

How Stock Options Work

An Overview

Employee stock option programs are typically authorized by a company's board of directors and approved by its shareholders. The approval gives management the discretion to award a specific number of stock options often stated as a percentage of the company's shares outstanding. Unlike qualified benefit plans, company management can exercise considerable discretion in determining which employees will be given options.

Options give employees the right to buy a certain number of their company's shares at a fixed price for a certain period of time, usually 10 years.

The fixed price is usually the market price of the stock on the date the options are granted or it can be a price less than the current market price. This price is called the "strike price".

Options usually begin vesting after one year and vest fully after four years. If an employee leaves the company before his/her options vest, they are canceled.

Once an option is vested, the employee can then "exercise" it -- that is, purchase from the company the allotted number of shares at the strike price -- and then either hold the stock or sell it on the open market.

The difference between the strike price and the market price of the shares at the time the option is exercised is the employee's gain in the value of the shares.

When the option's strike price exceeds the market price of the stock, the option is technically worthless, or "under water". When the market price of the stock exceeds the strike price of the vested option, the option has value, or is "in the money".

When an employee exercises an option, the company must issue a new share of stock that can be publicly traded. While the employee pays the company the strike price for that share, the company's market capitalization grows by the market price of that share. Having more shares outstanding dilutes (or reduces) earnings per share -- and thus the value of shares held by investors who already own the stock.

To forestall dilution, one of two things must happen: earnings must increase commensurate with the increase in outstanding shares, or the company must

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repurchase shares on the open market to reduce the number of outstanding shares.

Types of Stock Options

Incentive Stock Option: The strike price is set equal to the market price on the grant date. Income is reported only when the stock is sold. If the stock is held long enough, the gain is taxed at the long-term capital gain tax rate which could offer a significant savings.

Nonqualified Stock Option: The strike price is usually set less than the market price. The gain is treated as ordinary income for tax purposes and must be reported upon exercising the option. The company receives a tax deduction when the option is exercised.

Related Topics

Black-Scholes Model: A mathematical model used to determine the value of stock options. It takes into consideration the stock price on grant date, option price, number of years an option is exercisable, the company's expected dividend yield and stock price volatility, and the risk-free interest rate.

Cashless Exercise: Individual exercises option through a broker with the broker in effect making simultaneous purchases and sales of the option shares and delivering cash or stock to the individual.

Determining Amount of Stock Option Grant: One method is to base the number of options on a multiple of total cash compensation. The number of options is determined by dividing total cash (times the multiple) by the current market price of the stock. Watson Wyatt reports that average CEO grant, as a multiple of salary, is 6.4 times (2001 / 2002 Survey of Top Management Compensation). Within an organization, the higher the salary the larger the multiple. Therefore, a Manager may receive 1x, a Director 2x, a VP 3x, Sr. VP 4x, COO 5x and the President 6x. A study by Hewitt Associates reports that companies do not strictly follow guidelines. Factors such as retention, individual performance, and recruiting needs will influence the amount of the options granted. (WorkSpan-June 2000)

Sources

Inc. Magazine February 1998
Equity at Work, WorldatWork
Executive Compensation Answer Book, The Panel Answer Book Series