



Microsoft Employee Stock and Savings Plans^{*}

The Seattle metropolitan area is populated with tales about the impact “Microsoft millionaires” have on the community. And of course, co-founder and largest stockholder, Chairman Bill Gates, often occupies the top spot in Fortune’s list of the wealthiest individuals on earth. Microsoft has a reputation for paying average salaries but rewarding employees with valuable stock options. Microsoft encourages broad-based employee ownership through a stock option program in which all employees are eligible to participate. Once vested, employee stock options (ESOs) give the employee the right to purchase a specified number of common shares at a specified price (the exercise price) for a specified period of time. Current Microsoft ESOs typically vest 4.5 years after the grant date and expire 7 years after the grant date.¹ At June 30, 2000, 832 million vested and unvested options were outstanding as compared to 5,283 million common shares outstanding.

In recent years, accounting policymakers, business executives and politicians have vigorously debated whether or not stock options have compensation value and whether this value (if any) can be measured. For a summary of developments to date, see Exhibit 2, A Brief History of Accounting for Stock Options. Current accounting practice is governed by Statement of Financial Accounting Standards #123 (SFAS #123), *Accounting for Stock-Based Compensation*. Under SFAS #123, firms are encouraged to record the value of stock options as compensation expense. Other things equal, this approach would lower the earnings of firms with ESOs. However, after intense lobbying and intervention from members of Congress, the FASB compromised (some would say capitulated) and also allowed firms to continue to follow the reporting guidelines outlined in the *former* standard,

^{*} This case was prepared using publicly available data by Robert M. Bowen and Michelle Hanlon for classroom discussion purposes. Revised, September 3, 2001. The comments of Jane Kennedy, Terry Shevlin and D. Shores on an earlier version of this case are appreciated.

¹ Exhibit 1 provides definitions of terms and depicts the timing of events related to stock option plans.

Accounting Principles Board Opinion #25.² Under APB #25, *no compensation expense is recognized* in the financial statements when options are issued “out of the money,” i.e., when the option exercise price is greater than or equal to the market price of the underlying stock on the date of grant. Perhaps not surprisingly, only two companies among the Fortune 500, Boeing and Winn-Dixie, have elected to record their out-of-the money ESOs as compensation expense. In other words, essentially all firms (including Microsoft) continue to follow the guidelines in APB #25 and do not record the value of ESOs in compensation expense in the income statement.

SFAS #123 does, however, require companies that continue to follow APB #25 to disclose in the notes to the financial statements the estimated value of ESO grants and the pro forma impact on the income statement of expensing such value over the vesting period of the ESOs.³ Microsoft follows this practice and Exhibit 4, note on Employee Stock and Savings Plans, contains this information.

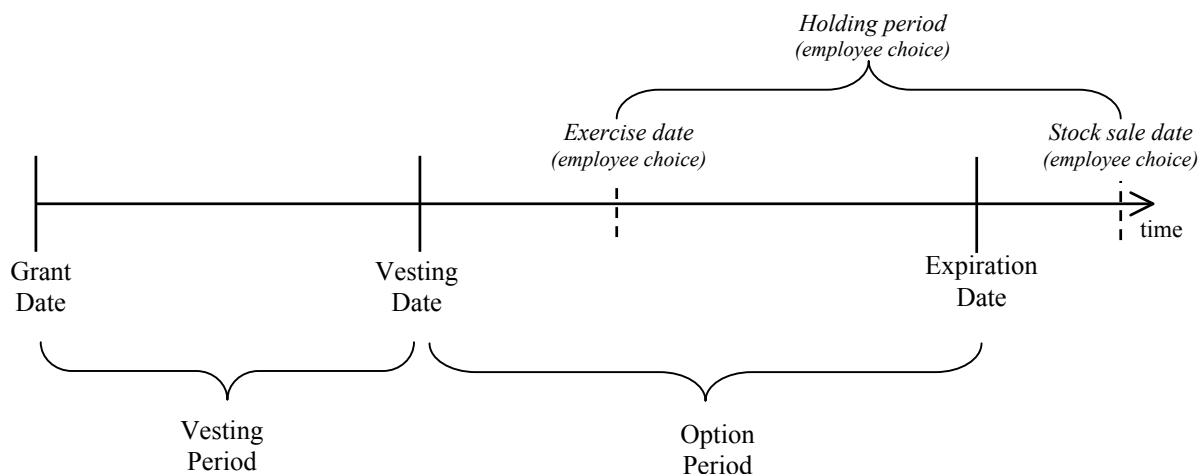
Questions:

1. Speculate on the types of compensation typically received by Microsoft employees. Which of these are treated as part of compensation expense?
2. How can the value of ESOs be positive when they are issued “out of the money”?
3. In general, why do companies grant ESOs?
4. In your opinion, should the ‘value’ of ESOs be included as part of compensation expense? Would you recommend that Microsoft record compensation expense as described in the pro forma statements in Exhibit 4? Why or why not?
5. What would be the effect on fiscal 2000 net income if Microsoft had adopted SFAS #123 for preparing its financial statements?
6. Given the pro forma disclosures in Exhibit 4, which employees appear to receive the most stock options at Microsoft?
7. Assume you are considering a job as a new employee at Microsoft. What are the expected risks and rewards of having ESOs?
8. Assume you are an outside (non-employee) stockholder of Microsoft. What would be your reaction to Microsoft's stock option plans?

² The Accounting Principles Board (APB) was the predecessor to the FASB for setting accounting standards in the United States. APB opinion #25 was issued in 1972.

³ These options are valued using the Black-Scholes option valuation method, which will be discussed in your Finance course.

Exhibit 1

Employee Stock Options – Terminology and TimingDefinitions of terms:

Option	=	A right given or sold to an employee that allows that employee the opportunity to purchase the underlying stock of the Company at a specified exercise price during the option period
Exercise (or strike) price	=	Price stated in the option contract at which the employee can purchase the underlying stock by using the option
Grant date	=	Date on which the option is granted (i.e., given or sold) to the employee
Vesting date	=	Date on which the employee may first exercise the option
<i>Exercise date</i>	=	Date on which the employee uses the option to purchase the underlying stock at the pre-determined strike price
<i>Stock sale date</i>	=	Date on which the employee sells the underlying stock purchased using the option
Expiration date	=	Date on which the right to exercise the options lapses (i.e., expires)
Vesting period	=	Period of time between the grant date and the vesting date given in the option contract, usually stated in months or years.
<i>Holding period</i>	=	Period of time the employee retains the stock before selling, i.e., the time between the option exercise date and the stock sale date. Note that the sale can occur anytime on or after the exercise date.
Option period	=	Period of time between the vesting date and the expiration date, i.e., the time the employee has to exercise the option
In-the-money	=	Whenever the current stock price is greater than the exercise (i.e., strike) price
Underwater stock option	=	An option that is out of the money, i.e., the exercise (i.e., strike) price is greater than the current market price

Terms in *italics* reflect decisions made by the employee holding Company stock options.

Exhibit 2

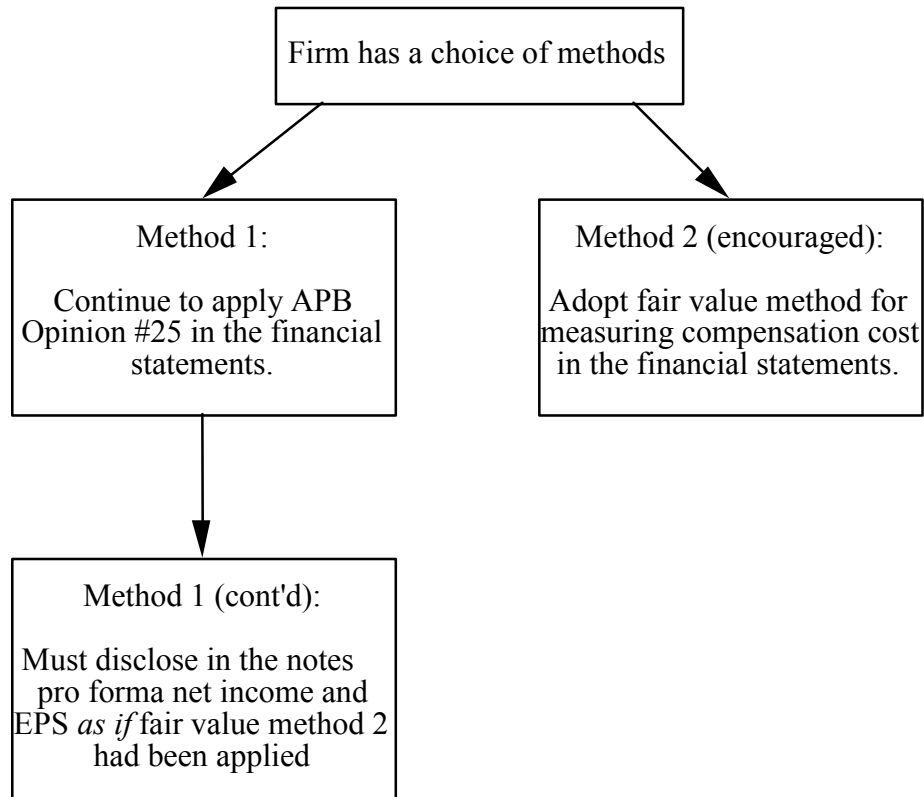
A Brief History of Accounting for Stock Options

- 1972: Accounting Principles Board (APB) issues Opinion #25 which treats stock options as valueless as long as the exercise price is greater than or equal to the stock price on the grant date. This reasoning is at least partially driven by the lack of any accepted model for valuing options.
- 1973: Professors Fisher Black and Myron Scholes publish their article "The Pricing of Options and Corporate Liabilities." A theoretical model now exists for valuing ESOs.
- Late 1970s and early 1980s: Option pricing *theory* turns into option pricing *practice* and many more firms issue employee stock options. Many financial experts now consider the presumption under APB #25 (that options are valueless) to be incorrect.
- 1984: Financial Accounting Standards Board (FASB) begins to revisit accounting for employee stock options.
- Late 1980s (to the mid-1990s): Opposition from the business community mounts as the FASB begins to consider requiring firms to record compensation expense related to employee stock options.
- Early 1990s: Pay for top corporate executives becomes a hot political issue.
- 1993: Congress limits the deductibility of executive compensation to \$1 million per employee (unless tied to explicit predetermined performance goals). The FASB's plan to add the value of new ESOs to compensation expense becomes even less popular (if that is possible).
- 1993: Senator Feinstein (California) introduces a bill to block the FASB plan. FASB stays the course toward treating granting ESOs as compensation expense.
- 1994: Senator Lieberman (Connecticut) introduces legislation that would have eliminated the FASB's independence by requiring the SEC to approve all new FASB standards. The FASB (finally) caves.
- 1995: FASB issues their compromise standard, *SFAS #123, Accounting for Stock-Based Compensation*, which encourages the treatment of ESOs as a valuable component of compensation (which they label as the fair value approach). At a minimum, the statement requires firms to disclose in the notes the pro forma effects on net income and earnings per share *as if* the company had expensed the fair value of options granted over the vesting period (which for Microsoft is generally over 4.5 years). Under SFAS #123, firms also have the option of not disclosing the pro forma impact of valuing options granted in fiscal years ending before December 15, 1994.
- 1997: Black (deceased) and Scholes (Stanford) win the Nobel Prize in Economics.
- Late 1990s: All but two of the Fortune 500 continue to use APB #25 for book purposes and thus disclose the pro forma effects of SFAS #123 in the notes.
- 1999-2001: Microsoft rumored to be considering adopting SFAS #123 for its financial statements.
- 2001: Policy makers that set international accounting standards are revisiting the treatment of ESOs.

Sources: SFAS #123; *Financial Reporting & Analysis* by Revsine, Collins and Johnson, Prentice-Hall, 1999; Bear Stearns, 2000; rumors.

Exhibit 3

SFAS #123, Accounting for Stock-Based Compensation
Alternative Treatment of Employee Stock Options



Sources: *Financial Reporting & Analysis* by Revsine, Collins and Johnson, Prentice-Hall, 1999, p. 760.

Exhibit 4

Note on EMPLOYEE STOCK AND SAVINGS PLANS

From the fiscal 2000 Microsoft 10-K filed with the Securities and Exchange Commission

Employee Stock and Savings Plans**Employee Stock Purchase Plan**

The Company has an employee stock purchase plan for all eligible employees. Under the plan, shares of the Company's common stock may be purchased at six-month intervals at 85% of the lower of the fair market value on the first or the last day of each six-month period. Employees may purchase shares having a value not exceeding 10% of their gross compensation during an offering period. During 1998, 1999, and 2000, employees purchased 4.4 million, 2.7 million, and 2.5 million shares at average prices of \$27.21, \$52.59, and \$72.38 per share. At June 30, 2000, 68.4 million shares were reserved for future issuance.

Savings Plan

The Company has a savings plan, which qualifies under Section 401(k) of the Internal Revenue Code. Participating employees may contribute up to 15% of their pretax salary, but not more than statutory limits. The Company contributes fifty cents for each dollar a participant contributes, with a maximum contribution of 3% of a participant's earnings. Matching contributions were \$39 million, \$49 million, and \$65 million in 1998, 1999, and 2000.

Stock Option Plans

The Company has stock option plans for directors, officers, and employees, which provide for nonqualified and incentive stock options. Options granted prior to 1995 generally vest over four and one-half years and expire 10 years from the date of grant. Options granted during and after 1995 generally vest over four and one-half years and expire seven years from the date of grant, while certain options vest either over four and one-half years or over seven and one-half years and expire after 10 years. At June 30, 2000, options for 341 million shares were vested and 734 million shares were available for future grants under the plans.

Stock options outstanding were as follows:

	Shares	Price per Share		Weighted Average
		Range		
Balance, June 30, 1997	956	\$ 0.56	– \$29.80	\$ 7.86
Granted	138	16.56	– 43.63	31.28
Exercised	(176)	0.56	– 31.24	4.64
Canceled	(25)	4.25	– 41.94	14.69
Balance, June 30, 1998	893	0.56	– 43.63	11.94
Granted	78	45.59	– 83.28	54.62
Exercised	(175)	0.56	– 53.63	6.29
Canceled	(30)	4.25	– 74.28	21.06
Balance, June 30, 1999	766	0.56	– 83.28	23.87
Granted	304	65.56	– 119.13	79.87
Exercised	(198)	0.56	– 82.94	9.54
Canceled	(40)	4.63	– 116.56	36.50
Balance, June 30, 2000	832	0.56	– 119.13	41.23

Notes to Financial Statements continued (in millions, except per share amounts)

For various price ranges, weighted average characteristics of outstanding stock options at June 30, 2000 were as follows:

Range of Exercise Prices	Outstanding Options			Exercisable Options	
	Shares	Remaining Life (Years)	Weighted Average Price	Shares	Weighted Average Price
\$ 0.56 – \$ 5.97	133	2.1	\$ 4.57	127	\$ 4.53
5.98 – 13.62	104	3.0	10.89	84	10.83
13.63 – 29.80	135	3.7	14.99	77	14.83
29.81 – 43.62	96	4.5	32.08	39	31.98
43.63 – 83.28	198	7.3	63.19	14	54.64
83.29 – 119.13	166	8.6	89.91	–	–

The Company follows Accounting Principles Board Opinion 25, *Accounting for Stock Issued to Employees*, to account for stock option and employee stock purchase plans. An alternative method of accounting for stock options is SFAS 123, *Accounting for Stock-Based Compensation*. Under SFAS 123, employee stock options are valued at grant date using the Black-Scholes valuation model, and this compensation cost is recognized ratably over the vesting period. Had compensation cost for the Company's stock option and employee stock purchase plans been determined as prescribed by SFAS 123, pro forma income statements for 1998, 1999, and 2000 would have been as follows:

Year Ended June 30	1998		1999		2000	
	Reported	Pro Forma	Reported	Pro Forma	Reported	Pro Forma
Revenue	\$ 15,262	\$ 15,262	\$ 19,747	\$ 19,747	\$ 22,956	\$ 22,956
Operating expenses:						
Cost of revenue	2,460	2,603	2,814	3,013	3,002	3,277
Research and development	2,601	2,963	2,970	3,479	3,775	4,817
Acquired in-process technology	296	296	–	–	–	–
Sales and marketing	2,828	2,977	3,231	3,438	4,141	4,483
General and administrative	433	508	689	815	1,009	1,243
Other expenses	230	230	115	115	92	92
Total operating expenses	8,848	9,577	9,819	10,860	12,019	13,912
Operating income	6,414	5,685	9,928	8,887	10,937	9,044
Investment income	703	703	1,803	1,803	3,182	3,182
Gain on sales	–	–	160	160	156	156
Income before income taxes	7,117	6,388	11,891	10,850	14,275	12,382
Provision for income taxes	2,627	2,369	4,106	3,741	4,854	4,210
Net income	\$ 4,490	\$ 4,019	\$ 7,785	\$ 7,109	\$ 9,421	\$ 8,172
Diluted earnings per share	\$ 0.84	\$ 0.75	\$ 1.42	\$ 1.30	\$ 1.70	\$ 1.48

The weighted average Black-Scholes value of options granted under the stock option plans during 1998, 1999, and 2000 was \$11.81, \$20.90, and \$36.67. Value was estimated using a weighted average expected life of 5.3 years in 1998, 5.0 years in 1999, and 6.2 years in 2000, no dividends, volatility of .32 in 1998 and 1999 and .33 in 2000, and risk-free interest rates of 5.7%, 4.9%, and 6.2% in 1998, 1999, and 2000.