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Accounting for Compensation in the Form of Stock Options

INTRODUCTION

1. The practice of granting to officers and other employees options to purchase or subscribe for shares of the corporation's capital stock has been followed by a considerable number of corporations. These options generally are a part of the corporation's cost of the services of officers and other employees, and should be accounted for as such. The amounts involved are sometimes substantial and omission of such costs from the corporation's income accounting may result in overstatement of net income to a significant degree. Accordingly, consideration is given in this bulletin to the accounting treatment of stock options involving compensation.

2. Stock options granted by corporations to their officers and other employees are presumed to be a form of compensation for services unless it is clear that they are granted primarily (a) for the purpose of raising capital or (b) to promote widespread ownership of the corporation's stock among its employees. In either of these situations, the statements made herein are not intended to apply. No differentiation is made in this bulletin as to the nature of compensation. Salaries, wages, inducements, incentives, and similar terms are all considered to be descriptive of compensation.

3. A stock option involving compensation usually arises out of an agreement between an employer corporation and an officer or other employee (hereinafter referred to as the grantee) stipulating that at a specified time or during some determinable period, at the grantee's election, and usually upon the fulfillment by the grantee of certain conditions, the corporation will issue shares of its capital stock to the grantee at a stated price. The agreement usually contains provisions specifying the period of time, or conditions, if any, which must elapse or be met, before the option may be exercised, the time the option expires, the price to be paid for the shares, and

a variety of circumstances relating to the issuance of the option. It is recognized that stock options may be granted pursuant to, or even in the absence of, an announced corporate policy and without formal agreement. Although in such cases certain problems regarding the agreement date may not arise, the accounting procedures recommended herein are applicable.

ACCOUNTING PROBLEMS

4. The two principal accounting problems involved in the issuance of the type of stock options here considered are (a) the selection of the date on which the compensation is deemed to have accrued and (b) the manner in which it should be measured. Customarily, compensation is due upon performance of a service agreed upon. If compensation is paid in cash, the work is usually first performed for a stipulated period. The charge accrues during the period and payment falls due at the end of the period. In the case of compensation paid in stock as a bonus at the end of a period, the amount of the compensation is not definitely determined until the end of the period. In such cases, the amount of the compensation would be the fair value of the bonus shares at the end of the period, although there might be a recording of estimated accrual during the period.

5. In the case of options to purchase shares, the time of accrual and the amount of the compensation are not always clear. There may be as many as four dates to be considered: (a) the date of the option agreement, (b) the date when the option right becomes the property of the grantee, (c) the date on which the grantee *may* first exercise the option, and (d) the date the option *is* exercised by the grantee.

DATE OF OPTION AGREEMENT

6. The agreement to grant an option of the character dealt with herein states the terms under which the option will be issued. At the date of the agreement the services contemplated usually have not been performed by the grantee and no accountable obligation has been incurred by the corporation. Argument has been advanced that the worth to the corporation of the right to receive the services of the grantee should be measured as of the date of the agreement on the ground that a corporation would not purchase services without knowing the price it must pay. This argument loses much of its force when it is noted that a corporation does not always know in advance its costs for all services, as when, for example, compensation

is to be calculated as a percentage of profits. The committee, therefore, believes that the date of the agreement is not *per se* the date as of which the amount of compensation involved in the option should be measured.

DATE OPTION RIGHT BECOMES THE PROPERTY OF THE GRANTEE

7. The committee believes the date on which the option right becomes the property of the grantee is the proper date as of which to measure the value of the option. Upon that date the grantee has met all conditions precedent to receiving the option, and the corporation then has an unqualified obligation under the agreement. While this date may not coincide with the date on which the grantee may first exercise his option, the committee believes this to be the date as of which the corporation should ordinarily measure compensation resulting from the option agreement. It should be recognized that the date of the option agreement may coincide with the date at which the option right becomes the property of the grantee.

DATE GRANTEE MAY FIRST EXERCISE THE OPTION

8. The committee believes the date on which the grantee may first exercise the option is not the date as of which to measure the value of the option, unless that date happens to coincide with the date the option right becomes the property of the grantee. The fact that the date the grantee may first exercise the option differs from the date on which it becomes his property in no way changes the grantee's right to the option nor does it change in any way the corporation's obligation under the agreement. If this date follows the date on which the option right becomes the property of the grantee, it merely defers the time when the grantee may exercise the option. Such deferment could, however, affect the value of the option as of the date the option right becomes the property of the grantee.

THE DATE EXERCISED[1]

9. The date when the option is exercised has been advocated as both the date of accrual and the time for measurement of the value of the option. Use of this date is supported by two principal arguments.

[1] Treasury Department regulations provide for recognition of compensation as of the date the option is exercised to the extent the fair value of the property exceeds the amount paid therefor.

First, only then will it be known whether or not the option will be exercised. Second, the value of the option to the grantee cannot be determined until he exercises it, and since the value to the grantee should be the equivalent of the compensation paid by the corporation, such cost should be determined as of the date the option is exercised.

10. An effective answer to the arguments in the preceding paragraph is that the corporation at the time of giving to the grantee the property right inherent in the option has then given valuable consideration for the grantee's services. If the grantee delays exercise or sale of his unrestricted right, he is speculating for his own account. If he does not exercise his option, he is in the position of having made a contribution to the corporation to the extent of the consideration given to him in the form of the option.

MANNER OF MEASUREMENT

11. When property is given for services, the cost of those services would be determined by their fair value or by the fair value of the property given, whichever is the more clearly evident.[2] While the market price of the shares will usually be an important factor and often the principal factor in determining fair value, market value is not necessarily conclusive evidence. However, there is a presumption that the value of the option should be measured by deducting the price payable by the grantee from the fair value of the shares on the date the option right becomes the property of the grantee. The amount so determined should, in most cases, represent substantially what the corporation could have realized in excess of the option price by sale of the shares on that date. When the agreement contains provisions which defer the date when the option may first be exercised, or which prevent the option from being sold or transferred, the value of the option may be less.

OTHER CONSIDERATIONS

12. When treasury shares are used by the corporation to fulfill the option agreement, the compensation is to be measured in the same way as if unissued shares had been used.

13. The entry to be made on the books should be a charge against the income account for the value of the option and a credit to an account similar to the account to which subscriptions for capital

[2] See Accounting Research Bulletin No. 24, p. 196.

stock should be credited. If the period for which payment for services is being made by the issuance of the stock option is not specifically indicated in the agreement, the period over which the charge against income should be apportioned must be selected on the basis of the existing circumstances.

14. Until the option is exercised or expires, the existence of such option agreements and the rights outstanding under such agreements should be disclosed with appropriate explanation in the corporation's financial statements.

The statement entitled "Accounting for Compensation in the Form of Stock Options" was adopted by the assenting votes of nineteen members of the committee, of whom one, Mr. Wellington, assented with qualification. Two members, Messrs. Himmelblau and Lindquist, dissented.

Mr. Wellington assents to the bulletin but believes the value of the option, and the compensation, should be measured at the date of the option agreement, at which time he believes there has been a meeting of minds as to value, rather than at the date the option right becomes the property of the grantee.

Mr. Himmelblau dissents because he believes the bulletin should require that, whenever an employee fails to exercise his option, the credit should be to earned surplus as would be the case in an adjustment of any other liability. He also objects to the bulletin because it fails to distinguish between stock options intended to be "bargain purchases" and those intended to be "compensation."

Mr. Lindquist dissents from the requirement that an accounting should be made before the option is exercised. He believes that until all of the acts up to and including the delivery of the optioned shares have been performed, the option is no more than a commitment on the part of the grantor of the option to deliver shares upon demand of the grantee. In his opinion, to require an accounting before the option is exercised, is to demand the accounting of a transaction that has not become, and may never become, completed.

NOTES

1. Accounting Research Bulletins represent the considered opinion of at least two-thirds of the members of the committee on accounting procedure, reached on a formal vote after examination of the subject matter by the committee and the research department. Except in cases in which formal adoption by the Institute membership has been asked and secured, the authority of the bulletins rests upon the general acceptability of opinions so reached. (See Report of Committee on Accounting Procedure to Council, dated September 18, 1939.)

2. Recommendations of the committee are not intended to be retroactive, nor applicable to immaterial items. (See Bulletin No. 1, page 3.)

3. It is recognized also that any general rules may be subject to exception; it is felt, however, that the burden of justifying departure from accepted procedures must be assumed by those who adopt other treatment. (See Bulletin No. 1, page 3.)

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