

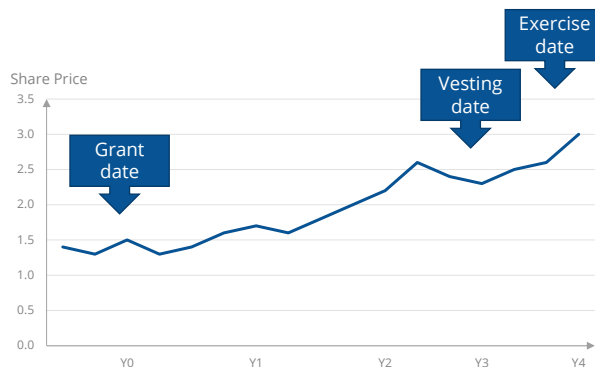


What are Stock Options?

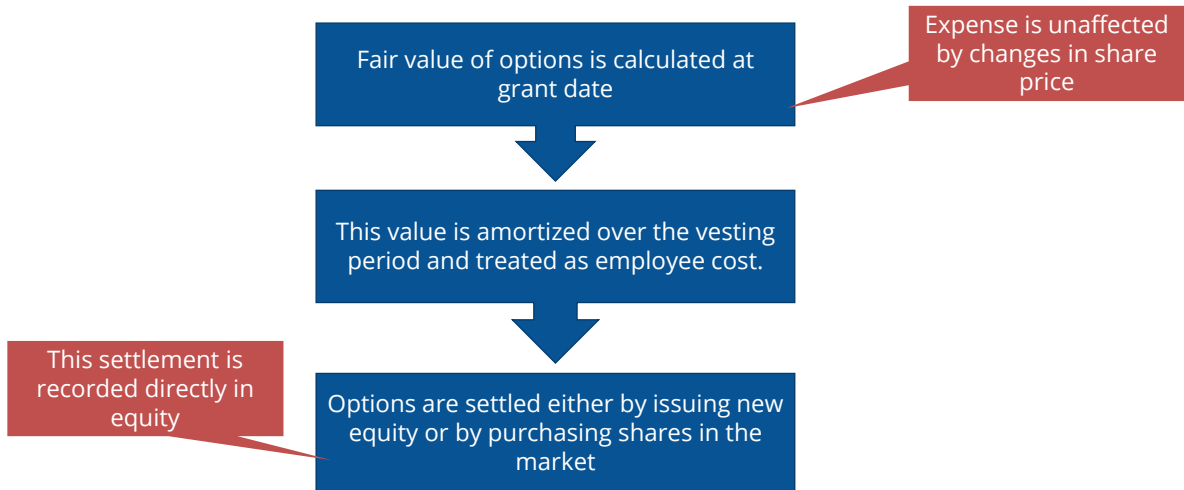
A company grants 500 options to employees with an exercise price of \$2.5
 The options vest in 3 years and the options are forfeited if employment ceases

Vesting period

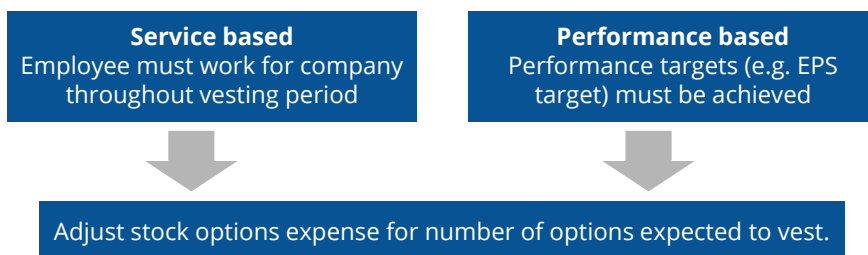
Vesting condition



Stock Options Accounting



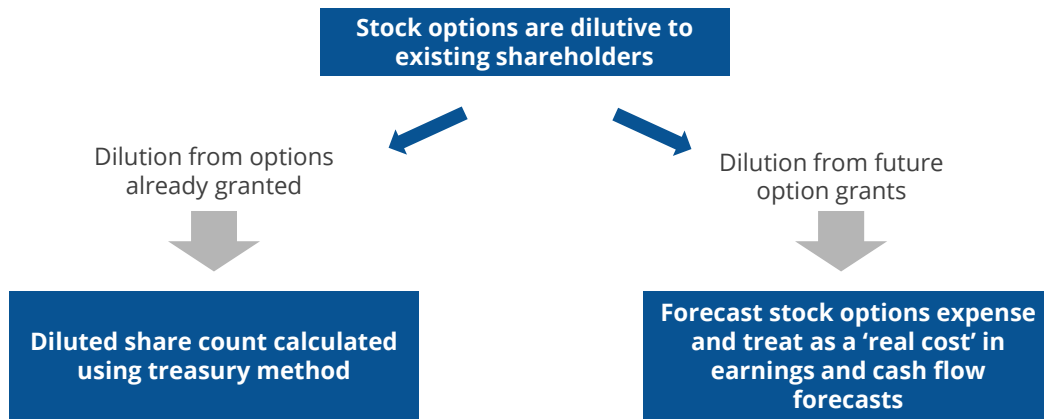
Vesting Conditions



300 options are granted at FY0 with a fair value of \$1.0 and a vesting period of 3 years

	Expected to vest	Cumulative expense	Expense in year
FY1	270.0	[270 x 1.0 x 1/3 =] 90.0	90.0
FY2	240.0	[240.0 x 1.0 x 2/3 =] 160.0	[160.0-90.0 =] 70.0
FY3	240.0	[240.0 x 1.0 x 3/3 =] 240.0	[240.0-160.0 =] 80.0

Stock Options in Valuation



Deferred Tax on Stock Options

Accounting expense
Based on fair value at grant date

Tax deduction
Usually based on intrinsic value at exercise date

A company grants 100.0 stock options with a vesting period of 3 years. The fair value of each option at grant date is \$1.0 and the intrinsic value at exercise date is \$2.0. The company's marginal tax rate is 20.0%

	FY1	FY2	FY3
Operating profits	300.0	300.0	300.0
Stock option expense	-33.3	-33.3	-33.3
Pre-tax profits after stock based comp	266.7	266.7	266.7
Tax expense on operating profits	-60.0	-60.0	-60.0
Tax benefit from stock options	0.0	0.0	40.0
Income tax expense	206.7	206.7	246.7
Effective tax rate	22.5%	22.5%	7.5%

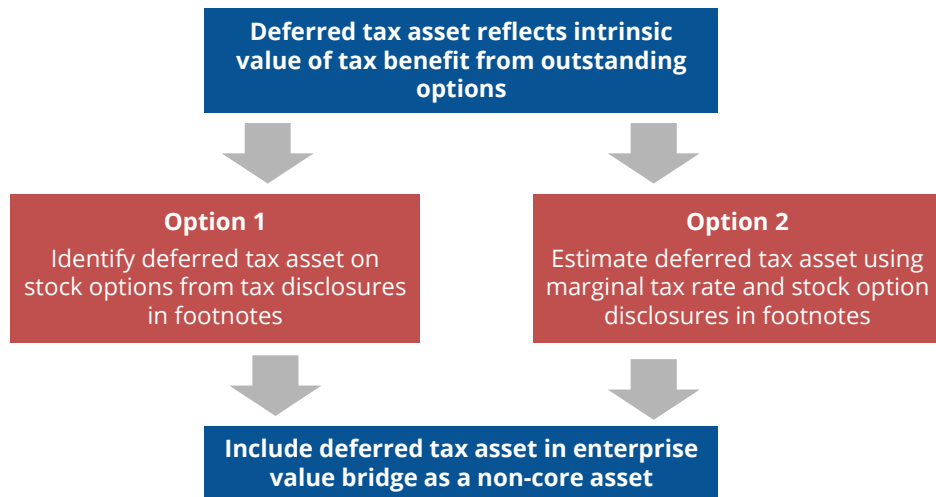
Accounting expense occurs before tax benefit

Tax benefit at exercise greater than cumulative accounting expense

Problem = effective tax rate is no longer meaningful

The solution = deferred tax!

Deferred Tax on Stock Options in Valuation

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