

Statutory Issue Paper No. 82

Stock Options and Stock Purchase Plans

STATUS

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Current Authoritative Guidance for Stock Options and Stock Repurchase Plans: SSAP No. 104R

This issue paper may not be directly related to the current authoritative statement.

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SUMMARY OF ISSUE

1. Current statutory guidance provides for disclosures concerning deferred compensation plans such as profit sharing, stock options or incentive plans in the NAIC Annual Statement Instructions. However, specific guidance regarding the accounting for such plans is not currently provided.
2. GAAP addresses the accounting for stock issued to employees in *Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25)*, *Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins (ARB 43)*, *Accounting Interpretation of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (AIN-APB 25)*, *FASB Interpretation No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans (FIN 28)*, *FASB Interpretation No. 38, Determining the Measurement Date for Stock Option, Purchase, and Award Plans Involving Junior Stock (FIN 38)* and *FASB Statement No. 123, Accounting for Stock-Based Compensation (FAS 123)*.
3. This purpose of this issue paper is to establish statutory accounting principles for employee stock options and stock purchase plans that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. A plan is any arrangement to issue stock to officers and employees, as a group or individually. Stock purchase and stock option plans shall be classified as either compensatory or noncompensatory. A reporting entity recognizes no compensation expense for services received in return for stock issued through noncompensatory plans. Stock purchase and stock option plans which do not meet the criteria of a noncompensatory plan shall be classified as compensatory. A reporting entity recognizes compensation cost for stock issued through compensatory plans.

Noncompensatory Plans

5. The following 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.

Compensatory Plans

6. Consideration that a reporting entity receives for stock issued through employee stock option, purchase, and award plans in the form of services shall be measured by the fair value of the stock at the measurement date less the amount, if any, that the employee is required to pay.

7. 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. However, the measurement date may be later than the date of grant or award in plans with variable terms that depend on events after the date of grant or award. Thus, a reporting entity 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.

8. Compensation cost in stock option, purchase, and award plans shall 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. An employee may perform services in several periods before a reporting entity issues stock for those services. The reporting entity shall 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, a reporting entity shall record the compensation expense each period from date of grant or award to date of measurement based on the fair value of the stock at the end of each period.

9. Quoted market prices in active markets are the best evidence of fair value and are to be used as fair value, if available. If quoted market prices are not available, the estimate of fair value shall be based on the best information available in the circumstances.

10. If stock is issued in a plan before some or all of the services are performed, part of the consideration recorded for the stock issued is unearned compensation and shall be reported as a component of unassigned funds. The unearned compensation should be accounted for as expense of the period or periods in which the employee performs service.

Accounting for Income Tax Benefits

11. A reporting entity may obtain an income tax benefit related to stock issued to an employee through a stock option, purchase, or award plan. Generally, the reporting entity is 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, the amount and timing of the deduction for income tax purposes, if any, may differ from the related compensation expense recognized in the financial statements. For example, the reporting entity may be entitled to a deduction for income tax purposes even though no compensation expense is recognized in measuring net income.

12. The income tax reduction, if any, related to a stock option, purchase, or award plan shall be accounted for within one or more of the following three components:

- a. Income tax expense for a period shall be reduced by no more than the income tax reduction related to the stock option, purchase, or award plan that is proportionate to compensation expense recognized during the period, for such plan.
 - b. Compensation expense that is deductible in the income tax return for a period different from the one in which such expense is reported in measuring net income results in a temporary difference. Deferred income taxes shall be recognized for such differences and included with all deferred income taxes as a separate component of gains and losses in surplus consistent with *Issue Paper No. 83—Accounting for Income Taxes*.
 - c. The remainder of the income 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 income tax reduction shall not be included in income, but shall be added to capital stock or gross paid-in and contributed surplus in the period of the income tax reduction. Conversely, a tax reduction may be less than if recorded compensation expenses were deductible for income tax purposes. If so, the reporting entity may deduct the difference from capital stock or gross paid-in and contributed surplus in the period of the income tax reduction, to the extent that income tax reductions under the same or similar compensatory stock option, purchase, or award plans have been included in capital stock or gross paid-in and contributed surplus.
13. In certain situations, it may be advantageous to the reporting entity to compensate an employee to make an option that is detrimental to him but advantageous to the company. A reporting entity may, either by cash payment or otherwise 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 reporting entity; for example, in incentive stock purchase plans a reduction in the purchase price of stock is allowed. The reporting entity shall include any such reimbursement as an expense.
14. Stock option, purchase, and award plans of the principal stockholder (i.e., a holding company) or equity instruments granted or otherwise transferred directly to an employee by a principal stockholder shall be treated as contributed surplus by the principal stockholder with the offsetting charge accounted for in accordance with this issue paper, unless such transfers are clearly for a purpose other than compensation for services rendered the reporting entity.
15. Compensation expense related to stock appreciation rights and other variable stock option or award plans shall be measured at the end of each period as the amount by which the quoted market value of the shares of the enterprise's stock covered by a grant exceeds the option price or value specified under the plan and should be accrued as a charge to expense over the periods the employee performs the related services. Changes in the quoted market value should be reflected as an adjustment of accrued compensation and compensation expense in the periods in which the changes occur until the date the number of shares and purchase price, if any, are both known.

Disclosure

16. The notes to financial statements shall disclose deferred stock compensation plans for employees such as profit sharing, stock options or incentive plans. If warranted by materiality, the following information with regard to stock options shall be furnished and analogous information shall be supplied for warrants or rights:
- a. A brief description of the terms of each option arrangement including the title and amount of securities to option; the year or years during which the options were granted; and the year or years during which the optionees became, or will become, entitled to exercise the options;

- b. The number of shares under option at the end of the statement year; the number of shares with respect to which options became exercisable during the year; and the number of shares with respect to which options were exercised during the year; and the option price and fair market value thereof, per share, and in total for each of the three categories;
- c. The required information may be summarized as appropriate with respect to each of these categories. The above information shall be supplied whether the stock involved relates to the company, the parent of the company, a subsidiary of the company, or an affiliated corporation. The information shall be shown separately for (1) agents and brokers and (2) employees and others.

DISCUSSION

17. Current statutory guidance provides for disclosures concerning deferred compensation plans such as profit sharing, stock options or incentive plans in the Annual Statement Instructions. This issue paper is consistent with such guidance. This issue paper expands current statutory guidance to provide specific guidance regarding the accounting for such plans. *Issue Paper No. 78—Employee Stock Ownership Plans* (Issue Paper No. 78) addresses the accounting for Employee Stock Ownership Plans by the plan sponsor.

18. This issue paper rejects FAS 123. FAS 123 encourages, but does not require, that companies report stock based compensation plans using a fair value method of accounting versus the intrinsic value method of accounting promulgated in APB 25. The differences between these two methods of accounting primarily affect the accounting related to stock option plans. Under the intrinsic value method of accounting, the compensation cost of such plans is measured by the excess, if any, of the market price of the underlying stock versus the exercise price of the option at the measurement date. The fair value method of accounting requires that a fair value be determined for the options, generally by utilization of option-pricing models or other valuation techniques, and that the fair value be charged to compensation cost with a corresponding credit to paid in capital. The fair value method of accounting for these plans is rejected because it does not reflect a change in statutory assets or liabilities. Consistent with rejection of FAS 123, the disclosure requirements in the conclusion above retain the current statutory requirements.

19. This issue paper adopts GAAP guidance set forth in APB 25 except for paragraph 19 regarding disclosure. The disclosure required by this issue paper is consistent with the disclosure requirements of ARB 43, Chapter 13B, prior to its amendment by FAS 123. This issue paper adopts GAAP guidance set forth in ARB 43 with modification to exclude the additions to paragraph 2 and the deletion of paragraph 15 pursuant to FAS 123. This issue paper also adopts the GAAP guidance set forth in AIN-APB 25. This issue paper also adopts the GAAP guidance set forth in FIN 28 and FIN 38.

20. Additionally, this issue paper adopts the following pronouncements which clarify and/or provide guidance in certain circumstances (such pronouncements are not reproduced herein due to length and limited scope):

FASB Emerging Issues Task Force Issue No. 84-13, Purchase of Stock Options and Stock Appreciation Rights in a Leveraged Buyout

FASB Emerging Issues Task Force Issue No. 84-18, Stock Option Pyramiding

FASB Emerging Issues Task Force Issue No. 85-45, Business Combinations: Settlement of Stock Options and Awards

FASB Emerging Issues Task Force Issue No. 87-6, Adjustments Relating to Stock Compensation Plans

FASB Emerging Issues Task Force Issue No. 87-23, Book Value Stock Purchase Plans

FASB Emerging Issues Task Force Issue No. 87-33, Stock Compensation Issues Related to Market Decline

FASB Emerging Issues Task Force Issue No. 88-6, Book Value Plans in an Initial Public Offering

FASB Emerging Issues Task Force Issue No. 90-7, Accounting for a Reload Stock Option
FASB Emerging Issues Task Force Issue No. 90-9, Changes to Fixed Employee Stock Option Plans as a Result of Equity Restructuring
FASB Emerging Issues Task Force Issue No. 94-6, Accounting for the Buyout of Compensatory Stock Options
FASB Emerging Issues Task Force Issue No. 95-16, Accounting for Stock Compensation Arrangements with Employer Loan Features under APB Opinion No. 25

This issue paper rejects the following pronouncements:

FASB Emerging Issues Task Force Issue No. 96-3, Accounting for Equity Instruments That Are Issued for Consideration Other Than Employee Services Under FASB Statement No. 123
FASB Emerging Issues Task Force Issue No. 96-18, Accounting for Equity Instruments with Variable Terms That Are Issued for Consideration Other Than Employee Services Under FASB Statement No. 123

21. The conclusions above are consistent with the consistency and recognition concepts in the Statement of Concepts. Pertinent excerpts follow:

Consistency

The regulators' need for meaningful, comparable financial information to determine an insurer's financial condition requires consistency in the development and application of statutory accounting principles. Because the marketplace, the economic and business environment, and insurance industry products and practices are constantly changing, regulatory concerns are also changing. An effective statutory accounting model must be responsive to these changes and address emerging accounting issues. Precedent or historically accepted practice alone should not be sufficient justifications for continuing to follow a particular accounting principle or practice which may not coincide with the objectives of regulators.

Recognition

The principal focus of solvency measurement is determination of financial condition through analysis of the balance sheet. However, protection of the policyholders can only be maintained through continued monitoring of the financial condition of the insurance enterprise. Operating performance is another indicator of an enterprise's ability to maintain itself as a going concern. Accordingly, the income statement is a secondary focus of statutory accounting and should not be diminished in importance to the extent contemplated by a liquidation basis of accounting.

The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet but rather should be charged against surplus when acquired or when availability otherwise becomes questionable.

Liabilities require recognition as they are incurred. Certain statutorily mandated liabilities may also be required to arrive at conservative estimates of liabilities and probable loss contingencies (e.g., excess of statutory reserves over statement reserves, interest maintenance reserves, asset valuation reserves, and others).

Revenue should be recognized only as the earnings process of the underlying underwriting or investment business is completed. Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.

SAP income reflects the extent that changes have occurred in SAP assets and liabilities for current period transactions, except changes in capital resulting from receipts or distributions to

owners. SAP income also excludes certain other direct charges to surplus which are not directly attributable to the earnings process, (e.g., changes in non-admitted assets).

Drafting Notes/Comments

- *Issue Paper No. 78—Employee Stock Ownership Plans* addresses the accounting for Employee Stock Ownership Plans by the plan sponsor.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

22. The Life Annual Statement Instructions provide the following guidance (only the pertinent excerpts are included below):

6. Retirement Plans, Deferred Compensation and Other Postretirement Benefit Plans
 - b. Deferred Compensation Plans
 1. Indicate if the company has deferred compensation plans for officers or employees such as profit sharing, stock options or incentive plans.
 2. If warranted by materiality, the following information with regard to stock options should be furnished and analogous information should be supplied for warrants or rights:
 - a. A brief description of the terms of each option arrangement including the title and amount of securities to option; the year or years during which the options were granted; and the year or years during which the optionees became, or will become, entitled to exercise the options.
 - b. The number of shares under option at the end of the statement year; the number of shares with respect to which options became exercisable during the year; and the number of shares with respect to which options were exercised during the year; and the option price and fair market value thereof, per share, and in total for each of the three categories.

Options to buy stock are deemed to be granted on the date that a designated number of shares are assigned to a specific individual, notwithstanding the stipulation at that time that such options are not exercisable until certain attached conditions are met, such as those relating to persistency of insurance produced by the optionee or his continuance in employment for a period of years.

The required information may be summarized as appropriate with respect to each of these categories. The above information should be supplied whether the stock involved relates to the company, the parent of the company, a subsidiary of the company, or an affiliated corporation. The information should be shown separately for (1) agents and brokers and (2) employees and others.

The Property and Casualty Annual Statement Instructions contain similar guidance.

Generally Accepted Accounting Principles

23. ARB 43 provides the following guidance (only the pertinent excerpts are included below):

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

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, 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.

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. *FASB Statement No. 123, Accounting for Stock-Based Compensation*, specifies a fair value based method of accounting for stock-based compensation plans and encourages entities to adopt that method for all arrangements under which employees receive shares of stock or other equity instruments of the employer or the employer incurs liabilities to employees in amounts based on the price of the employer's stock. However, Statement 123 permits an employer in determining its net income to continue to apply the accounting provisions of this section and Opinion 25 to all its stock-based employee compensation arrangements. Entities that continue to apply this section and Opinion 25 shall comply with the disclosure requirements of Statement 123.

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 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.

Other Considerations

14. 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.

24. APB 25, prior to amendment by FAS 123 as FAS 123 is rejected in this issue paper, provides the following guidance (only the pertinent excerpts are included below):

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 study¹ on stockholders' equity that is in process.

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.

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 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 necessarily require that compensation cost be recognized.²

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.

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 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 10.b.). 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.

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

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 31-33. 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 in a period that differs from the one in which the corporation recognizes compensation expense in measuring net income.

⁴ A corporation may be entitled to a deduction for income tax purposes even though it recognizes no compensation expenses 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 result in temporary differences, and deferred taxes should be recorded in accordance with the provisions of *FASB Statement No. 109, Accounting for Income Taxes*. 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

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.

25. AIN-APB 25 provides the following guidance (only the pertinent excerpts are included below):

1. STOCK PLANS ESTABLISHED BY A PRINCIPAL STOCKHOLDER

Question—Accounting for compensatory and noncompensatory stock option, purchase and award plans adopted by a corporation is discussed in APB Opinion No. 25 and ARB No. 43, Chapter 13B. Should a corporation account for plans or transactions (“plans”), if they have characteristics otherwise similar to compensatory plans adopted by corporations, that are established or financed by a principal stockholder (i.e., one who either owns 10% or more of the corporation’s common stock or has the ability, directly or indirectly, to control or influence significantly the corporation)?

Interpretation—It is difficult to evaluate a principal stockholder’s intent when he establishes or finances a plan with characteristics otherwise similar to compensatory plans generally adopted by corporations. A principal stockholder may be satisfying his generous nature, settling a moral obligation, or attempting to increase or maintain the value of his own investment. If a principal stockholder’s intention is to enhance or maintain the value of his investment by entering into such an arrangement, the corporation is implicitly benefiting from the plan by retention of, and possibly improved performance by, the employee. In this case, the benefits to a principal stockholder and to the corporation are generally impossible to separate. Similarly, it is virtually impossible to separate a principal stockholder’s personal satisfaction from the benefit to the corporation. *Accounting Principles Board Statement No. 4, Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*, paragraph 127 states that “Financial accounting emphasizes the economic substance of events even though the legal form may differ from the economic substance and suggest different treatment.”

The economic substance of this type of plan is substantially the same for the corporation and the employee, whether the plan is adopted by the corporation or a principal stockholder. Consequently, the corporation should account for this type of plan when one is established or financed by a principal stockholder unless (1) the relationship between the stockholder and the corporation’s employee is one which would normally result in generosity (i.e., an immediate family relationship), (2) the stockholder has an obligation to the employee which is completely unrelated to the latter’s employment (e.g., the stockholder transfers shares to the employee because of personal business relationships in the past, unrelated to the present employment situation), or (3) the corporation clearly

does not benefit from the transaction (e.g., the stockholder transfers shares to a minor employee with whom he has had a close relationship over a number of years).

This type of plan should be treated as a contribution to capital by the principal stockholder with the offsetting charge accounted for in the same manner as compensatory plans adopted by corporations.

Compensation cost should be recognized as an expense of one or more periods in accordance with the provisions of APB Opinion No. 25, paragraphs 12-15.

The corporation should account for tax benefits, if any, from this type of plan in accordance with the provisions of APB Opinion No. 25, paragraphs 16-18. If the corporation receives no tax benefit from this type of plan, but would have received such benefit had the plan been adopted by the corporation, the absence of such tax benefit is one of the variables in estimating the plan's cost to the corporation (see APB Opinion No. 16, paragraph 89).

26. FIN 28, prior to amendment by FAS 123 as FAS 123 is rejected in this issue paper, provides the following guidance (only the pertinent excerpts are included below):

FIN 28 Summary

This Interpretation clarifies aspects of accounting for compensation related to stock appreciation rights and other variable stock option or award plans. The Interpretation specifies that compensation should be measured at the end of each period as the amount by which the quoted market value of the shares of the enterprise's stock covered by a grant exceeds the option price or value specified under the plan and should be accrued as a charge to expense over the periods the employee performs the related services. Changes in the quoted market value should be reflected as an adjustment of accrued compensation and compensation expense in the periods in which the changes occur until the date the number of shares and purchase price, if any, are both known.

INTRODUCTION

1. The FASB has been asked to clarify whether the provisions of *APB Opinion No. 25, Accounting for Stock Issued to Employees*, apply to stock appreciation rights and, if so, how the Opinion should be applied. Similar questions have been raised about awards under other stock compensation plans with variable terms, that is, plans for which the number of shares of stock the employee may receive, the price per share the employee must pay, or both the number of shares and the price are unknown at the date of grant or award. Appendix A provides additional background information about these matters. Appendix B illustrates applications of this Interpretation.

INTERPRETATION

2. APB Opinion No. 25 applies to plans for which the employer's stock is issued as compensation or the amount of cash paid as compensation is determined by reference to the market price of the stock or to changes in its market price. Plans involving stock appreciation rights and other variable plan awards¹ are included in those plans dealt with by Opinion No. 25. When stock appreciation rights or other variable plan awards are granted, an enterprise shall measure compensation as the amount by which the quoted market value of the shares of the enterprise's stock covered by the grant exceeds the option price or value specified, by reference to a market price or otherwise, subject to any appreciation limitations under the plan. Changes, either increases or decreases, in the quoted market value of those shares between the date of grant and the measurement date² result in a change in the measure of compensation for the right or award.

¹ Plans for which the number of shares of stock that may be acquired by or awarded to an employee or the price or both are not specified or determinable until after the date of grant or award are referred to in this Interpretation as “variable plan awards.” However, plans described in paragraph 11.c. of Opinion No. 25 (see paragraph 12 in Appendix A of this Interpretation) and book value stock option, purchase, or award plans are not covered by this Interpretation. Plans under which an employee may receive cash in lieu of stock or additional cash upon the exercise of a stock option are variable plans for purposes of this Interpretation if the amount is contingent on the occurrence of future events.

² Paragraph 10 of Opinion No. 25 defines the measurement date as “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.” Generally, the number of shares of stock that may be acquired or awarded under stock appreciation rights and many other variable plan awards are not known until the date that they are exercised.

3. Compensation determined in accordance with paragraph 2 shall be accrued as a charge to expense over the period or periods the employee performs the related services (hereinafter referred to as the “service period”). If the stock appreciation rights or other variable plan awards are granted for past services, compensation shall be accrued as a charge to expense of the period in which the rights or awards are granted. If the service period is not defined in the plan or some other agreement, such as an employment agreement, as a shorter or previous period, the service period shall be presumed to be the vesting period.³

³ For purposes of this Interpretation, stock appreciation rights and other variable plan awards become vested when the employee's right to receive or retain shares or cash under the rights or awards is not contingent upon the performance of additional services. Frequently, the vesting period is the period from the date of grant to the date the rights or awards become exercisable.

4. Compensation accrued during the service period in accordance with paragraph 3 shall be adjusted in subsequent periods up to the measurement date⁴ for changes, either increases or decreases, in the quoted market value of the shares of the enterprise's stock covered by the grant but shall not be adjusted below zero. The offsetting adjustment shall be made to compensation expense of the period in which changes in the market value occur. Except as provided in paragraph 5, the accrued compensation for a right that is forfeited or canceled shall be adjusted by decreasing compensation expense in the period of forfeiture, in accordance with paragraph 15 of APB Opinion No. 25.

⁴ See footnote 2.

5. For purposes of applying paragraph 11.h.⁵ of APB Opinion No. 25, compensation expense for a combination plan⁶ involving stock appreciation rights or other variable plan awards (including those that are granted after the date of grant of related stock options) shall be measured according to the terms the employee is most likely to elect based on the facts available each period. An enterprise shall presume that the employee will elect to exercise the stock appreciation rights or other variable plan awards, but the presumption may be overcome if past experience or the terms of a combination plan that limit the market appreciation available to the employee in the stock appreciation rights or other variable plan awards provide evidence that the employee will elect to exercise the related stock option. If an enterprise has been accruing compensation for a stock appreciation right or other variable plan award and a change in circumstances provides evidence that the employee will likely elect to exercise the related stock option, accrued compensation recorded for the right or award shall not be adjusted.⁷ If the employee elects to exercise the stock option, the accrued compensation recorded for the right or award shall be recognized as a consideration for the stock issued. If all parts of the grant or award (e.g., both the option and the right or award) are forfeited or canceled, accrued compensation shall be adjusted by decreasing compensation expense in that period.

⁵ See paragraph 13 in Appendix A of this Interpretation.

⁶ See paragraph 10 in Appendix A of this Interpretation.

⁷ A change in the circumstances may be indicated by market appreciation in excess of any appreciation limitations under the plan or the cancellation or forfeiture of the stock appreciation right or other variable plan award without a concurrent cancellation or forfeiture of the related stock option. A subsequent decrease in market value that reduces the appreciation to a level below the limitations under the plan would require adjustment of accrued compensation in accordance with paragraph 4 of this Interpretation if evidence then indicates that the employee will elect to exercise the stock appreciation right or other variable plan award.

27. FIN 38, prior to amendment by FAS 123 as FAS 123 is rejected in this issue paper, provides the following guidance (only the pertinent excerpts are included below):

FIN 38 Summary

APB Opinion No. 25, Accounting for Stock Issued to Employees, specifies that the measurement date for determining compensation cost in stock option, purchase, and award plans is the first date on which are known both (a) the number of shares that an individual employee is entitled to receive and (b) the option or purchase price, if any. Opinion 25 also specifies that the measurement date for a grant or award of convertible stock is the date on which the ratio of conversion is known unless other terms are variable at that date. Questions have been raised about determining the measurement date for stock option, purchase, and award plans involving junior stock, a separate class of stock issued to certain employees that is subordinate to an employer's regular common stock but is convertible into common stock if specified future events occur. This Interpretation clarifies that the measurement date for grants under stock option, purchase, and award plans involving junior stock is the date on which the number of shares of the employer's regular common stock that an employee is entitled to receive in exchange for the junior stock is known. This Interpretation is effective for grants made to employees on or after March 14, 1984 under stock option, purchase, and award plans involving junior stock.

INTRODUCTION

1. The Board has been asked to clarify certain provisions of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, relating to determining the measurement date for grants made to employees under stock option, purchase, and award plans involving junior stock. As used in this Interpretation, the term junior stock refers to a specific type of stock issued to employees that generally is subordinate to an employer's regular common stock with respect to voting, liquidation, and dividend rights and is convertible¹ into regular common stock if certain performance goals are achieved or if certain transactions occur. Junior stock generally is not transferable, except back to the issuing enterprise, and has a fair value lower than regular common stock because of its subordinate rights and the uncertainty of conversion to regular common stock.

¹ Junior stock that is not convertible per se but that has restrictions that lapse (such as restrictions that lapse when certain performance goals are achieved) so that it ultimately becomes regular common stock is considered to be convertible for purposes of applying this Interpretation.

2. Stock option, purchase, and award plans involving junior stock are designed to provide that an employer ultimately will issue shares of regular common stock to employees. Those plans are variable plans² because the number of shares of regular common stock that an individual employee is entitled to receive is not known until certain performance goals are achieved or certain transactions occur. Therefore, for purposes of measuring compensation cost under Opinion 25, the measurement date for grants under stock option, purchase, and award plans

involving junior stock is the first date on which are known both the number of shares of the employer's regular common stock that an employee is entitled to receive in exchange for the junior stock and the option or purchase price, if any.

² The term variable plan, as used in this Interpretation, is defined in paragraph 14.

3. In considering the convertible features of junior stock, paragraph 11.f. of Opinion 25 indicates that the measurement date for a grant or award of convertible stock is the date on which the ratio of conversion is known, unless other terms are variable at that date. Because conversion of junior stock to regular common stock generally is contingent on achieving certain performance goals or on certain transactions occurring, the conversion ratio³ is not known with certainty until those future events occur. After those goals are achieved or those transactions occur, the conversion ratio is determinable and, accordingly, the number of shares of regular common stock that an individual is entitled to receive is known.

³ If junior stock becomes convertible only to an equal number of shares of regular common stock upon achieving certain performance goals, the conversion ratio is either one-to-zero or one-to-one; some junior stock plans provide for different ratios of conversion depending on the level of performance attained.

4. Compensation cost for stock option, purchase, and award plans involving junior stock shall be accrued according to the provisions of paragraphs 2-4 of *FASB Interpretation No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans*, and paragraph 11.g. of Opinion 25. However, the provisions of paragraph 2 of Interpretation 28 shall be applied only when it becomes probable⁴ that certain performance goals will be achieved or certain transactions will occur; that probability may or may not be present at the date junior stock is issued.

⁴ Probable is used here, consistent with its use in FASB Statement No. 5, *Accounting for Contingencies*, to mean that it is likely that certain performance goals will be achieved or certain transactions will occur.

5. Stock option, purchase, and award plans involving junior stock generally are based on certain performance goals being achieved or certain transactions occurring within specific periods. Some plans, however, do not specify a period during which those future events must occur. If it is probable that the future event will occur at some time, compensation cost shall be charged to expense over the period from the date the future event becomes probable to the date the future event is most likely to occur or the end of any required service period.⁵ Other plans provide for different ratios of conversion of junior stock to regular common stock within a specific period based on variable performance goals. If achieving more than one performance goal is probable, compensation cost shall be based on the highest ratio of conversion of junior stock to regular common stock attributable to those goals whose achievement is probable. However, the final measure of compensation cost shall be based on the ratio of conversion attributable to the performance goal achieved at the measurement date. For all plans, total compensation shall be based on the market price of the regular common stock as of the date compensation cost is determined.

⁵ The term service period, as used in this Interpretation, is defined in paragraph 16.

6. Total compensation cost shall be the amount by which the market price at the measurement date of the employer's regular common stock that an employee is entitled to receive exceeds the amount that the employee paid or will pay for the junior stock. If vesting provisions cause junior stock to become convertible to regular common stock after the measurement date, compensation cost shall be recognized during the period from (a) the first date that it becomes probable that the future events will occur or the date the events have occurred to (b) the date that junior stock becomes convertible or the end of the service period, whichever occurs first. If junior stock does not become convertible to regular common stock but cash is paid to an employee to purchase previously issued junior stock, total compensation cost is the amount by which cash paid to the employee exceeds the amount initially paid by the employee for the junior stock.

28. FAS 123 provides the following guidance (only the pertinent excerpts are included below):

INTRODUCTION

1. This Statement establishes a fair value¹ based method of accounting for **stock-based compensation plans**. It encourages entities to adopt that method in place of the provisions of *APB Opinion No. 25, Accounting for Stock Issued to Employees*, for all arrangements under which employees receive shares of stock or other equity instruments of the employer or the employer incurs liabilities to employees in amounts based on the price of its stock.

¹ Terms defined in Appendix E, the glossary, are set in boldface type the first time they appear.

2. This Statement also establishes fair value as the measurement basis for transactions in which an entity acquires goods or services from nonemployees in exchange for equity instruments. This Statement uses the term *compensation* in its broadest sense to refer to the consideration paid for goods or services, regardless of whether the supplier is an employee or not. For example, employee compensation includes both cash salaries or wages and other consideration that may be thought of more as means of attracting, retaining and motivating employees than as direct payment for services rendered.

3. Opinion 25, issued in 1972, requires compensation cost² for stock-based employee compensation plans to be recognized based on the difference, if any, between the quoted market price of the stock and the amount an employee must pay to acquire the stock. Opinion 25 specifies different dates for the pertinent quoted market price of the stock used in measuring compensation cost, depending on whether the terms of an award³ are fixed or variable, as those terms are defined in Opinion 25.

² This Statement refers to recognizing *compensation cost* rather than *compensation expense* because part of the amount recognized in a period may be capitalized as part of the cost to acquire an asset, such as inventory.

³ The Statement used the term award as the collective noun for multiple instruments with the same terms granted at the same time either to a single employee or to a group of employees. An award may specify multiple vesting dates, referred to as graded vesting, and different parts of an award may have different expected lives.

4. Since 1972, stock options and other forms of stock-based employee compensation plans have become increasingly common. Also, option-pricing models have become widely used for measuring the value of stock options and similar equity instruments other than those issued to employees as compensation. Opinion 25 has been criticized for producing anomalous results and for providing little general guidance to use in deciding how to account for new forms of stock-based employee compensation plans. Several FASB Interpretations and Technical Bulletins have dealt with specific kinds of plans, and the Emerging Issues Task Force has considered numerous related issues.

5. Because of the perceived deficiencies in Opinion 25, early in the 1980s the AICPA's Accounting Standards Executive Committee, the staff of the Securities and Exchange Commission, most of the larger accounting firms, industry representatives and others asked the Board to reconsider the accounting specified in Opinion 25. This Statement, which is the result of that reconsideration, establishes an accounting method based on the fair value of equity instruments awarded to employees as compensation that mitigates many of the deficiencies in Opinion 25. The Board encourages entities to adopt the new method. However, this Statement permits an entity in determining its net income to continue to apply the accounting provisions of Opinion 25 to its stock-based employee compensation arrangements. An entity that continues to apply Opinion 25 must comply with the disclosure requirements of this Statement, which supersede the disclosure requirements of paragraph 19 of Opinion 25. This Statement also supersedes or amends other accounting pronouncements listed in Appendix D. Appendix A explains the reasons the Board decided not to require recognition of compensation cost for stock-based employee compensation arrangements measured in accordance with the fair value based method described in this Statement.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Scope and Alternative Accounting Methods

6. This Statement applies to all transactions in which an entity acquires goods or services by issuing equity instruments⁴ or by incurring liabilities to the supplier in amounts based on the price of the entity's common stock or other equity instruments. Therefore, it applies to all transactions in which an entity grants shares of its common stock, stock options, or other equity instruments to its employees, except for equity instruments held by an employee stock ownership plan.⁵

⁴ An entity may conditionally transfer an equity instrument to another party under an arrangement that permits that party to choose at a later date or for a specified time whether to deliver the consideration for it or to forfeit the right to the conditionally transferred instrument with no further obligation. In that situation, the equity instrument is not *issued* until the issuing entity has received the consideration, such as cash, an enforceable right to receive cash, other financial instruments, goods, or services, agreed to by the parties to the transaction. For that reason, this Statement does not use the term *issued* for the grant of stock options or other equity instruments subject to service or performance conditions (or both) for vesting.

⁵ AICPA Statement of Position No. 93-6, *Employers' Accounting for Employee Stock Ownership Plans*, specifies the accounting by employers for employee stock ownership plans.

7. The accounting for all stock-based compensation arrangements with employees or others shall reflect the inherent rights and obligations, regardless of how those arrangements are described. For example, the rights and obligations embodied in a transfer to stock to an employee for consideration of a nonrecourse note are substantially the same as if the transaction were structured as the grant of a stock option, and the transaction shall be accounted for as such. The terms of the arrangement may affect the fair value of the stock options or other equity instruments and shall be appropriately reflected in determining that value. For example, whether an employee who is granted an implicit option structured as the exchange of shares of stock for a nonrecourse note is required to pay nonrefundable interest on the note affects the fair value of the implicit option.

Accounting for Transactions with Other Than Employees

8. Except for transactions with employees that are within the scope of Opinion 25, all transactions in which goods or services are the consideration received for the issuance of equity instruments shall be accounted for based on the fair value of the consideration received or the fair value of the equity instruments issued, whichever is more reliably measurable. The fair value of goods or services received from suppliers other than employees frequently is reliably measurable and therefore indicates the fair value of the equity instruments issued. The fair value

of the equity instruments issued shall be used to measure the transaction if that value is more reliably measurable than the fair value of the consideration received.⁶ A common example of the latter situation is the use of the fair value of tradable equity instruments issued in a purchase business combination to measure the transaction because the value of the equity instruments issued is more reliably measurable than the value of the business acquired.

⁶ The consideration received for issuing equity instruments, like the consideration involved in a repurchase of treasury shares, may include intangible rights. *FASB Technical Bulletin No. 85-6, Accounting for a Purchase of Treasury Shares at a Price Significantly in Excess of the Current Market Price of the Shares and the Income Statement Classification of Costs Incurred in Defending Against a Takeover Attempt*, provides pertinent guidance.

9. This Statement uses the term *fair value* for assets and financial instruments, including both liability and equity instruments, with the same meaning as in *FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Live Assets to be Disposed Of*, Statement 121 says that the fair value of an asset is

...the amount at which the asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available. If quoted market prices are not available, the estimate of fair value shall be based on the best information available in the circumstances. Examples of valuation techniques include the present value of estimated expected future cash flows using a discount rate commensurate with the risks involved, option-pricing models, matrix pricing, option-adjusted spread models, and fundamental analysis [paragraph 7].

10. If the fair value of the goods or services received is not reliably measurable, paragraph 8 of this Statement requires that the measure of the cost of goods or services acquired in a transaction with other than an employee is based on the fair value of the equity instruments issued. However, this Statement does not prescribe the **measurement date**, that is, the date of the stock price on which the fair value of the equity instrument is based, for a transaction with a nonemployee (paragraphs 70-73).

Accounting for Transactions with Employees

11. This Statement provides a choice of accounting methods for transactions with employees that are within the scope of Opinion 25. Paragraphs 16-44 of this Statement describe a method of accounting based on the fair value, rather than the **intrinsic value**, of an employee stock option or a similar equity instrument. The Board encourages entities to adopt the fair value based method of accounting, which is preferable to the Opinion 25 method for purposes of justifying a change in accounting principle under *APB Opinion No. 20, Accounting Changes*.⁷ However, an entity may continue to apply Opinion 25 in accounting for its stock-based employee compensation arrangements. An entity that does so shall disclose pro forma net income and, if presented, earnings per share, determined as if the fair value based method had been applied in measuring compensation cost (paragraph 45).

⁷ Opinion 20, paragraph 8, provides that initial adoption of an accounting principle for a transaction that the entity has not previously had to account for is not a change in accounting principle.

12. The fair value based method described in paragraphs 16-44 of this Statement applies for (a) measuring stock-based employee compensation cost by an entity that adopts that method for accounting purposes and (b) determining the pro forma disclosures required of an entity that measures stock-based employee compensation cost in accordance with the intrinsic value based

method in Opinion 25. Neither those paragraphs (16-44) nor subsequent paragraphs (45-54) of this Statement affect application of the *accounting provisions* of Opinion 25 by an entity that continues to apply it in determining reported net income.

13. For convenience, in describing the fair value based method, paragraphs 16-44 of this Statement refer only to *recognition* or *accounting* requirements. However, those provisions apply equally in determining the pro forma amounts that must be disclosed if an entity continues to apply Opinion 25.

14. An entity shall apply the same accounting method—either the fair value based method described in this Statement or the intrinsic value based method in Opinion 25—in accounting for all of its stock-based employee compensation arrangements. Once an entity adopts the fair value based method for those arrangements, that election shall not be reversed.⁸

15. Equity instruments granted or otherwise transferred directly to an employee by a **principal stockholder** are stock-based employee compensation to be accounted for by the entity under either Opinion 25 or this Statement, whichever method the entity is applying, unless the transfer clearly is for a purpose other than compensation.⁹ The substance of a transaction in which a principal stockholder directly transfers equity instruments to an employee as compensation is that the principal stockholder makes a capital contribution to the entity and the entity awards equity instruments to its employee. An example of a situation in which a direct transfer of equity instruments to an employee from a principal stockholder is not compensation cost is a transfer to settle an obligation of the principal stockholder unrelated to employment by the reporting entity.

⁸ APB Opinion No. 22, *Disclosure of Accounting Policies*, requires an entity to include a description of all significant accounting policies as an integral part of the financial statements. The method used to account for stock-based employee compensation arrangements is an accounting policy to be included in that description.

⁹ That accounting has been required since 1973 in accordance with AICPA Accounting Interpretation 1, “Stock Plans Established by a Principal Stockholder,” of Opinion 25.

VALUATION OF EQUITY INSTRUMENTS ISSUED FOR EMPLOYEE SERVICES

Measurement Basis

16. Frequently, part or all of the consideration received for equity instruments issued to employees is past or future employee services. Equity instruments issued to employees and the cost of the services received as consideration shall be measured and recognized based on the fair value of the equity instruments issued. The portion of the fair value of an equity instrument attributed to employee services is net of the amount, if any, that employees pay for the instrument when it is granted. Paragraphs 17-25 of this Statement provide guidance on how to measure the fair value of stock-based employee compensation. Paragraphs 26-33 provide guidance on how to attribute compensation cost to the periods in which employees render the related services. Appendix B, which is an integral part of this Statement, provides additional guidance on both measurement and attribution of employee compensation cost.

Measurement Objective and Date

17. The objective of the measurement process is to estimate the fair value, based on the stock price at the **grant date**, of stock options or other equity instruments to which employees become entitled when they have rendered the requisite service and satisfied any other conditions necessary to earn the right to benefit from the instruments (for example, to exercise stock options or to sell shares of stock). Restrictions that continue in effect after employees have earned the rights to benefit from their instruments, such as the inability to transfer **vested** employee stock options to third parties, affect the value of the instruments actually issued and therefore are

reflected in estimating their fair value. However, restrictions that stem directly from the forfeitability of instruments to which employees have not yet earned the right, such as the inability either to exercise a nonvested option or to sell **nonvested stock**, do not affect the value of the instruments issued at the vesting date, and their effect therefore is not included in that value. Instead, no value is attributed to instruments that employees forfeit because they fail to satisfy specified service- or performance-related conditions.

Measurement Methods

Awards That Call for Settlement by Issuing Equity Instruments

18. The fair value of a share of nonvested stock awarded to an employee shall be measured at the market price (or estimated market price, if the stock is not publicly traded) of a share of the same stock as if it were vested and issued on the grant date. Nonvested stock granted to employees usually is referred to as **restricted stock**, but this Statement reserves that term for shares whose sale is contractually or governmentally restricted after the shares are vested and fully outstanding. The fair value of a share of restricted stock awarded to an employee, that is, a share that will be restricted after the employee has a vested right to it, shall be measured at its fair value, which is the same amount as a share of similarly restricted stock issued to nonemployees.

19. The fair value of a stock option (or its equivalent) granted by a **public entity** shall be estimated using an option-pricing model (for example, the Black-Scholes or a binomial model) that takes into account as of the grant date the exercise price and expected life of the option, the current price of the underlying stock and its expected **volatility**, expected dividends on the stock (except as provided in paragraphs 32 and 33), and the risk-free interest rate for the expected term of the option. For options that a U.S. entity grants on its own stock, the risk-free interest rate used shall be the rate currently available on zero-coupon U.S. government issues with a remaining term equal to the expected life of the options. Guidance on selecting other assumptions is provided in Appendix B. The fair value of an option estimated at the grant date shall not be subsequently adjusted for changes in the price of the underlying stock or its volatility, the life of the option, dividends on the stock or the risk-free interest rate.

20. A **nonpublic entity** shall estimate the value of its options based on the factors described in the preceding paragraph, except that a nonpublic entity need not consider the expected volatility of its stock over the expected life of the option. The result of excluding volatility in estimating an option's value is an amount commonly termed **minimum value**.

21. It should be possible to reasonably estimate the fair value of most stock options and other equity instruments at the date they are granted. Appendix B illustrates techniques for estimating the fair values of several options with complicated features. However, in unusual circumstances, the terms of a stock option or other equity instrument may make it virtually impossible to reasonably estimate the instrument's fair value at the date it is granted. For example, it may be extremely difficult, if not impossible, to reasonably estimate the fair value of a stock option whose exercise price decreases (or increases) by a specified amount with specified changes in the price of the underlying stock. Similarly, it may not be possible to reasonably estimate the value of a convertible instrument if the conversion ratio depends on the outcome of future events.

22. If it is not possible to reasonably estimate the fair value of an option or other equity instrument at the grant date, the final measure of compensation cost shall be the fair value based on the stock price and other pertinent factors at the first date at which it is possible to reasonably estimate that value. Generally, that is likely to be the date at which the number of shares to which an employee is entitled and the exercise price are determinable. Estimates of compensation cost for periods during which it is not possible to determine fair value shall be based on the current intrinsic value of the award, determined in accordance with the terms that would apply if the option or similar instrument had been currently exercised.

23. If an employee stock purchase plan satisfies all of the following criteria, the plan is not compensatory. Therefore, the discount from market price merely reduces the proceeds from issuing the related shares of stock.

- a) The plan incorporates no option features other than the following, which may be incorporated:
 - (1) Employees are permitted a short period of time—not exceeding 31 days—after the purchase price has been fixed to enroll in the plan.
 - (2) The purchase price is based solely on the stock's market price at date of purchase, and employees are permitted to cancel participation before the purchase date and obtain a refund of amounts previously paid (such as those paid by payroll withholdings).
- b) The discount from the market price does not exceed the greater of (1) a per-share discount that would be reasonable in a recurring offer of stock to stockholders or others or (2) the per-share amount of stock issuance costs avoided by not having to raise a significant amount of capital by a public offering. A discount of 5 percent or less from the market price shall be considered to comply with this criterion without further justification.
- c) Substantially all full-time employees that meet limited employment qualifications may participate on an equitable basis.

24. A plan provision that establishes the purchase price as an amount based on the lesser of the stock's market price at date of grant or its market price at date of purchase is, for example, an option feature that causes the plan to be compensatory. Similarly, a plan in which the purchase price is based on the stock's market price at date of grant and that permits a participating employee to cancel participation before the purchase date and obtain a refund of amounts previously paid is a compensatory plan.

Awards That Call for Settlement in Cash

25. Some awards of stock-based compensation result in the entity's incurring a liability because employees can compel the entity to settle the award by transferring its cash or other assets to employees rather than by issuing equity instruments. For example, an entity may incur a liability to pay an employee either on demand or at a specified date an amount to be determined by the increase in the entity's stock price from a specified level. The amount of the liability for such an award shall be measured each period based on the current stock price. The effects of change in the stock price during the **service period** are recognized as compensation cost over the service period in accordance with the method illustrated in *FASB Interpretation No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans*. Changes in the amount of the liability due to stock price changes after the service period are compensation cost of the period in which the changes occur.

Recognition of Compensation Cost

26. The total amount of compensation cost recognized for an award of stock-based employee compensation shall be based on the number of instruments that eventually vest. No compensation cost is recognized for awards that employees forfeit either because they fail to satisfy a service requirement for vesting, such as for a **fixed award**, or because the entity does not achieve a **performance condition**, unless the condition is a target stock price or specified amount of intrinsic value on which vesting or exercisability is conditioned. For awards with the latter condition, compensation cost shall be recognized for awards to employees who remain in service for the requisite period regardless of whether the target stock price or amount of intrinsic value is reached.¹⁰ Previously recognized compensation cost shall not be reversed if a vested employee stock option expires unexercised.

¹⁰ The existence of a target stock price that must be achieved to make an option exercisable generally affect the value of the option. Option-pricing models have been adapted to value many of those *path-dependent* options.

27. For purposes of this Statement, a stock-based employee compensation award becomes vested when an employee's right to receive or retain shares of stock or cash under the award is not contingent on the performance of additional services. Typically, an employee stock option that is vested also is immediately exercisable. However, if performance conditions affect either the exercise price or the exercisability date, the service period used for attribution purposes shall be consistent with the assumptions used in estimating the fair value of the award. Paragraphs 209 and 310 in Appendix B illustrate how to account for an option whose exercise price depends on a performance condition.

28. An entity may choose at the grant date to base accruals of compensation cost on the best available estimate of the number of options or other equity instruments that are expected to vest and to revise that estimate, if necessary, if subsequent information indicates that actual forfeitures are likely to differ from initial estimates. Alternatively an entity may begin accruing compensation cost as if all instruments granted that are subject only to a service requirement are expected to vest. The effect of actual forfeitures would then be recognized as they occur. Initial accruals of compensation cost for an award with a performance condition that will determine the number of options or shares to which all employees receiving the award will be entitled shall be based on the best estimate of the outcome of the performance condition, although forfeitures by individual employees may either be estimated at the grant date or recognized only as they occur.¹¹

¹¹ For convenience, the remainder of this document refers to options or shares *expected to vest* because referring specifically to both acceptable methods of accounting for forfeitures by individual employees each time the point is mentioned would be too unwieldy.

29. Compensation cost estimated at the grant date for the number of instruments that are expected to vest based on performance-related conditions, as well as those in which vesting is contingent only on future service for which the entity chooses to estimate forfeitures at the grant date pursuant to paragraph 28, shall be adjusted for subsequent changes in the expected or actual outcome of service- and performance-related conditions until the vesting date. The effect of a change in the estimated number of shares or options expected to vest is a change in an estimate, and the cumulative effect of the change on current and prior periods shall be recognized in the period of the change.

30. The compensation cost for an award of equity instruments to employees shall be recognized over the period(s) in which the related employee services are rendered by a charge to compensation cost and a corresponding credit to equity (paid-in capital) if the award is for future service. If the service period is not defined as an earlier or shorter period, the service period shall be presumed to be the period from the grant date to the date that the award is vested and its exercisability does not depend on continued employee service (paragraph 27). If an award is for past services, the related compensation cost shall be recognized in the period in which it is granted.

31. Compensation cost for an award with a graded vesting schedule shall be recognized in accordance with the method described in Interpretation 28 if the fair value of the award is determined based on different expected lives for the options that vest each year, as it would be if the award is viewed as several separate awards, each with a different vesting date. If the expected life or lives of the award is determined in another manner, the related compensation cost may be recognized on a straight-line basis. However, the amount of compensation cost

recognized at any date must at least equal the value of the vested portion of the award at that date. Appendix B illustrates application of both attribution methods to an award accounted for by the fair value based method.

32. Dividends or dividend equivalents paid to employees on the portion of an award of stock or other equity instruments that vests shall be charged to retained earnings. Nonforfeitable dividends or dividend equivalents paid on shares of stock that do not vest shall be recognized as additional compensation cost. The choice of whether to estimate forfeitures at the grant date or to recognize the effect of forfeitures as they occur described in paragraph 28 also applies to recognition of nonforfeitable dividends paid on shares that do not vest.

33. If employees received only the dividends declared on the class of stock granted to them after the stock becomes vested, that value of the award at the grant date shall be reduced by the present value of dividends expected to be paid on the stock during the vesting period, discounted at the appropriate risk-free interest rate. The fair value of an award of stock options on which dividend equivalents are paid to employees or are applied to reduce the exercise price pursuant to antidilution provisions shall be estimated based on a dividend payment of zero.

Additional Awards and Modifications of Outstanding Awards

34. The fair value of each award of equity instruments, including an award of **reload options**, shall be measured separately based on its terms and the current stock price and related factors at the date it is granted.

35. A modification of the terms of an award that makes it more valuable shall be treated as an exchange of the original award for a new award. In substance, the entity repurchases the original instrument by issuing a new instrument of greater value, incurring additional compensation cost for that incremental value. The incremental value shall be measured by the difference between (a) the fair value of the modified option determined in accordance with the provisions of this Statement and (b) the value of the old option immediately before its terms are modified, determined based on the shorter of (1) its remaining expected life or (2) the expected life of the modified option. Appendix B provides further guidance on and illustrates the accounting for modifications of both vested and nonvested options.

36. Exchanges of options or changes to their terms in conjunction with business combinations, spin-offs, or other equity restructurings, except for those made to reflect the terms of the exchange of shares in a business combination accounted for as a pooling of interests, are modifications for purposes of this Statement. However, a change to the terms of an award in accordance with antidilution provisions that are designed, for example, to equalize an option's value before and after a stock split or a stock dividend is not a modification of an award for purposes of this Statement.

Settlements of Awards

37. An entity occasionally may repurchase equity instruments issued to employees after the employees have vested rights to them. The amount of cash or other assets paid (or liabilities incurred) to repurchase an equity instrument shall be charged to equity, provided that the amount paid does not exceed the value of the instruments repurchased. For example, an entity that repurchases for \$10 a share of stock on the date it becomes vested does not incur additional compensation cost if the market price of the stock is \$10 at that date. However, if the market price of the stock is only \$8 at that date, the entity incurs an additional \$2 (\$10 - \$8) of cost. An entity that settles a nonvested award for cash has, in effect, vested the award, and the amount of compensation cost measured at the grant date but not yet recognized shall be recognized at the date of repurchase.

38. For employee stock options, the incremental amount, if any, to be recognized as additional compensation cost upon cash settlement shall be determined based on a comparison of the amount paid with the value of the option repurchased, determined based on the remainder

of its original expected life at that date. As indicated in paragraph 37, if stock options are repurchased before they become vested, the amount of unrecognized compensation cost shall be recognized at the date of the repurchase.

39. The accounting shall reflect the terms of a stock-based compensation plan as those terms are mutually understood by the employer and the employees who receive awards under the plan. Generally, the written plan provides the best evidence of its terms. However, an entity's past practice may indicate that the **substantive terms** of a plan differ from its written terms. For example, an entity that grants a **tandem award** consisting of either a stock option or a cash stock appreciation right (SAR) is obligated to pay cash on demand if the choice is the employee's, and the entity thus incurs a liability to the employee. In contract, if the choice is the entity's, it can avoid transferring its assets by choosing to settle in stock, and the award qualifies as an equity instrument. However, if an entity that nominally has the choice of settling awards by issuing stock generally settles in cash, or if the entity generally settles in cash whenever an employee asks for cash settlement, the entity probably is settling a substantive liability rather than repurchasing an equity instrument. The substantive terms shall be the basis for the accounting.

40. To restrict control to a limited group, for example, the members of a particular family, a nonpublic entity may obligate itself to repurchase its equity instruments for their fair value at the date of repurchase. In practice, such an obligation is not deemed to convert the stock to a liability. This Statement is not intended to change that view of the effect of a fair value repurchase agreement for a nonpublic entity. Thus, a nonpublic entity may grant or otherwise issue to employees equity instruments subject to such a repurchase agreement. The repurchase agreement does not convert those equity instruments to liabilities, provided that the repurchase price is the fair value of the stock at the date of repurchase.

Accounting for Tax Consequences of Equity Instruments Awarded to Employees

41. Income tax regulations specify allowable tax deductions for stock-based employee compensation arrangements in determining an entity's income tax liability. Compensation cost recognized under this Statement is measured based on the fair value of an award to an employee. Under existing U.S. tax law, allowable tax deductions are generally measured at a specified date as the excess of the market price of the related stock over the amount the employee is required to pay for the stock (that is, at intrinsic value). The **time value** component of the fair value of an option is not tax deductible. Therefore, tax deductions generally will arise in different amounts and in different periods from compensation cost recognized in financial statements.

42. The cumulative amount of compensation cost recognized for a stock-based award that ordinarily results in a future tax deduction under existing tax law shall be considered to be a deductible temporary difference in applying *FASB Statement No. 109, Accounting for Income Taxes*. The deferred tax benefit (or expense) that results from increases (or decreases) in that temporary difference, for example, as additional service is rendered and the related cost is recognized, shall be recognized in the income statement. Recognition of compensation cost for an award that ordinarily does not result in tax deductions under existing tax law shall not be considered to result in a deductible temporary difference in applying Statement 109. A future event, such as an employee's disqualifying disposition of stock under existing U.S. tax law, can give rise to a tax deduction for an award that ordinarily does not result in a tax deduction. The tax effects of such an event shall be recognized only when it occurs.

43. Statement 109 requires a deferred tax asset to be evaluated for future realization and to be reduced by a valuation allowance if, based on the weight of the available evidence, it is more likely than not that some portion or all of the deferred tax asset will not be realized. Differences between (a) the deductible temporary difference computed pursuant to paragraph 42 and (b) the tax deduction inherent in the current fair value of the entity's stock shall not be considered in measuring either the gross deferred tax asset or the need for a valuation allowance for a deferred tax asset recognized under this Statement.

44. If a deduction reported on a tax return for a stock-based award exceeds that cumulative compensation cost for that award recognized for financial reporting, the tax benefit for that excess deduction shall be recognized as additional paid-in capital. If the deduction reported on a tax return is less than the cumulative compensation cost recognized for financial reporting, the write-off of a related deferred tax asset in excess of the benefits of the tax deduction, net of the related valuation allowance, if any, shall be recognized in the income statement except to the extent that there is remaining additional paid-in capital from excess tax deductions from previous stock-based employee compensation awards accounted for in accordance with the fair value based method in this Statement. In that situation, the amount of the write-off shall be charged against that additional paid-in capital.

Disclosures

45. Regardless of the method used to account for stock-based employee compensation arrangements, the financial statements of an entity shall include the disclosures specified in paragraphs 46-48. In addition, an entity that continues to apply Opinion 25 shall disclose for each year for which an income statement is provided the pro forma net income and, if earnings per share is presented, pro forma earnings per share, as if the fair value based accounting method in this Statement had been used to account for stock-based compensation cost. Those pro forma amounts shall reflect the difference between compensation cost, if any, included in net income in accordance with Opinion 25 and the related cost measured by the fair value based method, as well as additional tax effects, if any, that would have been recognized in the income statement if the fair value based method had been used. The required pro forma amounts shall reflect no other adjustments to reported net income or earnings per share.

46. An entity with one or more stock-based compensation plans shall provide a description of the plan(s), including the general terms of awards under the plan(s), such as vesting requirements, the maximum term of options granted, and the number of shares authorized for grants of options or other equity instruments. An entity that uses equity instruments to acquire goods or services other than employee services shall provide disclosures similar to those required by this paragraph and paragraphs 47 and 48 to the extent that those disclosures are important in understanding the effects of those transactions on the financial statements.

47. The following information shall be disclosed for each year for which an income statement is provided:

- a. The number and weighted-average exercise prices of options for each of the following groups of options: (1) those outstanding at the beginning of the year, (2) those outstanding at the end of the year, (3) those exercisable at the end of the year, and those (4) granted, (5) exercised, (6) forfeited, or (7) expired during the year.
- b. The weighted-average grant-date fair value of options granted during the year. If the exercise prices of some options differ from the market price of the stock on the grant date, weighted-average exercise prices and weighted-average fair values of options shall be disclosed separately for options whose exercise price (1) equals, (2) exceeds, or (3) is less than the market price of the stock on the grant date.
- c. The number and weighted-average grant-date fair value of equity instruments other than options, for example, shares of nonvested stock, granted during the year.
- d. A description of the method and significant assumptions used during the year to estimate the fair values of options, including the following weighted-average information: (1) risk-free interest rate, (2) expected life, (3) expected volatility, and (4) expected dividends.

- e. Total compensation cost recognized in income for stock-based employee compensation awards.
- f. The terms of significant modifications of outstanding awards.

An entity that grants options under multiple stock-based employee compensation plans shall provide the foregoing information separately for different types of awards to the extent that the differences in the characteristics of the awards make separate disclosure important to an understanding of the entity's use of stock-based compensation. For example, separate disclosure of weighted-average exercise prices at the end of the year for options with a fixed exercise price and those with an indexed exercise price is likely to be important, as would segregating the number of options not yet exercisable into those that will become exercisable based solely on employees rendering additional service and those for which an additional condition must be met for the options to become exercisable.

48. For options outstanding at the date of the latest statement of financial position presented, the range of exercise prices (as well as the weighted-average exercise price) and the weighted-average remaining contractual life shall be disclosed. If the range of exercise prices is wide (for example, the highest exercise price exceeds approximately 150 percent of the lowest exercise price), the exercise prices shall be segregated into ranges that are meaningful for assessing the number and timing of additional shares that may be issued and the cash that may be received as a result of option exercises. The following information shall be disclosed for each range:

- a. The number, weighted-average exercise price, and weighted-average remaining contractual life of options outstanding
- b. The number and weighted-average exercise price of options currently exercisable.

Earnings per Share Implications

49. *APB Opinion No. 15, Earnings per Share*, requires that employee stock options, nonvested stock, and similar equity instruments granted to employees be treated as common stock equivalents in computing earnings per share. The number of nonvested equity instruments used in computing primary earnings per share shall be the same as the number that are used in measuring the related compensation cost in accordance with this Statement. Fully diluted earnings per share shall continue to be based on the actual number of options or shares granted and not yet forfeited, unless doing so would be antidilutive. If vesting is contingent on other factors, such as the level of future earnings, the shares or options shall be treated as contingent shares in accordance with paragraph 62 of Opinion 15. AICPA Accounting Interpretation 91, "Earnings Conditions," of Opinion 15 provides additional guidance on applying paragraph 62 of Opinion 15 to stock-based employee compensation plans. If stock options or other equity instruments are granted during a period, the shares issuable shall be weighted to reflect the portion of the period during which the equity instruments were outstanding.

50. In applying the treasury stock method of Opinion 15, the assumed proceeds shall be the sum of (a) the amount, if any, the employee must pay, (b) the amount of compensation cost attributed to future services and not yet recognized, and (c) the *Interpretation No. 31, Treatment of Stock Compensation Plans in EPS Computations*, provides detailed examples of the treatment of stock compensation plans accounted for under Opinion 25 in earnings per share computations. Although the related cost and tax amounts will differ if the fair value based accounting method in this Statement is applied, the principles in Interpretation 31 remain applicable.

Effective Date and Transition

51. The requirement in paragraph 8 of this Statement shall be effective for transactions entered into after December 15, 1995.

52. The recognition provisions of this Statement may be adopted upon issuance. Regardless of when an entity initially adopts those provisions, they shall be applied to all awards granted after the beginning of the fiscal year in which the recognition provisions are first applied. The recognition provisions shall not be applied to awards granted in fiscal years before the year of initial adoption except to the extent that prior years' awards are modified or settled in cash after the beginning of the fiscal year in which the entity adopts the recognition provisions. Accounting for modifications and settlements of awards initially accounted for in accordance with Opinion 25 is discussed and illustrated in Appendix B.

53. The disclosure requirements of this Statement shall be effective for financial statements for fiscal years beginning after December 15, 1995, or for the fiscal year for which this Statement is initially adopted for recognizing compensation cost, whichever comes first. The disclosure requirements need not be applied in an interim report unless a complete set of financial statements is presented for that period. Pro forma disclosures for awards granted in the first fiscal year beginning after December 15, 1994 need not be included in financial statements for that fiscal year but shall be presented subsequently whenever financial statements for that fiscal year are presented for comparative purposes with financial statements for a later fiscal year.

54. During the initial phase-in period, the effects of applying this Statement for either recognizing compensation cost or providing pro forma disclosures are not likely to be representative of the effects on reported net income for future years, for example, because options vest over several years and additional awards generally are made each year. If that situation exists, the entity shall include a statement to that effect. The entity also may wish to provide supplemental disclosure of the effect of applying the fair value based accounting method to all awards made in fiscal years beginning before the date of initial adoption that were not vested at that date.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- NAIC Annual Statement Instructions
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 78—Employee Stock Ownership Plans*
- *Issue Paper No. 83—Accounting for Income Taxes*

Generally Accepted Accounting Principles

- *Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees*
- *Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins, Chapter 13, Section B,*
- *Accounting Interpretation of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees*
- *FASB Statement No. 123, Accounting for Stock-Based Compensation*
- *FASB Interpretation No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans*
- *FASB Interpretation No. 38, Determining the Measurement Date for Stock Option, Purchase, and Award Plans Involving Junior Stock*
- *FASB Emerging Issues Task Force Issue No. 84-13, Purchase of Stock Options and Stock Appreciation Rights in a Leveraged Buyout*
- *FASB Emerging Issues Task Force Issue No. 84-18, Stock Option Pyramiding*
- *FASB Emerging Issues Task Force Issue No. 85-45, Business Combinations, Settlement of Stock Options and Awards*
- *FASB Emerging Issues Task Force Issue No. 87-6, Adjustments Relating to Stock Compensation Plans*

- *FASB Emerging Issues Task Force Issue No. 87-23, Book Value Stock Purchase Plans*
- *FASB Emerging Issues Task Force Issue No. 87-33, Stock Compensation Issues Related to Market Decline*
- *FASB Emerging Issues Task Force Issue No. 88-6, Book Value Plans in an Initial Public Offering*
- *FASB Emerging Issues Task Force Issue No. 90-7, Accounting for a Reload Stock Option*
- *FASB Emerging Issues Task Force Issue No. 90-9, Changes to Fixed Employee Stock Option Plans as a Result of Equity Restructuring*
- *FASB Emerging Issues Task Force Issue No. 94-6, Accounting for the Buyout of Compensatory Stock Options*
- *FASB Emerging Issues Task Force Issue No. 95-16, Accounting for Stock Compensation Arrangements with Employer Loan Features under APB Opinion No. 25*
- *FASB Emerging Issues Task Force Issue No. 96-3, Accounting for Equity Instruments That Are Issued for Consideration Other Than Employee Services Under FASB Statement No. 123*
- *FASB Emerging Issues Task Force Issue No. 96-18, Accounting for Equity Instruments with Variable Terms That Are Issued For Consideration Other Than Employee Services Under FASB Statement No. 123*

State Regulations

- No additional guidance obtained from state statutes or regulations.