); vice presidents; or any other officer or person who performs a policy-making function, including executive officers of the issuer's parent(s) or subsidiaries.

S-K Item 402(w) disclosure

The Final Rule also adds new Item 402(w) to Regulation S-K to require an issuer to disclose actions taken to recover erroneously awarded compensation. When an accounting restatement occurs that requires recovery of erroneously awarded compensation, the issuer is required to disclose the following information:

- Date the accounting restatement was prepared;
- Aggregate dollar amount of erroneously awarded compensation and calculation of that amount; if the amount is not yet determined, an issuer must disclose this fact and include the known amount and other required disclosures in the next filing that is subject to S-K Item 402;
- Aggregate dollar amount of erroneously awarded compensation that remains outstanding at the end of the last completed fiscal year; and
- Estimates used in determining the erroneously awarded compensation and an explanation of the methodology used for the estimates if the financial reporting measure is related to a stock price or total shareholder return metric.

If recovery is impracticable, the issuer is required to disclose the amount of recovery forgone and to provide a description of the reasons why recovery is not being pursued. Additional disclosures are required when the recovery amount has been outstanding for 180 days or longer.

When an accounting restatement is prepared that does not require recovery of erroneously awarded compensation, the issuer is required to disclose the reasons for this conclusion.

Grant Thornton insight

Materiality in error correction determinations continues to be a focus of the SEC staff, with heightened attention on the qualitative assessment. In a March 2022 statement, SEC Acting Chief Accountant Paul Munter said that determining whether an error is material is an "objective assessment" focusing on whether there is a substantial likelihood that the error would be important to a reasonable investor.

Further, the Final Rule commentary reminds registrants, audit committee members, and auditors to apply a well-reasoned, holistic, and objective approach when assessing an error. When assessing the materiality of an error, any misstatement that positively impacted compensation should be considered as a qualitative factor.

Accounting considerations for clawback provisions

The Final Rule defines "incentive-based compensation" as "any compensation that is granted, earned or vested based wholly or in part upon the attainment of any financial reporting measure." Further, the Final Rule states that "financial reporting measures" are "measures that are determined and presented in accordance with the accounting principles used in preparing the issuer's financial statements, any measures derived wholly or in part from such financial information, and stock price and total shareholder return." As a result, the guidance applies, but is not limited, to:

- Bonuses paid from a bonus pool where the bonus is determined based wholly or in part on satisfying a financial reporting measure performance goal
- Restricted stock or stock options that are granted or become vested based wholly or in part on satisfying a financial reporting measure performance goal.

Awards within the scope of the Final Rule can therefore be within the scope of ASC 450, ASC 710, or ASC 718.

Accounting considerations for incentive-based compensation awards within the scope of ASC 718 and erroneously awarded to executive officers are discussed below.

Grant-date considerations

In accordance with ASC 718, a grant date is established when all of the following conditions are met: (1) a mutual understanding of the terms of the award exists between the grantor and the grantee, (2) all appropriate approvals are obtained, (3) the entity is contingently obligated to issue the award, and (4) the grantee is affected by subsequent changes in the share price. For equity-classified awards, the grant date is the date when the fair value of the award is established and that amount is subsequently recognized as compensation expense over the grantee's requisite service period. For an entity with a rising share price, the establishment of the grant-date "locks in" the fair value of the award.

When establishing clawback policies, entities must make sure that there is a mutual understanding between the issuer and the grantee regarding the clawback, since having a mutual understanding of the terms and conditions of the award is necessary to establish a grant date. If clawback provisions are too vague and require significant discretion, a grant date may not be established, generally postponing both (1) the date when the fair value of the equity-award is "locked in," and (2) commencement of the period over which compensation expense is recognized, except in cases when the service inception date precedes the grant date. When the service inception date precedes the grant date, compensation expense would begin to be recognized and the fair value of the award would be remeasured every period until the grant date occurs.

Grant Thornton insight

We expect that entities who comply with the Final Rule will generally not fail to establish a grant date since the guidance provides clearly understandable and objective clawback triggers. The guidance also explicitly requires that the clawback is enforced with very few exceptions, limiting the amount of discretion management may exercise.

Recovery accounting for clawbacks

Once a grant date is established, clawbacks and other contingent features are not included in an award's grant-date fair value. Instead, they are accounted for if and when the contingent event occurs—in this case, triggered by a "Big R" or "little r" that requires the recovery of erroneously awarded compensation. Further, the accounting differs depending on whether an award is vested or not as well as based on the types of vesting (performance) or non-vesting (market) conditions of each award.

U.S. GAAP specifies the accounting for a clawback of an equity-classified vested award under ASC 718 and requires recognition of (1) a debit for the consideration received (for example, cash or the original award) in the appropriate balance-sheet account, and (2) a credit in the income statement equal to the lesser of the compensation cost previously recognized for the award and the fair value of the consideration received.

If the fair value of the consideration exceeds the previously recognized cost, the excess should be recognized as paid-in capital.

The accounting for non-vested awards will depend on whether the award includes a performance or market condition. Performance conditions are considered vesting conditions, so entities should recognize compensation expense if the award is probable of being achieved. If, during the vesting period, an entity considered the performance condition probable of achievement, it would have recognized compensation cost. However, a restatement triggers a reassessment of that probability, and the entity may conclude that it is no longer probable the award will vest when considering the restated financial information. As a result, any previously recognized compensation cost would be reversed. Conversely, market conditions are not considered vesting conditions and are instead recognized in the grant-date fair value of an award. Compensation cost is recognized regardless of whether or not the market condition is achieved, as long as the grantee provides the requisite service. As a result, a Big R or little r that reveals a market condition alone was not met will not result in a reversal of the associated compensation cost.

[1] For a "Big R" restatement, this date typically aligns with the restatement disclosure date in a non-reliance Form 8-K filed under Item 4.02

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