

FASB Interpretation No. 31

Note: This Interpretation has been completely superseded

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Treatment of Stock Compensation Plans in EPS Computations

an interpretation of APB Opinion No. 15 and a modification of
FASB Interpretation No. 28

February 1980



Financial Accounting Standards Board

of the Financial Accounting Foundation

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FIN 31: Treatment of Stock Compensation Plans in EPS Computations

an interpretation of APB Opinion No. 15 and a modification of FASB Interpretation No. 28

FIN 31 Summary

Earnings per share data reflect the dilutive effect of outstanding stock options, including stock appreciation rights and other variable plan awards, computed by application of the treasury stock method under APB Opinion No. 15, *Earnings per Share*. Under that method, earnings per share data are computed as if the options were exercised at the beginning of the period (or at date of grant, if later) and as if the funds obtained thereby were used to purchase common stock. This Interpretation specifies that the funds used in applying the treasury stock method are the sum of the cash to be received on exercise, the compensation related to the options to be charged to expense in the future, and any tax benefit to be credited to capital. The Interpretation also provides guidance for how to include the effect of variable plans, combination plans, or plans payable in cash or in stock in earnings per share computations.

INTRODUCTION

1. The FASB received several requests to clarify the provisions of FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans*, that discuss the dilutive effect of stock appreciation rights and other variable plan awards in EPS computations. Some believed that FASB Interpretation 28 conflicted with earlier pronouncements with respect to the composition of funds obtained from the assumed exercise of stock options, including stock appreciation rights and other variable plan awards. Such funds are hereinafter referred to as "exercise proceeds."

2. This Interpretation modifies AICPA Interpretation No. 82 of APB Opinion No. 15, *Earnings per Share*, and supersedes the second sentence of paragraph 6 of FASB Interpretation 28. This Interpretation is not intended to alter the treatment of shares issuable contingent upon

certain conditions being met, as discussed in paragraphs 61-64 of Opinion 15. Appendix A provides additional background information about this Interpretation. Appendix B illustrates applications of this Interpretation.

INTERPRETATION

3. In applying the treasury stock method of paragraph 36 of Opinion 15 to stock options, including stock appreciation rights and other variable plan awards, the exercise proceeds of the options are the sum of the amount the employee must pay, the amount of measurable compensation ascribed to future services and not yet charged to expense (whether or not accrued), and the amount of any "windfall" tax benefit ¹ to be credited ² to capital. Exercise proceeds shall not include compensation ascribed to past services.

4. The dilutive effect of stock appreciation rights and other variable plan awards on primary earnings per share shall be computed using the average aggregate compensation and average market price for the period. The market price of an enterprise's stock and the resulting aggregate compensation used to compute the dilutive effect of stock appreciation rights and other variable plan awards in fully diluted earnings per share computations shall be the more dilutive of the market price and aggregate compensation at the close of the period being reported upon or the average market price and average aggregate compensation for that period. ³

5. If an enterprise has a combination plan allowing the enterprise or the employee to make an election involving stock appreciation rights or other variable plan awards, earnings per share for a period shall be computed based on the terms used in the computation of compensation expense for that period.

6. If stock appreciation rights or other variable plan awards are payable in stock or in cash at the election of the enterprise or the employee, the decision of whether such rights or awards are common stock equivalents shall be made according to the terms most likely to be elected based on the facts available each period. It shall be presumed that such rights or awards will be paid in stock, but that presumption may be overcome if past experience or a stated policy provides a reasonable basis to believe that the rights or awards will be paid partially or wholly in cash.

EFFECTIVE DATE AND TRANSITION

7. The provisions of this Interpretation shall be effective for financial statements for fiscal years beginning after December 15, 1979. Earlier application is encouraged in financial statements for fiscal years beginning before December 16, 1979 that have not been previously issued. This Interpretation may be, but is not required to be, applied retroactively to previously issued financial statements.

This Interpretation was adopted by the unanimous vote of the seven members of the Financial Accounting Standards Board following submission to the Financial Accounting Standards Advisory Council and the Screening Committee on Emerging Problems.

Members of the Financial Accounting Standards Board:

Donald J. Kirk, *Chairman*

Frank E. Block

John W. March

Robert A. Morgan

David Mosso

Robert T. Sprouse

Ralph E. Walters

Appendix A: BACKGROUND INFORMATION

8. Paragraph 35 of Opinion 15 states that stock options "should be regarded as common stock equivalents at all times" and that ". . . earnings per share should reflect the dilution that would result from exercise... of these securities and use of the funds, if any, obtained." Paragraph 6 of FASB Interpretation 28 states that "stock appreciation rights and other variable plan awards are common stock equivalents to the extent payable in stock. . . ." Paragraph 36 of Opinion 15 discusses the treatment of stock options in earnings per share computations and provides that:

. . . the amount of dilution to be reflected in earnings per share data should be computed by application of the "treasury stock" method. Under this method, earnings per share data are computed as if the options. . . were exercised at the beginning of the period (or at time of issuance, if later) and as if the funds obtained thereby were used to purchase common stock. . . .

The dilutive effect that would result from assumed exercise of stock options is reflected in the earnings per share computation by an increase in shares assumed to be outstanding equal to the number of shares issuable upon exercise of the stock options less the number of shares assumed to be purchased with the funds obtained from such exercise.

9. AICPA Interpretation 82 defines exercise proceeds as the sum of the amount the employee must pay, the unamortized deferred compensation, and the "windfall" tax benefit credited to capital surplus. That definition results in treating shares "earned" by past services as outstanding for earnings per share computations. The Board believes that definition is an appropriate interpretation of Opinion 15 and has accordingly adopted a similar definition of

exercise proceeds in this Interpretation.

10. Stock appreciation rights are often granted in combination with stock options. Such combination plans usually provide that the rights are exercisable for the same period as the companion stock options and that the exercise of either cancels the other. Compensation expense and earnings per share for a period could differ depending on which terms (options or rights) were used in the computations. Paragraph 5 of FASB Interpretation 28 states that compensation expense for a combination plan "shall be measured according to the terms the employee is most likely to elect based on the facts available each period." The Board has concluded that earnings per share for a period should be computed according to the same terms used in the computation of compensation expense for that period.

11. A draft of a proposed Interpretation, *Treatment of Stock Compensation Plans in EPS Computations*, was released for comment October 1, 1979. The Board received 35 letters of comment in response to the proposed Interpretation. Certain of the comments received and the Board's consideration of them are discussed in paragraphs 12 and 13.

12. To simplify the EPS computation, the proposed Interpretation stated that "windfall" tax benefits credited to capital are not part of exercise proceeds. Some respondents contended that "windfall" tax benefits should be included in the definition of exercise proceeds because they represent a potential future cash flow to the enterprise. The definition of exercise proceeds in paragraph 3 has been modified to include "windfall" tax benefits.

13. Some respondents requested clarification or guidance on how to treat stock appreciation rights that are payable in cash or in stock at the option of the enterprise or the employee in EPS computations. As noted in paragraph 8, stock appreciation rights and other variable plan awards are common stock equivalents to the extent payable in stock. The Board has decided that to provide a conservative estimate of potential dilution, such rights and awards should be presumed to be payable in stock unless there is a reasonable basis to believe that they will be paid in cash. That guidance is provided in paragraph 6 of this Interpretation.

Appendix B: ILLUSTRATION OF THE APPLICATION OF THE TREASURY STOCK METHOD FOR STOCK APPRECIATION RIGHTS AND OTHER VARIABLE STOCK OPTION AWARD PLANS

14. This appendix illustrates applications of this Interpretation in computing the dilutive effect on earnings per share of stock appreciation rights and other variable stock option or award plans when the service period is presumed to be the vesting period. The examples do not comprehend all possible combinations of circumstances. Amounts and quantities have been rounded down to whole units for simplicity.

15. Provisions of the agreements:

Stock appreciation rights are granted in tandem with stock options for market value appreciation in excess of the option price. Exercise of the rights cancels the option for an equal number of shares and vice versa. Share appreciation is payable in stock, cash, or a combination of stock and cash at the enterprise's election.

Date of grant	January 1, 1979
Expiration date	December 31, 1988
Vesting	100% at the end of 1982
Number of shares under option	1,000
Option price	\$10 per share
Quoted market price at date of grant	\$10 per share

16. Assumptions:

There are no circumstances in these three examples that would overcome the presumption that the rights are payable in stock.

The tax deduction for compensation will equal the compensation recognized for financial reporting purposes.

Quoted market price per share at December 31 of subsequent years:

1979 —	\$11
1980 —	12
1981 —	15
1982 —	14
1983 —	15
1984 —	18

EXAMPLE 1

17. The following example illustrates the annual computation of incremental shares for the above described stock appreciation right plan. A single annual computation is shown for simplicity in this and the following examples. Normally, a computation would be done monthly or quarterly.

COMPENSATION

<u>Date</u>	<u>Market Price</u>	<u>Per Share</u>	<u>Aggregate (1)</u>	<u>Percentage Accrued (2)</u>	<u>Compensation Accrued to Date</u>	<u>Measurable Compensation Ascribed to Future Periods(3)</u>	<u>Amount to Be Paid by Employee</u>	<u>Exercise Proceeds</u>	<u>FOR PRIMARY EARNINGS PER SHARE</u>			<u>FOR FULLY DILUTED EARNINGS PER SHARE</u>		
									<u>Shares Issuable(4)</u>	<u>Treasury Shares Assumed Re-purchased (5)</u>	<u>Incremental Shares</u>	<u>Shares Issuable(6)</u>	<u>Treasury Shares Assumed Re-purchased (7)</u>	<u>Incremental Shares</u>
12/31/79	\$11	\$1	\$1,000	25%	\$ 250	\$ 750	—	\$ 750	47	35	12	68	90	22
12/31/80	12	2	2,000	50	1,000	1,000	—	1,000	130	76	54	166	83	83
12/31/81	15	5	5,000	75	3,750	1,250	—	1,250	259	83	176	333	83	250
12/31/82	14	4	4,000	100	4,000	—	—	—	310	43	267	285	—	285
12/31/83	15	5	5,000	100	5,000	—	—	—	310	—	310	333	—	333
12/31/84	18	8	8,000	100	8,000	—	—	—	393	—	393	444	—	444

Notes

- (1) Aggregate compensation for unexercised shares to be allocated to periods service performed.
- (2) The percentage accrued is based upon the four-year vesting period.
- (3) Unaccrued compensation in this example.
- (4) Average aggregate compensation divided by average market price.*
- (5) Average exercise proceeds divided by average market price.*
- (6) End-of-year aggregate compensation divided by market price as of year-end.
- (7) End-of-year exercise proceeds divided by market price as of year-end.

Illustration of computation for one year (1982)

<u>Date</u>	<u>Market Price</u>	<u>Aggregate Compensation</u>	<u>Exercise Proceeds</u>	<u>Shares Issuable</u>	<u>Treasury Shares Assumed Repurchased</u>	<u>Incremental Shares</u>	
12/31/81 (beginning of year)	\$15	\$5000	\$1,250	N/A	N/A	N/A	If average incremental shares were higher than end-of-year incremental shares, average incremental shares would be used for both primary and fully diluted earnings per share computations.
12/31/82 (end of year)	14	4000	—	285	—	285	
Average	14.50	4500	625	310	43	267	

EXAMPLE 2

18. If the stock appreciation rights vested 25 percent per year commencing in 1979, the annual computation of incremental shares for primary earnings per share in the preceding example would change as illustrated in the following example. Similar computations would be made for fully diluted earnings per share. The computation of compensation expense is explained in FASB Interpretation 28, Appendix B, Example 2.

19. Additional Assumptions:

On December 31, 1981, the employee exercises the right to receive share appreciation on 300 shares.

On March 15, 1982, the employee exercises the right to receive share appreciation on 100 shares; quoted market price \$15 per share.

On June 15, 1983, the employee exercises the right to receive share appreciation on 100 shares; quoted market price \$16 per share.

On December 31, 1983, the employee exercises the right to receive share appreciation on 300 shares.

On December 31, 1984, the employee exercises the right to receive share appreciation on 200 shares.

COMPENSATION

**ADDITIONAL SHARES FOR PRIMARY
EARNINGS PER SHARE**

<u>Date</u>	<u>Transaction</u>	<u>Number of Shares</u>	<u>Market Price</u>	<u>Per Share</u>	<u>Aggregate (1)</u>	<u>Percentage Accrued (2)</u>	<u>Compensation Accrued to Date</u>	<u>Measurable Compensation Ascribed to Future Periods (3)</u>	<u>Amount to Be Paid by Employee</u>	<u>Exercise Proceeds</u>	<u>Shares Issuable (4)</u>	<u>Treasury Shares Assumed</u>		<u>Weighted Average Shares Outstanding (6)</u>	<u>Total Shares</u>
												<u>Repurchased (5)</u>	<u>Incremental Shares</u>		
12/31/79			\$11	\$1	\$1,000	52%	\$ 520	\$ 480	—	\$480	47	22	25	—	25
12/31/80			12	2	2,000	79	1,580	420	—	420	130	39	91	—	91
12/31/81			15	5	5,000	94	4,700	300	—	300	259	26	233	—	233
12/31/81	E	300	15	5	(1,500)	—									
3/15/82	E	100	15	5	(500)	—									
12/31/82			14	4	2,400	100	2,400	—	—	—	193	10	183	126	309
6/15/83	E	100	16	6	(600)	—									
12/31/83			15	5	2,500	100	2,500	—	—	—	170	—	170	153	323
12/31/83	E	300	15	5	(1,500)	—									
12/31/84			18	8	1,600	100	1,600	—	—	—	78	—	78	270	348
12/31/84	E	200	18	8	(1,600)	—									

Transaction Code

E - Exercise of a stock appreciation right.

Notes

- (1) Aggregate compensation for unexercised shares to be allocated to periods service performed.
- (2) See the schedule in paragraph 24 of FASB Interpretation 28.
- (3) Unaccrued compensation in this example.
- (4) Average aggregate compensation divided by average market price, weighted for proportion of period during which rights were unexercised.
- (5) Average exercise proceeds divided by average market price.
- (6) Shares issued upon exercise of stock appreciation rights. These would be included in the enterprise's total weighted average shares outstanding.

Illustration of computation for one year (1982)

	<u>Number of Shares</u>	<u>Average Market Price</u>	<u>Average Aggregate Compensation</u>	<u>Aggregate Shares Issuable</u>	<u>Weighing Factor</u>	<u>Shares Issuable</u>
Rights outstanding entire year	600	\$14.50	\$2700	186	12/12	186
Rights outstanding 1/1-3/15	100	15.00	500	33	2.5/12	<u>7</u> <u>193</u>

EXAMPLE 3

20. If the plan limits the amount of share appreciation that the employee can receive to \$5, the computation of additional shares in Example 2 would change as illustrated in the following example.

21. When the quoted market price exceeds the appreciation limitations, the employee is more likely to exercise the related stock option rather than the stock appreciation right. Therefore, accrued compensation is not adjusted for changes in the quoted market price of the stock. The assumptions stated in paragraph 19 of this Interpretation are changed to the extent that on June 15, 1983 and December 31, 1984 the employee exercises the related stock option instead of the stock appreciation right. In addition, it is assumed that the market price does not exceed \$15 for substantially all of a three-month period until 1984. Therefore, for earnings per share purposes the incremental shares are computed based on assumed exercise of the stock appreciation rights prior to 1984 and on assumed exercise of the stock options in 1984.

		COMPENSATION						ADDITIONAL SHARES FOR PRIMARY EARNINGS PER SHARE ⁽⁶⁾							
<u>Date</u>	<u>Transaction</u>	<u>Number of Shares</u>	<u>Market Price</u>	<u>Per Share</u>	<u>Aggregate (1)</u>	<u>Percentage Accrued (2)</u>	<u>Compensation Accrued to Date</u>	<u>Measurable Compensation Ascribed to Future Periods (3)</u>	<u>Amount to Be Paid by Employee</u>	<u>Exercise Proceeds</u>	<u>Shares Issuable (4)</u>	<u>Treasury Shares Assumed Repurchased (5)</u>	<u>Incremental Shares</u>	<u>Weighted Average Shares Outstanding (7)</u>	<u>Total Shares</u>
12/31/79			\$11	\$1	\$1,000	52%	\$ 520	\$ 480	—	\$ 480	47	22	25	—	25
12/31/80			12	2	2,000	79	1,580	420	—	420	130	39	91	—	91
12/31/81			15	5	5,000	94	4,700	300	—	300	259	26	233	—	233
12/31/81	E	300	15	5	(1,500)	—									
3/15/82	E	100	15	5	(500)	—									
12/31/82			14	4	2,400	100	2,400	—	—	—	193	10	183	126	309
6/15/83	O	100	16	5	(500)	—									
12/31/83			15	5	2,500	100	2,500	—	—	—	170	—	170	187	357
12/31/83	E	300	15	5	(1,500)	—									
12/31/84			18	5	1,000	100	1,000	—	2,000	2,000	200	121	79	333	412
12/31/84	O	200	18	5	(1,000)	—									

Transaction Code

E - Exercise of a stock appreciation right.

O - Exercise of the related stock option.

Notes

- (1) Aggregate compensation for unexercised shares to be allocated to periods service performed.
- (2) See the schedule in paragraph 24 of FASB Interpretation 28.
- (3) Unaccrued compensation in this example.
- (4) Average aggregate compensation divided by average market price, weighted for proportion of period during which options or rights were unexercised.
- (5) Average exercise proceeds divided by average market price.
- (6) Similar computations would be made for fully diluted earnings per share.
- (7) Shares issued upon exercise of stock appreciation rights and stock options. These would be included in the enterprise's total weighted average shares outstanding.

Footnotes

FIN31, Footnote 1--The "windfall" tax benefit is the tax credit resulting from a tax deduction for compensation in excess of compensation expense recognized for financial reporting purposes. Such credit arises from an increase in the market price of the stock under option between the measurement date (as defined in APB Opinion No. 25, *Accounting for Stock Issued to Employees*) and the date at which the compensation deduction for income tax purposes is determinable. The amount of the "windfall" tax benefit shall be determined by a "with-and-without" computation as described in paragraph 36 of APB Opinion No. 11, *Accounting for Income Taxes*.

FIN31, Footnote 2--Paragraph 17 of Opinion 25 states that there may be instances when the tax deduction for compensation is less than the compensation expense recognized for financial reporting purposes. If the resulting difference in income tax will be deducted from capital in accordance with that paragraph, such taxes to be deducted from capital shall be treated as a reduction of exercise proceeds.

FIN31, Footnote 3--If the rights or awards were granted during the period, the shares issuable must be weighted to reflect the portion of the period during which the rights or awards were outstanding.

FIN31, Appendix B, Footnote*--These computations could also be done using other methods of averaging.