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The Valuation of Compensation Stock

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What is the proper basis of valuation for capital stock issued by a corporation to its employee in exchange solely for services? Possible bases of valuation might include:

1. Par value or stated value of the stock.
2. Market value or fair value of the stock on a given date.
3. Average market value of the stock over the employment term.
4. Cost of the stock to the issuing corporation.
5. Book value of the stock.
6. Fair value of the services to be given for the stock.

The total net worth shown on the balance-sheet of the issuing corporation is neither increased nor decreased by such an issue of stock on any basis of valuation, except where the shares issued are taken from treasury stock theretofore treated as an asset on the balance-sheet.

When new shares are issued solely in exchange for services and are valued at par, capital-stock account is increased and surplus account is decreased, leaving total net worth unchanged. If such new shares are valued at more than their par value, capital-surplus account is increased and earned-surplus account decreased by the amount in excess of par, still leaving total net worth unchanged. The net worth of the issuing corporation will not be changed, either, by placing an arbitrary value on no-par shares or by valuing shares at less than their par value (where the state corporation law does not prohibit original issues of stock for less than par value).

What happens is that the proprietary interest of each share of stock in the total net worth is reduced, and some of the previously earned surplus becomes unavailable for dividends.

Speaking generally, the differences in the mutual ratios of the net-worth accounts making up the total net worth on the corporation's balance-sheet, which would develop from the selection of one or another of the different bases of valuation, are scarcely ever of very great importance; while, on the other hand, the net result of the operations for a fiscal period, as shown on the income statement, is very likely to be affected to a much greater degree of importance by the choice of a basis of valuation. The income statement should include a substantially correct charge for the value of the services rewarded with capital stock.

Determination of the value to be accepted by the corporation in exchange for its capital stock is a prerogative of the board of directors. The reasonable value of the services should be determined first, and this value should be expressed in terms of money, because the corporation's accounts are stated in terms of money. The logical next step is to arrive at the fair value of one share of capital stock. The board of directors may have wide latitude here, but it cannot disregard the price of a share in a public market, such as a securities exchange; and, with respect to previously unissued stock, it cannot, in many states, fix a fair value below the par value. If the par value of a share is \$1 and the fair value is \$10, while the money value of the services is \$1,000, the number of shares which should be issued for the services is 100. Having reached this conclusion, the usual procedure is for the board of directors to authorize the issue of 100 shares for services, without indicating in the resolution of approval its judgment respecting the money value either of the capital stock or of the services.

Consequently, the accounting officer of the corporation must fix the money values, and when the corporation's accounts are audited, the professional accountant must express his opinion as to the fairness or reasonableness of the values used and also as to the conformity of the basis of valuation with accepted principles of accounting.

In fixing the money values, some accountants have set up in the corporation's accounts the amount taxable as income to the recipient of the stock and allowable as a deduction from the taxable income of the corporation under the federal income-tax law. This value is the fair value of the stock on the date when it becomes issuable. In many cases, the stock becomes issuable a year after the services for which it is issued were engaged. The February, 1938, bulletin of the New York Stock Exchange sets forth that the market quotations for all common stocks listed on this exchange increased 29.4 per cent from the beginning to the end of the calendar year 1936, while the market quotations declined 36.5 per cent from the beginning to the end of the calendar year 1937. As it is customary to fix the amount of salary when the employment agreement is made, how, at the beginning of either 1936 or 1937, for example, could the board of directors have determined a money value for services equal to the market value of the stock at the end of the year? Going back to the illustration given above, where the money value of the services was found to be $1,000, for which 100 shares of stock were to be issued—if this agreement had been made at the beginning of 1936, the money value of the services, under this basis of valuation, would be entered in the accounts as $1,294 instead of $1,000. This is equivalent to the payment of an unauthorized bonus. On the other hand, if this agreement had been made at the beginning of 1937, the compensation entered in the books, under this basis of valuation, would be $635 instead of $1,000, equivalent to a substantial reduction in the amount of compensation which one could reasonably assume was contemplated at the beginning of the year.

Any fluctuation in the market value or fair value of compensation stock subsequent to the date of the employment agreement, it seems to me, should not be reflected in the accounts of the issuing corporation.

But what of the rule under the federal income-tax law? This rule seems to rest entirely on the theory that the only value to be taken into account is the value on the date when complete ownership of the stock passes to the employee. It ignores completely the well established custom of fixing salaries in advance. The income-tax rule is obviously inconsistent also with the practice respecting a stock subscription where an employee undertakes to pay today's price in cash instalments to be spread over one year. In the case of such a stock subscription, the general practice is to use today's price as the basis of valuation for recording the actual issue of the stock a year hence, when the instalment payments will have been completed. I think that there should be no distinction between an agreement to issue stock at a future date after the full consideration has been paid in instalments of money, and an agreement to issue stock at a future date after the full consideration has been paid in instalments of work.

At least one large corporation (General Motors Corporation) has used a basis of valuation which is intended, apparently, to diminish the effect on the income statement of a large difference between market values at the beginning and end of a year. The basis used is the monthly average of the market quotations, which is a less objectionable method, but still subject to the serious criticism that its effect on the income statement is to show the market value of the stock, rather than the value of the services hired. There is not even a remote relationship between the market value of the services hired at one date and the subsequent fluctuations in the market value of the stock of the hiring corporation. Where an employee is hired at a salary payable entirely in cash, the amount of his compensation is not affected by the gyrations of the hiring corporation's shares in the stock market during the term of employment.

In some cases, treasury stock issued for services has been charged to compensation expense at the cost of such stock to the corporation. This method would be correct only if the cost of the number of shares to be issued represented the fair value of the services when the services were hired.

While it is conceivable that book value could represent a proper basis of valuation for capital stock to be issued for services, this would be true only if book value and market value (or fair value) happened to be the same. In other words, I think that book value, as such, does not afford a proper basis of valuation.

As I see the problem, its solution is found in the answers to the questions, "What is the reasonable value to the corporation of the services to be hired?" and "What is now the fair value of the shares of capital stock which we must now agree to issue in the future for these services?"

It seems to be the duty of the board of directors to write the answers to these questions when they approve the employment contract. Any rise or fall in the market value of the stock occurring after the date of the agreement seems to me to be unrealized gain or loss of the employee.

Some contracts providing for the issue of stock cover employment terms much longer than a year, and some include rather complicated provisions involving alternatives which the employee may choose.

Much more might be said on the subject. I hope it will be said, for I should like to have the profession work out reasoned conclusions as to bases of valuation which will achieve rather general acceptance.