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Hidden Costs of Stock Options May Soon Come Back to Haunt

By GRETCHEN MORGENSON JUNE 13, 2000

Microsoft and Cisco Systems, two of the nation's most profitable companies, are well on their way to owing nothing in federal income taxes on the money they have made so far this year.

How can powerful companies like these, reporting billions in income to shareholders, owe nothing in taxes? It is all thanks to the wonder of employee stock options.

Stock options have made many Americans wealthy beyond their wildest dreams over the last decade. Less understood is how much stock options have benefited the companies that offer them. But when stock prices stop rising, some economists and investors warn, companies and their shareholders will find themselves paying a heavy price for something they thought was a free lunch.

Consider how options help eliminate a company's income tax bill. Under I.R.S. rules, employees pay income taxes on the gain they receive when they exercise their options, even if the gain is only on paper. When they exercise their options, their company receives a tax deduction equal to the gain.

With the stock markets soaring and many employees cashing in, the taxes the employees pay on their gains have meant deductions that greatly reduce and in some cases even wipe out some companies' current tax bills. This does not mean the federal government is reaping less in taxes. It simply means that the tax burden has shifted from corporations to individuals, most of whom willingly pay because the taxes are so much less than the gains.

Microsoft's options-related tax deduction of roughly $11.4 billion in the first nine months of this fiscal year, for example, exceeds the $10.6 billion in pretax income that the company reported to shareholders. That saves the company $4 billion in taxes. So while Microsoft may escape taxes this year, its employees will presumably pay tax on that $11.4 billion at ordinary rates.

Tax breaks are not the only benefit to corporations. Options can also significantly cut companies' labor costs as employees, eager to get rich off their options, demand less in cash compensation. Lower labor costs. Lower taxes. What more could a company ask?

''Stock options have become as American as motherhood and apple pie,'' said Patrick S. McGurn, a vice president at Institutional Shareholder Services, an investment advisory firm in Rockville, Md. ''It has all been fueled by this notion that options have no cost and that there is an unlimited supply of them. It's like the government and its printing press. But ultimately the market is going to suffer. The day of reckoning will come.''

When that day comes is, of course, unclear. But when stocks stop soaring -- and many have done so this year -- the equation upon which option mania is based changes. Employees exercise fewer options and companies' tax bills will rise. And as worried employees begin to demand more of their compensation in cash, companies' labor costs rise.

Desperate to appease employees, many companies will issue even more options. After Microsoft's stock tumbled on the prospect of a breakup by the government, the company issued $1.9 billion in new options in April to supplement those issued last year that are worthless. This comes on top of the $69 billion in outstanding Microsoft stock options as of last June.

Trouble is, the more options there are, the less valuable the stock becomes.

Options carry significant costs. One is that companies must buy back millions of their own shares to offset the stock they have dispensed to employees at much lower prices in option programs. If they do not repurchase stock, there will be so many shares on the market that the company's earnings, on a per-share basis, will plunge. This is known as dilution.

In the last three years, for example, Dell Computer has bought back $3.6 billion worth of stock to reduce share dilution. In the period, Dell's net income totaled a little over $4 billion. The money Dell put into buybacks might have gone into research and development.

Dell is not alone in stock repurchases. A 1999 study by J. Nellie Liang and Steven A. Sharpe, researchers at the Federal Reserve Board, found that in 1998 the 140 largest nonfinancial companies in the United States expended 40 percent of their earnings to buy back shares, up from 17 percent of earnings used to do so in 1994. The study noted that large companies have borrowed money or run down financial assets to finance repurchases.

The upside of stock options has been well-chronicled in recent years. They allow cash-poor start-up companies to attract talented employees and help established companies keep the workers they have. And options reward hard-working employees and give them the benefit of ownership in their enterprise.

All to the good. But corporate America has played down the costs associated with options. As a result, what began as a dalliance threatens to become an addiction.

The number of employees receiving stock options in the United States has grown to as many as 10 million from about one million in the early 1990's, according to the National Center for Employee Ownership. About one-third of companies have programs offering options to lower-level workers as well as executives, according to Pearl Meyer & Partners, an executive compensation consulting firm in New York. Last year, 200 of the nation's largest companies granted equity incentives -- mostly options -- to employees that represented 2 percent of the companies' shares outstanding, on average, the firm said. Ten years earlier, the so-called grant rate was about half that.

Now that many share prices are falling, options will harm the value of a company's shares even more than they did when stocks were higher, Mr. McGurn of Institutional Shareholder Services said. That is because executives' option grants are typically based on a dollar figure, say $2 million, rather than on a number of shares. A falling stock price means more shares dispensed to the executive in an option grant.

As managers' compensation has depended more on stock options, keeping the share price rising -- and options in the money -- has become paramount. Walter P. Schuetze, former chief accountant for the enforcement division of the Securities and Exchange Commission, says the prevalence of accounting gimmickry at many American companies is in part a result of the increasing popularity of options.

''The amount of management compensation tied to the stock price is huge,'' Mr. Schuetze said. ''And it is driving corporate managers to make their numbers so the compensation gets even larger.''

An academic study by David Aboody, assistant professor of accounting at the University of California at Los Angeles, and Ron Kasznik, associate professor at Stanford University's business school, found that executives manage the disclosures of corporate news to increase the value of their options. The study will be published in the Journal of Accounting and Economics.

Studying option grants made between 1992 and 1996 at 1,264 public companies that make awards on fixed schedules, Professors Aboody and Kasznik found that companies had significantly lower returns in the period before the award than in the period immediately after it. This confirmed to the professors that executives delayed announcing good news until after the award dates and rushed out with bad news before the options were awarded.

''Such a disclosure strategy,'' the professors wrote, ''ensures that decreases in the firm's stock price related to the arrival of bad news occur before, rather than after, the award date, while stock price increases related to the arrival of good news occur after, rather than before, the award.''

Indeed, stock options have become so crucial to executives today that some economists say if stock prices tumble, managements interested in maximizing the value of their compensation plans would have an even greater interest in driving down their stocks' prices to guarantee future gains on options issued at rock-bottom levels.

Andrew Smithers, founder and economist at Smithers & Company, an investment advisory firm in London and the co-author with Stephen Wright of ''Valuing Wall Street: Protecting Wealth in Turbulent Markets,'' said: ''If the market were to fall, the interests of management would cease to be driving up the stock price. It would be driving it down so the next round of options are at a lower price.''

Even now, some companies' option grants are at odds with shareholder interests. A 1999 study of 900 companies by Ira Kay, a practice partner at the Watson Wyatt Worldwide consulting firm, found that companies with the greatest percentage of shares outstanding represented by unexercised options produced lower returns to shareholders than those with a smaller percentage of option grants hanging over them.

While Mr. Kay said that many companies produce good returns for shareholders in spite of the so-called option overhang, he added, ''It's a scarce and very valuable resource that needs to be optimally allocated by the board of directors.''

If the use of options were limited to a handful of companies, the overall market impact would not be great. But many companies have joined the option game recognizing that they are at a disadvantage to companies spreading the option wealth.

Laurence A. Tisch, co-chairman of the Loews Corporation, has for years refused to make options a part of the company's executive compensation plan because of their future costs to shareholders. Last year, however, he succumbed to the pressure and now hands out a tiny portion of options to managers. ''I'm against options and we haven't had options at Loews in 25 or 30 years,'' Mr. Tisch said. ''But it was a problem with some executives. Whether we needed it or didn't need it, we thought we needed it.''

One of the biggest arguments for options is that they help companies retain good workers and provide an incentive for employees to increase their productivity. John Connors, chief financial officer at Microsoft, said: "We very much continue to believe strongly in the direct linkage to our employees being shareholders and creating long-term shareholder value. Both shareholders and employees would look at this program as being an integral part of the success of our company."

Microsoft said it was impossible to predict what its tax bill would be in 2000 since the year is not yet over. The company confirmed that its options-related tax deduction exceeded its taxable income as reported to shareholders so far this year, but said that there were many different elements that go into figuring the company's taxes that are not available to the public. Microsoft declined to make its tax returns available.

Mr. Connors acknowledged that his company's happy experience with stock options had come in a bull market. It remains to be seen, he said, whether options will keep employees happy if their company's stock price falls.

For the moment, options maintain their allure. Even Washington is convinced that they are good for all. Rather than fretting about the decline in corporate tax receipts, some lawmakers want to give employees a tax break as well.

John Boehner, the Ohio Republican who is chairman of the House subcommittee on employer-employee relations, has written legislation that would create a new "superstock option." It would allow employees to pay taxes on the options at capital gains rates rather than higher ordinary income rates. The new options would still provide a tax deduction for the companies issuing them. This would almost certainly reduce Treasury receipts.

Mr. Boehner said the legislation would help workers "share in the tremendous growth of today's economy in a way that benefits them, their employers and the entire economy." To qualify for the tax treatment, companies would have to offer options to at least half of their employees. Democrats on the subcommittee are hardly objecting -- they are just insisting that companies make them available to 90 percent or more of employees to qualify.

But the cost of making options more attractive than they already are is high.

"If you believe in the free market system you have to have a scorecard that works," said Bill Parish, a former accountant and auditor who is an independent investment adviser in Portland, Ore. "The scorecard has been completely corrupted and the biggest way it has been corrupted is through the issuance of watered stock. And the average person doesn't know about it."