



Screen 001

The purpose of this illustration is to measure the financial statement effects of executive stock options.

Incredible Products Inc. (IPI)

Incredible Products Inc. (IPI) developed a business strategy that used stock options as a major compensation incentive for its top executives. On 1/1/09, 8 million options were granted, each giving the executive owning them the right to acquire one \$2 par value common share. The exercise price is the market price on the grant date — \$12 per share. Options vest on 1/1/13 and will expire on 12/31/14. The fair value of the 8 million options, estimated by an appropriate option pricing model, is \$3 per option.

Requirement 1

Compute IPI's compensation expense in 2009 for these stock options.

Your answer: \$

Screen 002

Incredible Products Inc. (IPI) developed a business strategy that used stock options as a major compensation incentive for its top executives. On 1/1/06, 8 million options were granted, each giving the executive owning them the right to acquire one \$2 par value common share. The exercise price is the market price on the grant date—\$12 per share. Options vest on 1/1/13 and will expire on 12/31/14. The fair value of the 8 million options, estimated by an appropriate option pricing model, is \$3 per option.

Your first requirement is to compute IPI's compensation expense in 2009 for these stock options.

Try to solve this before we proceed. Place your answer in the space provided. Once you have done so, click NEXT.

Incredible Products Inc. (IPI)

Requirement 1

Compute IPI's compensation expense in 2009 for these stock options.

Your answer: \$ _____ Correct answer: \$ 6 million

Estimated value of the options at January 1, 2009:

$$\begin{array}{r} \$3 \text{ estimated fair value/option} \\ \times \quad 8 \text{ million options granted} \\ \hline = \quad \$24 \text{ million fair value of award} \end{array}$$

Fair value is spread over four years of vesting period at **\$6 million/year**

Screen 003

The correct answer is \$6 million. Your answer is repeated here for comparison. Congratulations if you got it correct.

The computation of the 2009 compensation expense begins with the fair value of the options granted on 1/1/09—namely, 8 million options at an estimated fair value of \$3 each. This totals \$24 million. Because these options have a four-year vesting period, the total fair value of the options granted is spread over those four years at \$6 million compensation per year.

Incredible Products Inc. (IPI)

Information

Requirement 2

Incredible Products Inc. (IPI) developed a business strategy that used stock options as a major compensation incentive for its top executives. On 1/1/09, 8 million options were granted, each giving the executive owning them the right to acquire one \$2 par value common share. The exercise price is the market price on the grant date — \$12 per share. Options vest on 1/1/13 and will expire on 12/31/14. The fair value of the 8 million options, estimated by an appropriate option pricing model, is \$3 per option.

Screen 004

Assume the same facts as stated in requirement 1.

Incredible Products Inc. (IPI)

Information

Requirement 2

On June 1, 2013, when the market price of IPI's stock was \$16 per share, 5 million of the options were exercised.

Requirement 2

Place an amount in the blank space provided for each debit or credit in the journal entry IPI would make to record the exercise of these options.

Your answers:

Cash \$ million

Paid-in capital – stock options \$ million

Common stock \$ million

Paid-in capital (excess of par) \$ million

Screen 005

On June 1, 2013, when the market price of IPI's stock was \$16 per share, 5 million of the options were exercised.

Your second requirement is to determine the amount for each element of the recorded journal entry.

Try to solve this before we proceed. Place your answers in the spaces provided. Once you have done so, click NEXT.

Incredible Products Inc. (IPI)

Requirement 2

Your answers:

Cash	\$ _____ million	
Paid-in capital – stock options	\$ _____ million	
Common stock		\$ _____ million
Paid-in capital (excess of par)		\$ _____ million

Correct answers:

Cash	\$ <u>60</u> million	
Paid-in capital – stock options	\$ <u>15</u> million	
Common stock		\$ <u>10</u> million
Paid-in capital (excess of par)		\$ <u>65</u> million

* Cash: 5 million x \$12 each = \$60 million

** Paid-in Capital – stock options: \$24 million x (5/8) = \$15 million

***Common stock: 5 million x \$2 (par) = \$10 million

Screen 006

The correct answers are shown in the table below, along with your answers for comparison. Congratulations if you got them correct.

Let's think about each of the four answers. The amount received is simply the number of options exercised (5 million) times the exercise price of \$12, totaling \$60 million.

The amount of paid-in capital from the stock options is the original fair value of \$3 per option times the 5 million options exercised, totaling \$15 million.

The amount of common stock is the par value of the shares issued, 5 million x \$2 each, totaling \$10 million.

The remaining \$65 million to balance the journal entry is recorded as a credit to Paid-in-capital in excess of par.

Incredible Products Inc. (IPI)

Information

Requirement 3

Incredible Products Inc. (IPI) developed a business strategy that used stock options as a major compensation incentive for its top executives. On 1/1/09, 8 million options were granted, each giving the executive owning them the right to acquire one \$2 par value common share. The exercise price is the market on the grant date — \$12 per share. Options vest on 1/1/13 and will expire on 12/31/14. The fair value of the 8 million options, estimated by an appropriate option pricing model, is \$3 per option.

Screen 007

Assume the same facts as stated in requirement 1. When you are ready to proceed, click next.

Incredible Products Inc. (IPI)

Information

Requirement 3

On June 1, 2013, when the market price of IPI's stock was \$16 per share, 5 million of the options were exercised.

Suppose that the other 3 million options granted in 2009 that have vested expire before being exercised.

Requirement 3

Should IPI reverse the \$9 million in compensation expense originally granted for these options that have expired without being exercised?

Your answer: (click one) YES NO

Screen 008

Suppose that the other 3 million options granted in 2009 that have vested expire before being exercised.

Your third requirement is to determine if IPI should reverse the \$9 million in compensation expense originally granted for these options that have expired without being exercised.

Try to solve this before we proceed. Click on your answer, either YES or NO. Once you have done so, click NEXT.

Incredible Products Inc. (IPI)

Suppose that the other 3 million options granted in 2009 that have vested expire before being exercised.

Requirement 3

Should IPI reverse the \$9 million in compensation expense originally granted for these options that have expired without being exercised?

Your answer: _____

Correct answer: NO

Granting the option creates the compensation expense for IPI. If the holder chooses not to exercise it, that does not change the expense.

Screen 009

The correct answer is NO. Your answer is repeated here for comparison. Congratulations if you got it correct. The granting of options is the event that gives rise to the compensation expense, as seen in requirement 1. This grant cost IPI \$3 per option in an economic sense. What the option holder does with the valuable asset is of no consequence to IPI from an income measurement standpoint.