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Robert W. Glenn 6 Woodstock Court Greensboro, NC 27408-3816 (336) 288-8429

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Mr. Robert H. Hertz Chairman Financial Accounting Standards Board P.O. Box 5116 Norwalk, Connecticut 06856-5116

RE: FASB 123 Stock Option Abuse

Dear Chairman Hertz.

The recently released FASB No. 123 regarding stock option standards has a **loophole** a fleet of Mack trucks can drive through and most companies are doing so. FASB 123 completely ignores the relationship between stock options exercised and stock buyback programs. This oversight in the standards allows the corporate elite to legally pocket billions from shareholders, significantly understate compensation expense, overpay federal taxes, and most importantly overstate earnings to their shareholders. The billions Enron, WorldCom et al have pocketed from shareholders are peanuts when compared to what FASB 123 is allowing the corporate elite to do "legally" and in full compliance with Sarbanes-Oxley.

FASB 123 gives corporations a license to drain billions from corporate coffers into management pockets with minimal effect on earnings per share. When a company buys back its stock and the number of outstanding shares doesn't decline because the number of shares bought back is equal to or less than the shares exercised under the company's stock option plan, those cash funds used to buy back the shares should represent a compensation expense to the company because those corporate funds used to buyback shares are going directly to the corporate elite who exercise their options. FASB 123's use of the Black-Scholes option pricing model to record compensation expense results in an <u>understatement of compensation expense</u> and overstatement of earnings for those companies who take advantage of the loophole and most take full advantage.

Pfizer Inc is one such company whose management and board of directors take full advantage of the **loophole**. Here's how the **loophole** worked based on Pfizer's' annual reports for the five year period 2000-2004:

Pfizer spent \$29.4 billion (82% of its \$35.9 billion net income!) to buy back 880 million shares, but shares outstanding only decreased 519 million shares (6,129 billion to 5,610 billion shares outstanding excluding the 1.817 billion shares issued for Pharmacia acquisition in 2003)! Why didn't shares outstanding decrease by the 880 million shares bought back? What happen to the difference?

Three hundred and forty-one (341) million of those shares were issued to Management (or "corporate elite") as compensation under Pfizer's stock option programs (Footnote 13E, 2004 annual report) and Pfizer's Employee Benefit Trust.

Pfizer bought back those 880 million shares in the market for \$29.4 billion or \$33.36/share. The 341 million shares issued to Management at \$33.36 cost Pfizer shareholders \$11.4 billion. Thus \$11.4 billion in cash was used to buyback the 341 million shares issued under Pfizer's stock option programs and Employee Benefit Trust!

How much did Pfizer expense against earnings during this period? Absolutely nothing! \$11.4 Billion went into the pockets of management with no expense recorded against income, all in accordance with generally accepted accounting guidelines. **Amazing!** 

However on a <u>pro forma</u> basis over the 5-year period, GAAP (using Black-Scholes) required Pfizer to expense \$3.0 billion but that was <u>only 38% of the \$7.8 billion</u> (\$11.4 billion before tax)! **Thus Pfizer's** \$35.9 billion **net Income** (using a 31.3% as the average tax rate) was overstated \$7.8 billion or 27.8% over the five years 2000-2004 "in conformity with accounting principles generally accepted in the United States of America".

Here's how the loophole worked for the 2004 year based on Pfizer's latest annual report:

According to the Statement of Cash Flows on page 52, Pfizer spent \$6.7 billion (59% of its \$11.4 billion net income) to buy back 208 million shares (p.86, 13 A), but shares outstanding only decreased 148 million shares! (7,575 to 7,427) Why didn't shares outstanding decrease by the 208 million shares bought back? What happen to the difference?

Fifty-five (55) million of those shares were issued to Management (or "corporate elite") as compensation under Pfizer's stock option programs and Benefit Trust, and 5 million to "Other" per the Statement of Shareholders' Equity on page 51.

Pfizer bought back those 208 million shares for \$6.659 billion or \$32.01/share. The 55 million shares issued to Management at \$32.01 cost Pfizer shareholders \$1.761 billion. Thus \$1.761 billion in cash was used to buyback the 55 million shares issued under Pfizer's stock option programs!

How much did Pfizer expense against earnings during this period? Absolutely nothing! \$1.761 billion went into the pockets of management with no expense recorded against income, all in accordance with generally accepted accounting guidelines. Amazing!

However on a <u>pro forma</u> basis GAAP (using Black-Scholes) required Pfizer to expense \$574 million (Note 1N, p. 57) which is <u>only 40% of the \$1.426 billion</u> (\$1.761 billion before tax) in cash Pfizer used to buyback the 55 million shares. Thus Pfizer's \$11.4 billion net income (using a 19.0% tax rate) was overstated \$1.426 billion or 14.4% for the 2004 year "in conformity with accounting principles generally accepted in the United States of America".

On a per share basis for 2004 we have the following:

A. Diluted earnings per share under GAAP	\$1.49	
Compensation Expense (Black-Scholes)	(.08)	
Pro forma diluted earnings per share	\$1.41	
B. Diluted earnings per share under GAAP	\$1.49	
Compensation Expense (\$1.426 billion/7.614 billion shares)	<u>(.19)</u>	(1)
•	\$1.30	

(1) based on the 55 million shares bought back at \$32.01 with no reduction in the number of shares outstanding after tax.

So the bottom line is, the "new" FASB 123 allows earnings per share to be overstated, compensation expense understated, the corporate elite pocket billions, Uncle Sam gets billions more in tax revenues, and shareholders are duped. Because of this loophole, the investor, in order to get a truer picture of a company's performance must resort to an in-depth "cash" analysis involving "free cash flow" adjusted for dividends and now cash used for stock purchases. "Free cash flow" is defined as "earnings from operations less property, plant and equipment purchases – net, less cash dividends paid". Now, because of the loophole, "free cash flow" has to be adjusted by adding back dividends less cash used for common stock purchases to get a meaningful value per share. One has to wonder, what value is "Earnings per share"?

## How do we close the loophole?

Management and their boards will continue to "scratch each others' backs" with no limits on their respective compensations. The least the FASB should do is to make stock option compensation expense fully chargeable against earnings. As noted in the Pfizer 5-year period above, the current FASB No. 123 standard using Black-Scholes only charged 38% (\$3.0/\$7.8) of Pfizers' stock option compensation expense over the 5-year period against income (on a pro forma basis). Expensing only a fraction of the actual cost is morally wrong, misleading and violates every accounting convention.

The easiest way to close the loophole would be to integrate the following wording into the FASB No. 123 standard:

"Stock option compensation expense will be the <u>greater of</u>. (a) that determined under Black-Scholes, etal., <u>or</u> (b) the value of any shares bought back which are equal to or less than the shares exercised (issued) under the company's stock option plan(s)." (Any shares bought back which exceed the number of shares exercised under the stock option program need not be expensed because those shares will properly reduce the number of share outstanding, increasing earnings per share in accordance with GAAP).

FASB No. 123 as it now stands is systemically destroying the incentive to own stock for those who are aware of this under-expensing. Not only are shareholders being duped but management, board members, employees, and even customers lose. Accountants lose their credibility. It's a "lose-lose" situation for all concerned. FASB No. 123 accounting standard must change to stop this unfairness. Compensation expense must be properly recognized in order to restore credibility and investor confidence. As you most aptly stated in your opening statement to the roundtable participants on May 8, 2003, "Our capital markets, and the investors who participate in those markets, are demanding and deserve sound, transparent, and unbiased financial information."

Sincer Copies to: David M. Blitzer ( John C. Bogle Warren Buffett Kimberley Crook ( William H. Donaldson ( ) Dr. Alan Greenspan Pfizer Board of Directors Richard B. Rose ( Peter Schleck David L. Shedlarz S. Grey Steifel, Jr. ( Michael W. Tovey ( Sir David Tweedie (

FASB 123/fails far short of your standard.