Accounting for Stock Options in the United States

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The granting of stock options by companies in the United States has become an increasingly more significant form of employee compensation. According to estimates by the National Center for Employee Ownership, over the last decade the number of employees eligible for stock options has grown from about one million to somewhere between seven and ten million. Even more striking is the trend toward offering stock options to all employees in a firm, not just the top managers.

Compilers of U.S. national statistics are concerned that given the accounting rules for stock options, data on salaries and wages probably do not accurately represent workers’ total compensation. The Bureau of Labor Statistics (BLS) recently completed phase one of a pilot study to collect data on the incidence of stock options granted during 1999. The survey found that 1.7 percent of all-private industry employees received stock options in 1999 and 2.4 percent of companies offered some form of stock options to their employees. Phase two will examine the feasibility of collecting cost data on stock options for use in BLS surveys.

Favorable U.S. accounting rules have helped fuel the growth of stock options. A stock option gives an employee the right to buy a certain number of shares in the company at a company-set grant price within a particular time period, often 10 years. The grant price is usually the market price at the time the options are granted. There is also a minimum time, known as the vesting period, before an employee can exercise the options. Stock options can be used as an alternative to cash compensation, and thus, the company does not have to record an expense at the time they are granted. Because an individual must stay employed with the company to exercise options, the granting of stock options is often seen as a way to keep key employees and reduce turnover.

Different corporate accounting rules and personal income tax consequences apply to the two types of stock options -- incentive stock options (ISO) and nonqualified stock option (NSO) -- available in the U.S. When an ISO is exercised, the entire gain on the sale of the stock is taxed only when the stock is sold and then at the more favorable long-term capital gain rates, assuming the employee is not subject to the alternative minimum tax. The employee must have held the stock for at least two years from the grant date and one year from the exercise date. In this case the employer would receive no tax deduction for the stock option transaction. If the employee does not meet required holding periods, then the gain is taxed as compensation, and the employer receives a wage deduction. ISOs have a cap of $100,000 (determined at grant time) on the amount of options that can be exercised in any year, up to a $1 million limit over 10 years.

The more common type of stock option is the nonqualified stock option (NSO), whose gain as of the exercise date is taxed as ordinary income, even if the employee decides to continue to hold the shares. The employer receives a deduction equal to the amount of income the employee must recognize. Although an NSO reduces the taxes paid by an employer, accounting rules do not require this deduction be taken on financial statements, which would lower reported net income.

However, companies must disclose in the financial notes of their annual reports information on stock options at the time of grant. The Financial Accounting Standards Board (FASB) has issued over the years three opinions on the accounting of stock options in financial statements. APB Opinion No. 25, issued in 1972, states that the intrinsic value of the option is measured as the difference between the exercise price and the fair market value of the stock when the option was granted. This difference,
that in most cases is zero, is the compensation expense that must be recognized over the option’s vesting period.

In 1995 FAS 123 was issued, but firms were still allowed to follow APB Opinion No. 25 if they chose. Under FAS 123 companies must determine a fair value of employee stock options at time of grant, using an option pricing model such as the Black-Scholes model, and reflect such value as a charge to earnings over the life of the option. The model must factor in the stock option’s grant price, exercise price, expected life, volatility, and expected dividends, and the risk–free interest rate over the option’s expected life.

As expected most firms opted to report under APB Opinion No. 25 since they could understate their true compensation costs and thus overstate profits. However, on March 31, 2000 FASB issued Interpretation No. 44 that tightened up the rules by requiring firms to recognize a compensation expense when they reprice stock options. Repricing of stock options is more common in an environment of declining stock prices.

These accounting rules and tax consequences have made the collection of consistent data concerning the treatment of stock options for U.S. national income and product accounts (NIPA) most difficult. The 1993 System of National Accounts does not give explicit guidance on stock options in the section on employee compensation. However, it is generally agreed that stock options have value and should be treated as compensation. The fact that NSOs and ISOs have different tax treatments should not affect in theory whether they are compensation. Also, the different accounting rules a firm can follow in reporting profits and expenses leads to inconsistent source data for compiling the NIPA.

Estimates for wages and salaries in the NIPA come from tabulations by the BLS for the unemployment insurance program (UI). UI data, derived from administrative tax records, are assumed to include the exercising of NSOs, but not the exercising of ISOs. The main source of data for corporate profits in the NIPA is tabulations of federal corporate income tax returns by the Internal Revenue Service (IRS). Stock options are not identified separately on tax forms, but the exercise of NSOs would trigger an expense deduction for corporations. However, these tax data are not incorporated into the NIPA until the second annual revision for a given year.

A further shortcoming of the data is that the value of the stock option is included only when the option is exercised, even though most agree the option had value at the time it was granted. The NIPA compilers agree, in theory, with this view and believe that some type of option–pricing model should be used to value the option, similar to the accounting recommendations of FAS-123. However, this preferred treatment can not be implemented at this time due to lack of source data.

In U.S. financial accounts, in any given period net equity issuance by nonfinancial corporations is affected by a buyback of shares in anticipation of stock options being exercised now or in future periods, as well as by new stock being issued when a stock option is exercised; the issuance value would be equal to the exercise price, not the market price. In addition, for the household sector a stock buyback would be recorded at market value, whereas an exercised option would be recorded at the exercise price. However, the exercise of the option would result in an instantaneous capital gain in equity holdings on the household sector balance sheet.

REFERENCES


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