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Employee Stock Options in Balance of Payments Statistics

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A paper on employee stock options was presented by Japan to last year's Committee meeting (BOPCOM-01/30). The paper highlighted the range of alternative arrangements and the complexity of issues involved, particularly on classification, valuation and timing. Debate has gone on for some years in the national accounting and business accounting communities. The OECD meeting of National Accounts Experts on October 8–11, 2002 will deal with employee stock options and it proposes to make recommendations. Any recommendations will also be relevant to balance of payments statistics if transactions between residents and nonresidents are involved. It is planned to give a verbal report to BOPCOM on developments at the OECD National Accounts meeting to supplement this paper.

One issue is whether employee stock options are treated as financial derivatives or as contingent contracts. The definition of financial derivatives excludes contingencies (FD 6 of *Financial Derivatives: A Supplement to the Fifth Edition (1993) of the Balance of Payments Manual*), of which continuing employment or satisfactory performance would be examples, so an employee stock option cannot be a derivative until the employee fulfills the qualifications. Even then, it is not entirely clear that employee stock options would be treated as options (e.g., FD11 defines options as involving the payment of a premium to the writer).

The timing is also unclear, because the options are typically initially offered as part of an employment contract, the employee may or may not qualify sometime later, and the shares or options may not be issued until sometime after that. As well, the benefits typically relate to work done over several periods. The timing and valuation of employee stock options interact. If valuation is at the time of granting, the value of options would usually be zero or low. The timing can make a significant difference to the classification, as the value at the time of recognition would be compensation of employees, while all subsequent changes would be holding gains or losses.

In July 2002, the International Accounting Standards Board adopted a draft statement *Accounting for Share-Based Payment* (attached). It notes that several reviews of the issue have unanimously concluded that employee stock options should be treated as an expense at the time that the production underlying the granting of the options takes place. Transactions should be valued at the vesting data based on the fair value of the options issued. It noted that expense should not be subsequently reversed in a future accounting period even if the shares or options granted were subsequently forfeited due to failure to meet vesting conditions.

Most employee stock options are resident-to-resident arrangements. This note identifies the limited cases in which employee stock options involve BOP transactions.

Situation 1:

A resident employee of a resident enterprise receives options or stocks in a nonresident enterprise

An example of where this situation could arise is for resident subsidiaries. Because a subsidiary may not have publicly available stocks of their own, options or stocks in the parent company could be offered as an alternative incentive to the employees.

In such cases, if the subsidiary provides the stock or option to the employee, it is a resident-to-resident transaction. There will be BOP transactions between the employer and the owner or issuer of the stocks or options, however these will be straightforward as they do not have the classification, timing, or valuation issues associated with the payment of benefits to the employee. If those transactions involved stocks, rather than options, they would be classified as portfolio investment, rather than reverse direct investment, because the intended holder is the employee, not the subsidiary.[1] That classification would better show the economic reality and be consistent with the treatment of other transactions in kind in the national accounts—the transaction will be treated *as if* there were a cash payment by the employer to the employee (which is compensation of employees) and the employee then purchases the stock.

If the stock or option is issued by the parent (rather than bought on the market), it would be normally be expected that the resident subsidiary would reimburse the nonresident parent. If no payment by the employer has been identified, there may be a need to investigate whether there has been an undetected internal accounting entry or whether such an entry could be imputed to better reflect economic reality.

Situation 2:

(a) A resident employee of a nonresident enterprise receives stock options from the employer OR
(b) a nonresident employee of a resident enterprise receives stock options from the employer

Some employees may be residents of different economy from their employer (e.g., living near a border, by commuting or telecommuting). In these cases, the compensation of employees transactions are within the scope of the BOP.

In this case, the balance of payments transactions would be classified and valued in the same way as resident-to-resident transactions.

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[1] This appears to be the only issue in employee stock options that is exclusive to balance of payments, as resident-to-resident transactions do not have the direct/portfolio investment split.

Questions for the Committee:

1. Do Committee members find the issue of employee stock options to be significant in balance of payments compilation?

2. Do Committee members have views on the proper classification, valuation, and timing of employee stock options?

3. Can Committee members identify any other cases where employee stock options give rise to balance of payments transactions?

4. Do Committee members have any views on the International Accounting Standards proposals?

Attachment