

Summary of Statement No. 123

Accounting for Stock-Based Compensation (Issued 10/95)

Summary

This Statement establishes financial accounting and reporting standards for stock-based employee compensation plans. Those plans include all arrangements by 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. Examples are stock purchase plans, stock options, restricted stock, and stock appreciation rights.

This Statement also applies to transactions in which an entity issues its equity instruments to acquire goods or services from nonemployees. Those transactions must 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.

Accounting for Awards of Stock-Based Compensation to Employees

This Statement defines a *fair value based method* of accounting for an employee stock option or similar equity instrument and encourages all entities to adopt that method of accounting for all of their employee stock compensation plans. However, it also allows an entity to continue to measure compensation cost for those plans using the *intrinsic value based method* of accounting prescribed by APB Opinion No. 25, *Accounting for Stock Issued to Employees*. The fair value based method is preferable to the Opinion 25 method for purposes of justifying a change in accounting principle under APB Opinion No. 20, *Accounting Changes*. Entities electing to remain with the accounting in Opinion 25 must make pro forma disclosures of net income and, if presented, earnings per share, as if the fair value based method of accounting defined in this Statement had been applied.

Under the fair value based method, compensation cost is measured at the grant date based on the value of the award and is recognized over the service period, which is usually the vesting period. Under the intrinsic value based method, compensation cost is the excess, if any, of the quoted market price of the stock at grant date or other measurement date over the amount an employee must pay to acquire the stock. Most fixed stock option plans—the most common type of stock compensation plan—have no intrinsic value at grant date, and under Opinion 25 no compensation cost is recognized for them. Compensation cost is recognized for other types of stock-based compensation plans under Opinion 25, including plans with variable, usually performance-based, features.

Stock Compensation Awards Required to Be Settled by Issuing Equity Instruments

Stock Options

For stock options, fair value is determined using an option-pricing model that takes into account the stock price at the grant date, the exercise price, the expected life of the option, the volatility of the underlying stock and the expected dividends on it, and the risk-free interest rate over the expected life of the option. Nonpublic entities are permitted to exclude the volatility factor in estimating the value of their stock options, which results in measurement at *minimum value*. The fair value of an option estimated at the grant date is not 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.

Nonvested Stock

The fair value of a share of nonvested stock (usually referred to as restricted stock) awarded to an employee is measured at the market price of a share of a nonrestricted stock on the grant date unless a restriction will be imposed after the employee has a vested right to it, in which case fair value is estimated taking that restriction into account.

Employee Stock Purchase Plans

An employee stock purchase plan that allows employees to purchase stock at a discount from market price is not compensatory if it satisfies three conditions: (a) the discount is relatively small (5 percent or less satisfies this condition automatically, though in some cases a greater discount also might be justified as noncompensatory), (b) substantially all full-time employees may participate on an equitable basis, and (c) the plan incorporates no option

features such as allowing the employee to purchase the stock at a fixed discount from the lesser of the market price at grant date or date of purchase.

Stock Compensation Awards Required to Be Settled by Paying Cash

Some stock-based compensation plans require an employer to pay an employee, either on demand or at a specified date, a cash amount determined by the increase in the employer's stock price from a specified level. The entity must measure compensation cost for that award in the amount of the changes in the stock price in the periods in which the changes occur.

Disclosures

This Statement requires that an employer's financial statements include certain disclosures about stock-based employee compensation arrangements regardless of the method used to account for them.

The pro forma amounts required to be disclosed by an employer that continues to apply the accounting provisions of Opinion 25 will reflect the difference between compensation cost, if any, included in net income and the related cost measured by the fair value based method defined in this Statement, including 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 will not reflect any other adjustments to reported net income or, if presented, earnings per share.

Effective Date and Transition

The accounting requirements of this Statement are effective for transactions entered into in fiscal years that begin after December 15, 1995, though they may be adopted on issuance.

The disclosure requirements of this Statement are effective for financial statements for fiscal years beginning after December 15, 1995, or for an earlier fiscal year for which this Statement is initially adopted for recognizing compensation cost. Pro forma disclosures required for entities that elect to continue to measure compensation cost using Opinion 25 must include the effects of all awards granted in fiscal years that begin after December 15, 1994. 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 should be presented subsequently whenever financial statements for that fiscal year are presented for comparative purposes with financial statements for a later fiscal year.