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# Accounting for stock issued to employees; Opinions of the Accounting Principles Board 25; APB Opinion 25

American Institute of Certified Public Accountants. Accounting Principles Board

OPINIONS OF THE ACCOUNTING PRINCIPLES BOARD

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25

# Accounting for Stock Issued to Employees

CONTENTS



*Issued by the Accounting Principles Board of the American Institute of Certified Public Accountants*

## INTRODUCTION

### Scope of Opinion

1. Many corporations have adopted various plans, contracts, and agreements to compensate officers and other employees by issuing to them stock of the employer corporation. Under traditional stock option and stock purchase plans an employer corporation grants options to purchase a fixed number of shares of stock of the corporation at a stated price during a specified period or grants rights to purchase shares of stock of the corporation at a stated price, often at a discount from the market price of the stock at the date the rights are granted. Stock options and purchase rights are normally granted for future services of employees. Accounting Research Bulletin No. 43, Chapter 13B, *Compensation Involved in Stock Option and Stock Purchase Plans* (1953), contains the principles of accounting for those plans (Reproduced in Appendix B).

2. Among traditional plans not described in Chapter 13B of ARB No. 43 are plans in which an employer corporation awards to employees shares of stock of the corporation for current or future services. Some corporations have replaced or supplemented traditional plans with more complex plans, contracts, and agreements for issuing stock. An arrangement may be based on variable factors that depend on future events; for example, a corporation may award a variable number of shares of stock or may grant a stock option with a variable option price. Other arrangements combine the characteristics of two or more types of plans, and some give an employee an election.

3. Accounting for employee services received as consideration for stock issued is included in an accounting research study[1] on stockholders' equity that is in process.

4. This Opinion deals with some aspects of accounting for stock issued to employees through both noncompensatory and compensatory plans (a plan is any arrangement to issue stock

[1] Accounting research studies are not pronouncements of the Board or of the Institute but are published for the purpose of stimulating discussion on important accounting matters.

to officers and employees, as a group or individually). ARB No. 43, Chapter 13B, remains in effect for traditional stock option and stock purchase plans except that the measure of compensation is redefined in this Opinion. This Opinion recognizes certain practices that evolved after Chapter 13B of ARB No. 43 was adopted and applies the principles of that chapter to other plans in which the number of shares of stock that may be acquired by or awarded to an employee and the option or purchase price, if any, are known or determinable at the date of grant or award. It also specifies the accounting for (a) plans in which either the number of shares of stock or the option or purchase price depends on future events and (b) income tax benefits related to stock issued to employees through stock option, purchase, and award plans. Appendix A to the Opinion illustrates measuring and accounting for compensation under typical plans.

**Differing Views**

5. Some accountants believe that compensation cost for all compensatory plans should be recorded at the date of grant or not later than the date of exercise. They believe that past experience and outside evidence of values can overcome difficulties in measuring compensation. Other accountants believe that compensation need not be recorded if an employee pays an amount that is at least equal to the market price of the stock at the date of grant and that problems in accounting for compensation plans pertain to plans in which the number of shares of stock or the option or purchase price cannot be determined until after the date of grant or award. Still other accountants, although they agree in principle with the first group, believe that progress will result from specifying the accounting for plans with variable factors but leaving Chapter 13B of ARB No. 43 in effect with modifications while the entire topic of accounting for compensation involving stock is studied.

6. Some accountants believe that a tax benefit attributable to compensation that is deductible in computing taxable income but is not recorded as an expense of any period results from a permanent difference. The benefit should therefore be

recorded under paragraphs 33 and 34 of APB Opinion No. 11, *Accounting for Income Taxes,* as a reduction of income tax expense for the period that the benefit is received. Other accountants believe that the tax benefit results from issuing stock and should be accounted for as an adjustment of capital in addition to par or stated value of capital stock in accordance with paragraph 52 of APB Opinion No. 11.

## OPINION

### Noncompensatory Plans

7. Paragraphs 4 and 5 of Chapter 13B of ARB No. 43 describe stock option and stock purchase plans that may not be intended primarily to compensate employees. An employer corporation recognizes no compensation for services in computing consideration received for stock that is issued through noncompensatory plans. The Board concludes that at least four characteristics are essential in a noncompensatory plan: (a) substantially all full-time employees meeting limited employment qualifications may participate (employees owning a specified percent of the outstanding stock and executives may be excluded), (b) stock is offered to eligible employees equally or based on a uniform percentage of salary or wages (the plan may limit the number of shares of stock that an employee may purchase through the plan), (c) the time permitted for exercise of an option or purchase right is limited to a reasonable period, and (d) the discount from the market price of the stock is no greater than would be reasonable in an offer of stock to stockholders or others. An example of a noncompensatory plan is the "statutory" employee stock purchase plan that qualifies under Section 423 of the Internal Revenue Code.

### Compensatory Plans

8. Plans that do not possess the four characteristics of noncompensatory plans are classified as compensatory plans. Since the major principles of Chapter 13B of ARB No. 43 are not changed, classification as a compensatory plan does not neces-

sarily require that compensation cost be recognized.[2]

9. *Services as Consideration for Stock Issued.* The consideration that a corporation receives for stock issued through a stock option, purchase, or award plan consists of cash or other assets, if any, plus services received from the employee.

10. *Measuring Compensation for Services.* Compensation for services that a corporation receives as consideration for stock issued through employee stock option, purchase, and award plans should be measured by the quoted market price of the stock at the measurement date less the amount, if any, that the employee is required to pay. That is the principle in Chapter 13B of ARB No. 43 with two modifications: (a) the meaning of fair value of stock for compensatory plans is narrowed and (b) the measurement date for plans with a variable number of shares of stock or a variable option or purchase price is different.

a. *Quoted market price* is substituted for *fair value.* The Board acknowledges the conclusion in Chapter 13B that "market quotations at a given date are not necessarily conclusive evidence" of fair value of shares of stock but concludes that, for purposes of this Opinion, the unadjusted quoted market price of a share of stock of the same class that trades freely in an established market should be used in measuring compensation. An employee's right to acquire or receive shares of stock is presumed to have a value, and that value stems basically from the value of the stock to be received under the right. However, the value of the right is also affected by various other factors, some of which tend to diminish its value and some of which tend to enhance it. Those opposing factors include a known future purchase price (or no payment), restrictions on the employee's right to receive stock, absence of commissions on acquisition, different risks as compared

[2] All compensation arrangements involving stock, regardless of the name given, should be accounted for according to their substance. For example, an arrangement in which the consideration for stock issued to an employee is a nonrecourse note secured by the stock issued may be in substance the same as the grant of a stock option and should be accounted for accordingly. The note should be classified as a reduction of stockholders' equity rather than as an asset.

with those of a stockholder, tax consequences to the employee, and restrictions on the employee's ability to transfer stock issued under the right. The effects of the opposing factors are difficult to measure, and a practical solution is to rely on quoted market price to measure compensation cost related to issuing both restricted (or letter) and unrestricted stock through stock option, purchase, or award plans. If a quoted market price is unavailable, the best estimate of the market value of the stock should be used to measure compensation.

b. *The measurement date* for determining compensation cost in stock option, purchase, and award plans is the first date on which are known both (1) the number of shares that an individual employee is entitled to receive and (2) the option or purchase price, if any. That date for many or most plans is the date an option or purchase right is granted or stock is awarded to an individual employee and is therefore unchanged from Chapter 13B of ARB No. 43. However, the measurement date may be later than the date of grant or award in plans with variable terms that depend on events after date of grant or award.

Thus a corporation recognizes compensation cost for stock issued through compensatory plans unless the employee pays an amount that is at least equal to the quoted market price of the stock at the measurement date.

11. *Applying the measurement principle* — The following supplements paragraph 10 for special situations in some plans.

a. Measuring compensation by the cost to an employer corporation of reacquired (treasury) stock that is distributed through a stock option, purchase, or award plan is not acceptable practice. The only exception is that compensation cost under a plan with all the provisions described in paragraph 11(c) may be measured by the cost of stock that the corporation (1) reacquires during the fiscal period for which the stock is to be awarded and (2) awards shortly thereafter to employees for services during that period.

b. The measurement date is not changed from the grant or award date to a later date solely by provisions that termination of employment reduces the number of shares of stock that may be issued to an employee.

c. The measurement date of an award of stock for current service may be the end of the fiscal period, which is normally the effective date of the award, instead of the date that the award to an employee is determined if (1) the award is provided for by the terms of an established formal plan, (2) the plan designates the factors that determine the total dollar amount of awards to employees for the period (for example, a percent of income), although the total amount or the individual awards may not be known at the end of the period, and (3) the award pertains to current service of the employee for the period.

d. Renewing a stock option or purchase right or extending its period establishes a new measurement date as if the right were newly granted.

e. Transferring stock or assets to a trustee, agent, or other third party for distribution of stock to employees under the terms of an option, purchase, or award plan does not change the measurement date from a later date to the date of transfer unless the terms of the transfer provide that the stock (1) will not revert to the corporation, (2) will not be granted or awarded later to the same employee on terms different from or for services other than those specified in the original grant or award, and (3) will not be granted or awarded later to another employee.

f. The measurement date for a grant or award of convertible stock (or stock that is otherwise exchangeable for other securities of the corporation) is the date on which the ratio of conversion (or exchange) is known unless other terms are variable at that date (paragraph 10b). The higher of the quoted market price at the measurement date of (1) the convertible stock granted or awarded or (2) the securities into which the original grant or award is convertible should be used to measure compensation.

g. Cash paid to an employee to settle an earlier award of stock or to settle a grant of option to the employee should measure compensation cost. If the cash payment differs from the earlier measure of the award of stock or grant of option, compensation cost should be adjusted (paragraph 15). The amount that a corporation pays to an employee to purchase stock previously issued to the employee through a compensation plan is "cash paid to an employee to settle an earlier award of stock or to settle a grant of option" if stock is reacquired shortly after issuance. Cash proceeds that a corporation receives from sale of awarded stock or stock issued on exercise of an option and remits to the taxing authorities to cover required withholding of income taxes on an award is not "cash paid to an employee to settle an earlier award of stock or to settle a grant of option" in measuring compensation cost.

h. Some plans are a combination of two or more types of plans. An employer corporation may need to measure compensation for the separate parts. Compensation cost for a combination plan permitting an employee to elect one part should be measured according to the terms that an employee is most likely to elect based on the facts available each period.

12. *Accruing Compensation Cost.* Compensation cost in stock option, purchase, and award plans should be recognized as an expense of one or more periods in which an employee performs services and also as part or all of the consideration received for stock issued to the employee through a plan. The grant or award may specify the period or periods during which the employee performs services, or the period or periods may be inferred from the terms or from the past pattern of grants or awards (ARB No. 43, Chapter 13B, paragraph 14; APB Opinion No. 12, *Omnibus Opinion-1967,* paragraph 6).

13. An employee may perform services in several periods before an employer corporation issues stock to him for those services. The employer corporation should accrue compensation expense in each period in which the services are performed. If the measurement date is later than the date of grant or award, an employer corporation should record the compensation expense each period from date of grant or award to date of measurement based on the quoted market price of the stock at the end of each period.

14. If stock is issued in a plan before some or all of the services are performed,[3] part of the consideration recorded for the stock issued is unearned compensation and should be shown as a separate reduction of stockholders' equity. The unearned compensation should be accounted for as expense of the period or periods in which the employee performs service.

15. Accruing compensation expense may require estimates, and adjustment of those estimates in later periods may be necessary (APB Opinion No. 20, *Accounting Changes,* paragraphs 31 to 33). For example, if a stock option is not exercised (or awarded stock is returned to the corporation) because an employee fails to fulfill an obligation, the estimate of compensation expense recorded in previous periods should be adjusted by decreasing compensation expense in the period of forfeiture.

16. *Accounting for Income Tax Benefits.* An employer corporation may obtain an income tax benefit related to stock issued to an employee through a stock option, purchase, or award plan. A corporation is usually entitled to a deduction for income tax purposes of the amount that an employee reports as ordinary income, and the deduction is allowable to the corporation in the year in which the amount is includable in the gross income of the employee. Thus, a deduction for income tax purposes may differ from the related compensation expense that the corporation recognizes,[4] and the deduction may be allowable

[3] State law governs the issuance of a corporation's stock including the acceptability of issuing stock for future services.

[4] A corporation may be entitled to a deduction for income tax purposes even though it recognizes no compensation expense in measuring net income.

in a period that differs from the one in which the corporation recognizes compensation expense in measuring net income.

17. An employer corporation should reduce income tax expense for a period by no more of a tax reduction under a stock option, purchase, or award plan than the proportion of the tax reduction that is related to the compensation expense for the period. Compensation expenses that are deductible in a tax return in a period different from the one in which they are reported as expenses in measuring net income are timing differences (APB Opinion No. 11, paragraphs 34 to 37), and deferred taxes should be recorded. The remainder of the tax reduction, if any, is related to an amount that is deductible for income tax purposes but does not affect net income. The remainder of the tax reduction should not be included in income but should be added to capital in addition to par or stated value of capital stock in the period of the tax reduction. Conversely, a tax reduction may be less than if recorded compensation expenses were deductible for income tax purposes. If so, the corporation may deduct the difference from additional capital in the period of the tax reduction to the extent that tax reductions under the same or similar compensatory stock option, purchase, or award plans have been included in additional capital.

18. A corporation may, either by cash payment or otherwise — for example, by allowing a reduction in the purchase price of stock — reimburse an employee for his action related to a stock option, purchase, or award plan that results in a reduction of income taxes of the corporation. The corporation should include the reimbursement in income as an expense.

19. *Disclosure.* ARB No. 43, Chapter 13B, specifies in paragraph 15 the disclosures related to stock option and stock purchase plans that should be made in financial statements.[5]

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[5] Other disclosure requirements are in Regulation S-X for financial statements filed with the Securities and Exchange Commission and in listing agreements of the stock exchanges for financial statements included in annual reports to stockholders.

## EFFECTIVE DATE

20. This Opinion applies to all stock option, purchase, award, and bonus rights granted by an employer corporation to an individual employee after December 31, 1972 under both existing and new arrangements and to reductions of income taxes resulting from deductions as of a date after December 31, 1972 that are related to stock option, purchase, award, and bonus rights granted before as well as after the effective date of this Opinion.

*The Opinion entitled "Accounting for Stock Issued to Employees" was adopted by the assenting votes of fifteen members of the Board, of whom six, Messrs. Cummings, Ferst, Hayes, Horngren, Norr, and Watt assented with qualification. Messrs. Bows, Gellein and Halvorson dissented.*

Messrs. Cummings, Ferst and Watt assent to the issuance of this Opinion because it improves the accounting principles applicable to the measurement of compensation costs relating to some plans which have come into widespread use subsequent to the issuance of ARB No. 43, Chapter 13B. However, they disagree with the conclusion in paragraph 17 that the tax effects of a permanent difference (as defined in APB Opinion No. 11) in the amount of compensation expense recorded in the financial statements, if any, and the amount allowable for income tax purposes should be added to capital in addition to par or stated value of capital stock. The permanent difference arises as a result of the determination of compensation expense under generally accepted accounting principles in a manner differing from the determination of compensation expense by the taxing authorities. The tax effect of such difference is related, therefore, to an item affecting the determination of income and not to the amount of an employee's investment in the stock of the employer corporation. Accordingly, the tax effect should be reflected as a reduction of income tax expense.

Mr. Cummings also observes that the conclusions in paragraph 17 are inconsistent with those in paragraph 30 of APB

Opinion No. 17 which proscribes allocation of income taxes as to the amortization of nondeductible intangible assets even though such intangible assets may have been acquired through issuance of stock.

Mr. Hayes assents to the publication of this Opinion because he believes it will serve to clarify and promote consistency in accounting for stock compensation arrangements not explicitly covered by previous pronouncements, including arrangements which have evolved in recent years. However, he disagrees with certain conclusions in paragraph 10. He disagrees with the conclusion in paragraph 10(b) that compensation under certain types of plans should be measured at a date subsequent to the date an option or purchase right is granted or shares are awarded. He believes that the date of grant or award is the appropriate date for purposes of measuring compensation costs even though the number of shares that may be issued or the purchase price is not known at that time. Further, in his view, the measure of compensation resulting from issuance of a stock right should approximate the value of the right at the date it is conferred, and the effects of events or conditions subsequent to such date, including fluctuations in the value of optioned or awarded shares, should not affect compensation cost and, hence, an employer's net income.

Messrs. Ferst, Hayes and Watt disagree with the conclusion in paragraph 10(a) that the unadjusted quoted market price of a share of stock of the same class that trades freely in an established market should be used in measuring compensation in all arrangements where stock is issued to employees. They believe that a discount for the inability to trade restricted (or letter) stock is appropriate when employee rights or obligations which might affect the value of the stock are not present, for example, if at the date of issuance the employee has met all conditions of the award, including any obligations to perform services.

Mr. Horngren assents to the issuance of this Opinion because in his view it represents a step toward the desirable objective of attempting to measure all compensation costs. He believes that in all compensation plans the appropriate measure of the compensation is the value of the benefit at the time of its award.

Whether the compensation has fixed or contingent terms should not cloud the basic objective of valuation at date of grant. Although he recognizes the difficulties of measurement, he disagrees with the valuation model in paragraph 10(b), which (1) frequently provides a measurement of zero for a fixed option at date of grant, and which (2) for some other option and award plans, provides a measurement dependent on changes in market values subsequent to the date of grant or award.

Mr. Norr assents to the publication of this Opinion but qualifies his assent because he believes that non-compensatory plans of paragraph 7 involve measurable value. He also believes that stock options where employees pay an amount equal to the quoted market at the measurement date are valuable privileges involving compensation costs in contrast to the position taken in the first sentence of paragraph 10. He believes that the measurement date of paragraph 10 should not be the grant date but rather the exercise date. He also believes that there should be no exception in paragraph 11(a) for Treasury stock purchases.

Mr. Bows dissents from this Opinion because in his view compensation costs of a company's stock option, bonus, or award plan should be measured at the grant or award date and not be altered by later developments (such as changing market prices for the company's stock) arising after the option, bonus, or award is granted. While subsequent market action (or some other variable) may affect the later value of the grant to the officer or employee, such developments provide no basis for altering the compensation cost incurred at the time the grant or award is made. Therefore, the conclusions of paragraphs 10(b) and 13 are inappropriate. Mr. Bows also believes the Opinion is inequitable because grants made under many plans will not result in recognition of compensation costs under this Opinion even though such grants convey valuable rights to officers and employees at the date of grant. The conclusions of paragraph 10 permit the value of those rights to escape measurement as compensation costs, while the cost of other rights must be recognized under the Opinion. He also believes that techniques are available to develop the information needed to estimate the value of all rights.

Mr. Gellein dissents from the Opinion because in his view compensation generally should be measured by the fair value of that which is given in exchange for services at the time it is given. He believes therefore that in any compensation plan where an option to acquire stock is awarded or other benefit is granted, the appropriate measure of the compensation is the value of the benefit (in the case of an option, the value of the call on the company's stock) at the time it is awarded. The periods in which this compensation should be recognized as an expense are the ones in which the employee services are rendered. Mr. Gellein recognizes that there are problems to be resolved in connection with the measurement of the value of stock options, but he believes they can be resolved satisfactorily without undue delay. He recognizes, too, that the options granted and benefits given in certain rather recently adopted plans have value considerably in excess of that of conventional stock option plans, and believes that compensation commensurate with these values should be charged to income. He believes it inappropriate, however, to measure the compensation on the basis of changes in market value after the awards are made, as provided in paragraphs 10 and 13.

Mr. Halvorson believes that the Board is acting prematurely on a subject that presumably is being explored more comprehensively in an accounting research study now in progress and that the alleged abuses in accounting for stock compensation which the Opinion seeks to correct have been emphasized out of proportion to their real significance because of the abiding human concern and curiosity about executive compensation, which is a very different thing from the usually relatively immaterial accounting effect of the alleged abuses on results of operations and financial position. In respect of some specific aspects of the Opinion, Mr. Halvorson believes (1) that a convincing case cannot be made for the proposition that quoted market price is a fair measure of the value of stock issued subject to restrictions on the employee's privilege of selling or transferring the stock, despite the acknowledged existence of various factors which may or may not offset the difference in values (The resort to "best estimate" in the Opinion for situations in which a quoted market price is unobtainable suggests that similar "best estimates" could be obtained for restricted shares.); (2) that the unearned compensation evidenced by stock issued before services are performed should appropriately be reported as a prepaid expense as opposed to the recommended reporting as a reduction of stockholders' equity; and (3) that any difference between compensation deductible in the computation of taxable income and the corresponding charge, if any, in determining book income is a permanent difference and that the resultant tax benefit should therefore be included as a component of income in conformity with the requirements of Opinion No. 11, not as a component of paid-in capital.

## NOTES

*Opinions of the Accounting Principles Board present the conclusions of at least two-thirds of the members of the Board, which is the senior technical body of the Institute authorized to issue pronouncements on accounting principles.*

*Board Opinions are considered appropriate in all circumstances covered but need not be applied to immaterial items.*

*Covering all possible conditions and circumstances in an Opinion of the Accounting Principles Board is usually impracticable. The substance of transactions and the principles, guides, rules, and criteria described in Opinions should control the accounting for transactions not expressly covered.*

*Unless otherwise stated, Opinions of the Board are not intended to be retroactive.*

*Council of the Insttute has resolved that Institute members should disclose departures from Board Opinions in their reports as independent auditors when the effect of the departures on the financial statements is material or see to it that such departures are disclosed in notes to the financial statements and, where practicable, should disclose their effects on the financial statements (Special Bulletin,* Disclosure of Departures From Opinions of the Accounting Principles Board, *October 1964). Members of the Institute must assume the burden of justifying any such departures.*

## Accounting Principles Board (1972)

## APPENDIX A

### Measuring and Accounting for Compensation Under Typical Plans

### (For Illustration Only)

21. Corporations issue stock to officers and other employees through plans with a variety of names and a multiplicity of terms. Plans in which employees pay cash, either directly or through payroll withholding, as all or a significant part of the consideration for stock they receive, are commonly designated by names such as stock option, stock purchase, or stock thrift or savings plans. Plans in which employees receive stock for current or future services without paying cash (or with a nominal payment) are commonly designated by names such as stock bonus or stock award plans. Stock bonus and award plans are invariably compensatory. Stock thrift and savings plans are compensatory to the extent of contributions of an employer corporation. Stock option and purchase plans may be either compensatory or noncompensatory. The combination of terms in some plans tend to make various types of plans shade into one another, and an assigned name may not describe the nature of a plan.

22. This appendix is organized according to the most vital distinction in the Opinion — compensatory plans are divided between plans in which the cost of compensation is measured at the date of grant or award and those in which the cost of compensation depends on events after the date of grant or award. Combination plans are described briefly in a final section.

### Compensation Cost Measured at Date of Grant or Award

23. *Accounting.* Total compensation cost is measured by the difference between the quoted market price of the stock at the date of grant or award and the price, if any, to be paid by an employee and is recognized as expense over the period the employee performs related services. The sum of compensation and cash paid by the employee is the consideration received for the stock issued. Compensation cost related to an award of

stock may be adjusted for a later cash settlement (paragraph 11(g)).

24. *Typical Plans with Fixed and Determinable Terms.* The characteristic that identifies plans in this group is that the terms fix and provide means for determining at the date of grant or award both the number of shares of stock that may be acquired by or awarded to an employee and the cash, if any, to be paid by the employee. Plans usually presume or provide that the employee perform current or future services. The right to transfer stock received is sometimes restricted for a specified period.

25. *Stock option and stock purchase plans* — Typical terms provide for an employer corporation to grant to an employee the right to purchase a fixed number of shares of stock of the employer corporation at a stated price during a specified period.

26. *Stock bonus or award plans* — Typical terms provide for an employer corporation to award to an employee a fixed number of shares of stock of the employer corporation without a cash payment (or with a nominal cash payment) by the employee. Often the award is specified as a fixed dollar amount but is distributable in stock with the number of shares determined by the quoted market price of the stock at the date of award, the effective date of award (paragraph 11(c)), or the date treasury stock is acquired (paragraph 11(a)).

## Compensation Cost Measured at Other Than Date of Grant or Award

27. *Accounting.* Compensation cost is accounted for the same as for plans in the first group with one exception. The quoted market price used in the measurement is not the price at date of grant or award but the price at the date on which both the number of shares of stock that may be acquired by or awarded to an individual employee and the option or purchase price are known. Total compensation cost is measured by the difference between that quoted market price of the stock and the amount, if any, to be paid by an employee and is recognized

as expense over the period the employee performs related services. The sum of compensation and cash paid by the employee is the consideration received for the stock issued. Compensation cost related to an award of stock may be adjusted for a later cash settlement (paragraph 11(g)).

28. Estimates of compensation cost are recorded before the measurement date based on the quoted market price of the stock at intervening dates. Recorded compensation expense between the date of grant or award and the measurement date may either increase or decrease because changes in quoted market price of the stock require recomputations of the estimated compensation cost.

29. *Typical Plans with Variable Terms.* The characteristic that identifies plans in this group is that the terms prevent determining at the date of grant or award either the number of shares of stock that may be acquired by or awarded to an employee or the price to be paid by the employee, or both. The indeterminate factors usually depend on events that are not known or determinable at the date of grant or award. Plans usually presume or provide that the employee perform current or future services. The right to transfer stock received is sometimes restricted for a specified period.

30. *Stock option and stock purchase plans* – Some terms provide for an employer corporation to grant to an employee the right to purchase shares of stock of the employer corporation during a specified period. The number of shares of stock, the option or purchase price, or both may vary depending on various factors during a specified period, such as market performance of the stock, equivalents of dividends distributed, or level of earnings of the employer corporation.

31. *Stock bonus or award plans* – Some terms provide for an employer corporation to award to an employee the right to receive shares of stock of the employer corporation but the number of shares is not determinable at the date of award. Often the award is specified as a fixed dollar amount but is distribut-

able in stock with the number of shares of stock determined by the market price of the stock at the date distributed, or the award may be of an undesignated number of shares of stock and that number is to be determined by variable factors during a specified period.

32. The terms of some plans, often called *phantom stock* or *shadow stock* plans, base the obligations for compensation on increases in market price of or dividends distributed on a specified or variable number of shares of stock of the employer corporation but provide for settlement of the obligation to the employee in cash, in stock of the employer corporation, or a combination of cash and stock.

### Combination and Elective Plans

33. *Accounting.* In general, compensation is measured for the separate parts of combination or elective plans. Compensation expense is the sum of the parts that apply. An employer corporation may need to measure compensation at various dates as the terms of separate parts become known. For example, if an employee is entitled to dividend equivalents, compensation cost is the sum of the costs measured at the dates the dividends are credited to the employee in accordance with the terms of the plan. If an employee may choose between alternatives, compensation expense is accrued for the alternative that the employee is most likely to elect based on the facts available at the date of accrual.

34. *Typical Combination and Elective Plans.* Some plans provide for an employer corporation to grant or award to an employee rights with more than one set of terms. Often an employee may elect the right to be exercised. The combination of rights may be granted or awarded simultaneously or an employee who holds a right may subsequently be granted or awarded a second but different right. The rights may run concurrently or for different periods. An illustration is: an employee holding an option to purchase a fixed number of shares of stock at a fixed price during a specified period is granted an alternative

option to purchase the same number of shares at a different price or during a different specified period. Instead of a second option, the award may be the right to elect to receive cash or shares of stock without paying cash. Often the election to acquire or receive stock under either right decreases the other right. Plans combining rights are often called *tandem stock* or *alternate stock* plans; the second right may be of the type that is sometimes called a *phantom stock* plan.

# APPENDIX B

## Reprint of Accounting Research Bulletin No. 43, Chapter 13, Compensation

### *Section B—Compensation Involved in Stock Option and Stock Purchase Plans*

1. The practice of granting to officers and other employees options to purchase or rights to subscribe for shares of a corporation's capital stock has been followed by a considerable number of corporations over a period of many years. To the extent that such options and rights involve a measurable amount of compensation, this cost of services received should be accounted for as such. The amount of compensation involved may be substantial and omission of such costs from the corporation's accounting may result in overstatement of net income to a significant degree. Accordingly, consideration is given herein to the accounting treatment of compensation represented by stock options or purchase rights granted to officers and other employees.[1]

2. For convenience, this section will discuss primarily the problems of compensation raised by stock option plans. However, the committee feels that substantially the same problems may be encountered in connection with stock purchase plans made available to employees, and the discussion below is applicable to such plans also.

## RIGHTS INVOLVING COMPENSATION

3. Stock options involving an element of compensation usually arise out of an offer or agreement by an employer corporation to issue shares of its capital stock to one or more officers or

[1] Bulletin 37. "Accounting for Compensation in the Form of Stock Options," was issued in November, 1948. Issuance of a revised bulletin in 1953 and its expansion to include stock purchase plans were prompted by the very considerable increase in the use of certain types of option and purchase plans following the enactment in 1950 of Section 130A of the Internal Revenue Code. This section granted specialized tax treatment to employee stock options if certain requirements were met as to the terms of the option, as to the circumstances under which the option was granted and could be exercised and as to the holding and disposal of the stock acquired thereunder. In general, the effect of Section 130A is to eliminate or minimize the amount of income taxable to the employee as compensation and to deny to the issuing corporation any tax deduction in respect of such restricted options. In 1951, the Federal Salary Stabilization Board issued rules and regulations relating to stock options and purchase rights granted to employees whereby options generally comparable in nature to the restricted stock options specified in Section 130A might be considered for its purposes not to involve compensation, or to involve compensation only in limited amounts.

other employees (hereinafter referred to as grantees) at a stated price. The grantees are accorded the right to require issuance of the shares either at a specified time or during some determinable period. In some cases the grantee's options are exercisable only if at the time of exercise certain conditions exist, such as that the grantee is then or until a specified date has been an employee. In other cases, the grantees may have undertaken certain obligations, such as to remain in the employment of the corporation for at least a specified period, or to take the shares only for investment purposes and not for resale.

## RIGHTS NOT INVOLVING COMPENSATION

4. Stock option plans in many cases may be intended not primarily as a special form of compensation but rather as an important means of raising capital, or as an inducement to obtain greater or more widespread ownership of the corporation's stock among its officers and other employees. In general, the terms under which such options are granted, including any conditions as to exercise of the options or disposal of the stock acquired, are the most significant evidence ordinarily available as to the nature and purpose of a particular stock option or stock option plan. In practice, it is often apparent that a particular option or plan involves elements of two or more of the above purposes. Where the inducements are not larger per share than would reasonably be required in an offer of shares to all shareholders for the purpose of raising an equivalent amount of capital, no compensation need be presumed to be involved.

5. Stock purchase plans also are frequently an integral part of a corporation's program to secure equity capital or to obtain widespread ownership among employees, or both. In such cases, no element of compensation need be considered to be present if the purchase price is not lower than is reasonably required to interest employees generally or to secure the contemplated funds.

## TIME OF MEASUREMENT OF COMPENSATION

6. In the case of stock options involving compensation, the principal problem is the measurement of the compensation. This

problem involves selection of the date as of which measurement of any element of compensation is to be made and the manner of measurement. The date as of which measurement is made is of critical importance since the fair value of the shares under option may vary materially in the often extended period during which the option is outstanding. There may be at least six dates to be considered for this purpose: (a) the date of the adoption of an option plan, (b) the date on which an option is granted to a specific individual, (c) the date on which the grantee has performed any conditions precedent to exercise of the option, (d) the date on which the grantee may first exercise the option, (e) the date on which the option is exercised by the grantee, and (f) the date on which the grantee disposes of the stock acquired.

7. Of the six dates mentioned two are not relevant to the question considered in this bulletin – cost to the corporation which is granting the option. The date of adoption of an option plan clearly has no relevance, inasmuch as the plan per se constitutes no more than a proposed course of action which is ineffective until options are granted thereunder. The date on which a grantee disposes of the shares acquired under an option is equally immaterial since this date will depend on the desires of the individual as a shareholder and bears no necessary relation to the services performed.[2]

8. The date on which the option is exercised has been advocated as the date on which a cost may be said to have been incurred. Use of this date is supported by the argument that only then will it be known whether or not the option will be exercised. However, beginning with the time at which the grantee may first exercise the option he is in effect speculating for his own account. His delay has no discernible relation to his status as an employee but reflects only his judgment as an investor.

9. The date on which the grantee may first exercise the

[2] This is the date on which income or gain taxable to the grantee may arise under Section 130A. Use of this date for tax purposes is doubtless based on considerations as to the ability of the optionee to pay taxes prior to sale of the shares.

option will generally coincide with, but in some cases may follow, the date on which the grantee will have performed any conditions precedent to exercise of the option. Accordingly this date presents no special problems differing from those to be discussed in the next paragraph.

10. There remain to be considered the date on which an option is granted to a specific individual and the date on which the grantee has fulfilled any conditions precedent to exercise of the option. When compensation is paid in a form other than cash the *amount* of compensation is ordinarily determined by the fair value of the property which was agreed to be given in exchange for the services to be rendered. The time at which such fair value is to be determined may be subject to some difference of opinion but it appears that the date on which an option is granted to a specific individual would be the appropriate point at which to evaluate the cost to the employer, since it was the value at that date which the employer may be presumed to have had in mind. In most of the cases under discussion, moreover, the only important contingency involved is the continuance of the grantee in the employment of the corporation, a matter very largely within the control of the grantee and usually the main objective of the grantor. Under such circumstances it may be assumed that if the stock option were granted as a part of an employment contract, both parties had in mind a valuation of the option at the date of the contract; and accordingly, value at that date should be used as the amount to be accounted for as compensation. If the option were granted as a form of supplementary compensation otherwise than as an integral part of an employment contract, the grantor is nevertheless governed in determining the option price and the number of shares by conditions then existing. It follows that it is the value of the option at that time, rather than the grantee's ultimate gain or loss on the transaction, which for accounting purposes constitutes whatever compensation the grantor intends to pay. The committee therefore concludes that in most cases, including situations where the right to exercise is conditional upon continued employment, valuation should be made of the option as of the date of grant.

11. The date of grant also represents the date on which the corporation foregoes the principal alternative use of the shares which it places subject to option, i.e., the sale of such shares at the then prevailing market price. Viewed in this light, the *cost* of utilizing the shares for purposes of the option plan can best be measured in relation to what could then have been obtained through sale of such shares in the open market. However, the fact that the grantor might, as events turned out, have obtained at some later date either more or less for the shares in question than at the date of the grant does not bear upon the measurement of the compensation which can be said to have been in contemplation of the parties at the date the option was granted.

## MANNER OF MEASUREMENT

12. Freely exercisable option rights, even at prices above the current market price of the shares, have been traded in the public markets for many years, but there is no such objective means for measuring the value of an option which is not transferable and is subject to such other restrictions as are usually present in options of the nature here under discussion. Although there is, from the standpoint of the grantee, a value inherent in a restricted future right to purchase shares at a price at or even above the fair value of shares at the grant date, the committee believes it is impracticable to measure any such value. As to the grantee any positive element may, for practical purposes, be deemed to be largely or wholly offset by the negative effect of the restrictions ordinarily present in options of the type under discussion. From the viewpoint of the grantor corporation no measurable cost can be said to have been incurred because it could not at the grant date have realized more than the *fair value* of the optioned shares, the concept of fair value as here used encompassing the possibility and prospect of future developments. On the other hand, it follows in the opinion of the committee that the value to the grantee and the related cost to the corporation of a restricted right to purchase shares at a price *below* the fair value of the shares at the grant date may for the purposes here under discussion be taken as the excess of the then fair value of the shares over the option price.

13. While market quotations of shares are an important and often a principal factor in determining the fair value of shares, market quotations at a given date are not necessarily conclusive evidence.[3] Where significant market quotations cannot be obtained, other recognized methods of valuation have to be used. Furthermore, in determining the fair value of shares for the purpose of measuring the cost incurred by a corporation in the issuance of an option, it is appropriate to take into consideration such modifying factors as the range of quotations over a reasonable period and the fact that the corporation by selling shares pursuant to an option may avoid some or all of the expenses otherwise incurred in a sale of shares. The absence of a ready market, as in the case of shares of closely-held corporations, should also be taken into account and may require the use of other means of arriving at fair value than by reference to an occasional market quotation or sale of the security.

## OTHER CONSIDERATIONS

14. If the period for which payment for services is being made by the issuance of the stock option is not specifically indicated in the offer or agreement, the value of the option should be apportioned over the period of service for which the payment of the compensation seems appropriate in the existing circumstances. Accrual of the compensation over the period selected should be made by means of charges against the income account. Upon exercise of an option the sum of the cash received and the amount of the charge to income should be accounted for as the consideration received on issuance of the stock.

15. In connection with financial statements, disclosure should be made as to the status of the option or plan at the end of the period of report, including the number of shares under option, the option price, and the number of shares as to which options were exercisable. As to options exercised during the period, disclosure should be made of the number of shares involved and the option price thereof.

[3] Whether treasury or unissued shares are to be used to fulfill the obligation is not material to a determination of value.

*One member of the committee, Mr. Mason, assented with qualification to adoption of section (b) of chapter 13. One member, Mr. Knight, did not vote.*

Mr. Mason assents only under the assumption that if an option lapses after the grantee becomes entitled to exercise it, the related compensation shall be treated as a contribution by the grantee to the capital of the grantor.