Stock-Based Compensation (SBC)

Stock-Based Compensation (SBC) is a way for companies to pay employees in the form of equity compensation in addition to their base salary. Companies can offer their employees a few different forms of SBC: Shares, Restricted Share Units (RSUs), Options, Phantom Shares, and Employee Stock Ownership Plans (ESOP). Options or Restricted Stock Units are the forms of SBC that companies typically will offer to their employees. Technology companies have been issuing SBC to their employees for a long time to retain them and create an incentive for solid performance. Employees can participate and get rewarded when share prices increase but may be inclined to leave a company if the equity price falls for an extended period.

Stock-Based Compensation can dilute ownership when employees exercise their options or meet the requirements for their Restricted Stock Units. Employees will exercise their stock options when they are “in the money” or have a strike price lower than the stock price at the exercise time. Restricted Stock Units typically require an employee to work for the company for a certain amount of time or reach performance metrics until the units can be given to the employee. RSUs are better for employees when stock prices go lower, as they will still hold some value versus options potentially being worth nothing if the share price is lower than the strike price.

Investors can find SBC as a line item in the cash flow statement, where companies adjust net income by adding back their stock-based compensation given to employees. Investors can also see the difference between Weighted Diluted Shares Outstanding and Weighted Average Basic Shares Outstanding at the bottom of the income statement. Diluted shares outstanding refer to the number of shares that would be outstanding if all employees were to exercise their options (that are in the money) and other SBCs versus basic outstanding shares being the current number outstanding at the time of release.

Companies often repurchase shares to offset dilution from SBC, instead of buying back shares because they truly believe their shares are undervalued. And many management teams believe SBC shouldn’t be counted as an expense and report adjusted profitability numbers that add it back to earnings. Warren Buffett, however, believes SBC is an expense and should be booked accordingly. In his 1997 meeting, he discussed this: The Trouble with Stock Options as Compensation - Warren Buffett | BRK 1997

The following is an example pulled from Microsoft's 10-Q report issued on 10/25/2022:

CASH FLOWS STATEMENTS

(In millions) (Unaudited)

Three Months Ended September 30,	2022	2021
Operations		
Net income	$ **17,556**	$ 20,505
Adjustments to reconcile net income to net cash from operations:		
Depreciation, amortization, and other	**2,790**	3,212
Stock-based compensation expense	**2,192**	1,702
Net recognized gains on investments and derivatives	**(22)**	(364)
Deferred income taxes	**(1,191)**	(5,970)
Changes in operating assets and liabilities:		
Accounts receivable	**11,729**	10,486
Inventories	**(543)**	(777)
Other current assets	**(332)**	940
Other long-term assets	**(666)**	(598)
Accounts payable	**(1,567)**	(471)
Unearned revenue	**(3,322)**	(2,885)
Income taxes	**410**	2,653
Other current liabilities	**(4,024)**	(4,143)
Other long-term liabilities	**188**	250
Net cash from operations	**23,198**	24,540

STOCKHOLDERS' EQUITY STATEMENTS

(In millions, except per share amounts) (Unaudited)

Three Months Ended September 30,	2022	2021
Common stock and paid-in capital		
Balance, beginning of period	$ **86,939**	$ 83,111
Common stock issued	**575**	612
Common stock repurchased	**(1,171)**	(1,677)
Stock-based compensation expense	**2,192**	1,702
Other, net	**0**	3
Balance, end of period	**88,535**	83,751