

EXHIBIT 2
Reporting Fixed Stock Options; Exercise Price Less Than Market Price

Options granted	100,000	Market value at exercise	\$70
Expected forfeitures	0	Par value	\$20
Market price at time of grant	\$60		
Exercise price	\$50		
Vesting period	3 years		
Tax rate	30%		

APB 25

Grant date			
Deferred compensation on options		\$1,000,000	
Common stock options outstanding			\$1,000,000
$[(\$60 - \$50) \times 100,000 = \$1,000,000]$			
Yr. 1 Compensation expense		\$ 333,334	
Deferred compensation on options			\$ 333,334
$(\$1,000,000/3 \text{ years})$			
Deferred tax asset		\$ 100,000	
Income tax expense			\$ 100,000

Note: The deduction is required for calculating book income but is not allowable for tax purposes until options are exercised.

Yr. 2 Same entries

Yr. 3 Same entries

Exercise date:			
Income tax expense		\$ 300,000	
Deferred tax asset			\$ 300,000
Taxes Payable		\$ 900,000	
Add'l PIC – common stock			\$ 900,000
$[(\$70 - \$50) \text{ less } \$10 \text{ reported} = \$30/\text{share} \times 100,000 = \$3,000,000 \times .30]$			
Common stock options outstanding		\$1,000,000	
Cash $(\$50 \times 100,000)$		\$5,000,000	
Common stock (par)			\$2,000,000
Add'l PIC – common stock			\$4,000,000

Net result for income statement:		\$1,000,000 compensation
		\$ <u>300,000</u> tax benefit
		\$ 700,000 decrease in retained earnings