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Mr. Robert Herz
Chairman
FASB
401 Merritt 7
Norwalk, CT 06856

Dear Mr. Herz:

I composed the enclosed letter on employee stock options, which sheds some rather novel insights on options.

I hope that it may someday create some impact towards the end of having options recognized for being the huge cost that they are, which is currently overlooked, even by the ridiculous diluted method.

I welcome your feedback, good or bad.

Sincerely,

Richard Lazarow
Managing Partner
Americap Partners LP

# The Fleecing of U.S. Shareholders

As many investors are aware, there has been an ongoing debate regarding how to most equitably present the cost of management stock options in a company's financial reports to its shareholders. Currently, the cost of stock options is not expensed in the financial statements of most U.S. public companies. This, in and of itself, appears ludicrous, as these very valuable options are clearly a part of the recipient's compensation package, and therefore should be expensed like other compensation expense items; otherwise the shareholders are being misinformed. Some change to the current method is now being reconsidered by the powers that be, but in the meantime this situation results in a sham of over-reported earnings for many companies to wide-ranging degrees.

Unfortunately for shareholders, many lawmakers and other rulemaking bodies, who are either not fully aware of the cost of options, or perhaps are wooed/pressured by past or potential campaign contributions, have been so far hesitant to ruffle the feathers of management by altering the status quo. The various reasons given by management and some politicians to not expense options are awash in illogical arguments and/or driven by self-interests and greed.

Below I will refute the case of those in the 'non-expense' camp, and explain the lack of logic in ignoring the high cost of options to our corporations' shareholders. Further, while the basic debate on whether to expense or not normally encompasses simply expensing the options' *estimated value at the time of the grant*, I instead advocate the need to expense the costs that the company incurs from the *exercising* of these options (this may be why some companies agree to expense now; because they are only expensing the *estimated* cost of the option, not the actual —and often much larger— cost to shareholders). I also explain how investors may be misled into believing that the cost of options is somehow appropriately contemplated by the Diluted[1] EPS method.

**Refuting the Non-Expenser's Arguments**

Options are clearly an alternate form of compensation. Many managers negotiate for options as a part of their *compensation packages*, but then the companies declare that they should not consider them as compensation expense. And, as Warren Buffet is oft quoted, "...if options are not an expense, what are they?" (The answer is: Managers' most efficient method of getting really rich without risking capital, so they say and do whatever is necessary to preserve this bountiful perk). Options obviously have value, and all value that flows from the company (and its shareholders) to its employees needs to be reported unambiguously to shareholders as well as expensed in the financial statements.

Managers will often say that there is no *cash cost* involved in granting options. While this is true at *grant*, there is a transfer of *value* at that time. I invite the reader to look at the price of a *9-month* option on any company on which options are publicly-traded. With Boards often awarding *10-year* options, it is not hard to see that the value of these 10-year management options is many times that of the 9-month option's value (even taking illiquidity into account). Further, what about the forgotten additional cost to the company which occurs when the options are exercised, reaping their holders' huge windfalls right from the pockets of shareholders? Are these *cash costs* ever expensed? More on this below.

Other popular reasons to not expense include, 'It is difficult to value options perfectly, so let's not do it at all'. This is entirely ridiculous, as a good approximation will be closer to reality than simply

excluding the expense from the income statement. While only an estimate, the cost of management stock options can be valued using only a few assumptions, *just like other financial assets* such as exchange-traded options, other derivatives, and real estate, for example. Further, aren't all asset valuations really just estimates of what one or more people believe those assets are worth anyway? People use estimates to assess value all the time, so estimates should be completely appropriate for valuing management stock options as well. Lastly, and most critically, the necessity of this estimate to be perfectly correct is not great, because as mentioned above, the real cash cost of the options to shareholders results from their being exercised, not from their being granted. In fact, without an exercise (or cash payment in lieu of exercise), in fact, there is never a real cash cost. So the focus of this debate should be widened to include the impact of the option exercise, versus simply the value of the option. (Continued below).

'Our tech (and other) companies need these options to stay competitive', has been quoted many times as an important reason to not expense. I translate this into, 'Many tech companies are so unprofitable that they can't afford to expense the big (over-)compensation packages that managers desire, so Boards award very valuable options instead because they don't currently have any impact on the company's financial statements. Further, expensing options would make income statements look too weak, putting pressure on the stock, thus impairing the company's ability to sell additional overvalued stock to unsuspecting investors, thus hurting those companies' competitiveness. This is such a farce. If a company cannot compete and survive without presenting true financials to its shareholders, then I say that the company should not exist. How can we condone misrepresentative reporting in the name of encouraging overcapacity? Didn't we learn from the Worldcoms and Enrons? Furthermore, most or all of the employees would work at these companies without the options. Do we really need to pay VP's millions of dollars per year to work in their cushy jobs?

Also, Boards say that options align the *long-term* interests of managers and owners. But they do not. Many managers cash in their options in the early years of a 10-year option. This is contrary to the 'long term' argument posed by Boards. And, grant sizes of options are multiples higher than they need to be, as few people are focusing on the true cost of these option plans. Further, the lack of a meaningful lockup period can encourage more risky behavior, leading to higher stock volatility thus increasing option values.

**The IRS Considers Options an Expense**

Perhaps most convincingly, the IRS (an agency notoriously determined to not allow expenses that aren't actually expenses) allows companies to expense the cost of the options as an expense! If the IRS perceives options to be an expense, isn't this enough substantiation right here? So why doesn't FASB *mandate* their expensing? (The answer is obvious). Even worse, while EPS is already inflated due to the lack of option expensing, the company actually records a tax benefit from expensing the options for *tax purposes*, which actually has the effect of *boosting* EPS and operating cash flows in the report to shareholders even further! To summarize, in their report to the IRS, companies have argued for and won the ability to report options as an expense (thus minimizing taxes), but to shareholders and future investors these same companies show only a tax *benefit* but no expense, which actually increases the reported EPS instead of decreasing it! This duplicitous treatment of options is totally inconsistent and thus seriously deludes shareholders with misleading financials.

**The Cost of Exercising Needs to be Expensed as Well.**

There is little discussion in the press about the (often enormous) leakage of value which occurs from *exercising* options. Currently, only the estimated value of the options is being considered for

expensing. But, as options can increase in value by many times as they move above their exercise price, when would any increase in the initial option value ever get reported and expensed to shareholders? Realize here that selling a share of stock at under market prices, and allowing the employee to immediately sell the share at market is akin to simply giving the employee the profit directly (assuming the company buys back the shares on the open market). How is paying an employee as a result of exercising stock options really different from receiving a cash bonus? Cash is cash, so why is one method of cash payment expensed, and one is not? It should not matter to shareholders what the mechanism was that triggered this flow of cash to the employee from shareholders. People can argue the nuances all day, such as 'the options became valuable due to higher stock prices, benefiting all shareholders', etc., but the point in time of the exercise was, on average, over 6 months prior to the issuance of the annual report. Stocks naturally ebb and flow, and the employee has exited with his windfall, and it is not even presented in the financials (in fact, over 100% of Net Income could be, and sometimes is, transferred to employees through option exercises/stock grants, etc., and shareholders have no clue of this cost). A company should not be as cavalier as to say, 'So we sold company stock to an employee for less than its market value, but so what? Why should we expense that?' The answer is that every dollar reaped by the option holder as compensation, regardless of the vehicle from which it was derived, needs to be expensed, as these dollars represent a serious leakage of cash that companies are currently not recognizing anywhere meaningful in their financial statements.

**Diluted EPS is Faulty**

Opponents of expensing options have often hung their collective hats on the concept of Diluted earnings per share, maintaining that the additional number of shares calculated by this method fully incorporates the cost of the options. For a long while, this Diluted EPS method irked me in that it didn't seem to sufficiently account for the (often huge) amount of wealth being transferred to the option holders, while EPS was being penalized only very slightly.

I finally realized that the options were affecting the Diluted EPS calculation incorrectly. Instead of the cost effectively increasing the *number of shares* (i.e. the denominator of Earnings/<u>Share</u>), the cost should be a *dollar decrease to operating profits and thus hit after-tax Earnings* (i.e. the numerator of <u>Earnings</u>/Share). This would much more accurately reflect the impact to shareholders. As reasoned above, what is the difference whether an employee collects $1M resulting from an exercise of stock options, a cash bonus, or even a stock grant? Companies often buyback stock to negate the dilutive effects of these newly created shares, and then the $1M is out the door in all cases. The effect on the shareholder is the same, so the accounting treatment should be consistent.

**Stock Buybacks Countermand the Diluted Method**

Shareholders are further lead astray by companies' stock repurchase programs (regarding Diluted EPS), because buying back shares on the open market often negates the Diluted method significantly or even entirely. This has two very positive effects for option-holding managers. First, these purchases support the stock price, increasing the value of the managers' options (which they are occasionally concurrently exercising and selling, curiously). But most importantly, these buybacks decrease the number of shares outstanding, thus lessening the dilution to EPS. This is key, because by effecting a large enough buyback, there is never a hit to the EPS of a company, even on a Diluted basis. This creates a conflict of interest, as managers are incentivized to buy in stock to minimize the effects of the options almost irrespective of the stock's price, potentially hurting shareholders. Further, this is a mechanism through which Net Income effectively is drained from the company, usually unnoticed by shareholders. This needs to be put under a microscope by regulators and investors alike.

**A Better Method of Expensing Options**

A more logical method of determining the correct amount to expense is as follows. Simply focus on how much *total value* accrues to the employee from the option, rather than just the estimated value of the option at granting. This total value transference is the amount that needs to be expensed just like the other labor costs.

First, there is a *non-cash* transfer of value to the employee on the day of grant, and then there is a *cash* transfer of value the day the employee exercises the option. It is this in-the-money value of the options at exercise that represents the real total cash cost to shareholders, and this cost can be calculated to the penny. These two events are what should govern the timing of a company's recognition of an expense. The estimated value of the options could be expensed at granting (using the risk-free rate, actual trailing volatility of x-number of days, and other reasonable assumptions). Then, at exercise, the company would expense the in-the-money dollar value realized by the option holder, while crediting the amount previously expensed when the option was granted. If options expire worthless, the company would credit back the amount expensed at granting. Further, this accounting would affect the Statement of Cash Flows more properly, moving the cash hit (amount realized by option holder) into the operations section, versus the financing section where it is currently obscured and largely ignored by most investors. Whatever the eventual method adopted, the actual cash flows to the employees from the pockets of shareholders needs to be presented clearly and expensed.

**Illustration**

In order to concretely illustrate this point, let's consider a simple example of the cost of options: Say a very trusting entrepreneur (Owner) owns a company valued at roughly ten billion dollars, and entrusts full operating duties to his Board of Directors for 3 years. Say over this period the company's Board awards the employees options on the Owner's shares at various times, with the employees subsequently asking and getting the Board to redeem those options when valuations are deemed higher (using public market comparable valuations). Further assume that the company cumulatively earned about $1 billion in Net Income over this time (includes tax benefit of options). However, over the same time, suppose that the employees received almost that same $1 billion in cash from redeeming their options. What is actually left over for the Owner? Would the Owner still believe he earned $1 billion while he was away? If the Board said, 'Well, don't consider the options and $1 billion awarded to management in evaluating our results', should the Owner accept that? If the Board told the Owner that they redeemed the options prior to the end of the reporting period, so he was only 'slightly diluted', would he believe that? The employees have pocketed substantially all of the Net Income of the company, paid taxes on their windfall just like 'real' compensation, and the company expensed the options' real cost for tax purposes like real expenses. Yet the Owner has zero of the Net Income his company earned over 3 full years, but is still supposed to imagine that his company earned $1 billion for him? No. The Owner would consider the $1 billion paid to employees as compensation expense, and realize that his company netted him zero dollars over those 3 whole years. To varying degrees, this is the situation in which U.S. public shareholders currently find themselves.

Further, applying the currently-used reporting method for public companies to this example, Diluted EPS would have decreased by less than 4% per year if the options had not been redeemed by the company ($1 billion cost/$10 billion market cap / 3 years, assuming the value of the options equaled the cost of the exercise). But, since the options were redeemed, there would be almost *zero* reporting effect (depending on timing), except for that tax benefit, which again would actually *increase* the EPS reported to the Owner! Yet I contend that EPS should have been reduced to roughly *zero* for all 3

years on average, a difference of over 95% each year! This is quite a large difference. How can we allow such a system to exist?

**Summary**

Public shareholders are currently being treated like fools, there is no reasonable way to sugar coat it. And, if you think that this example is improbable, it's not. These are the approximate results of a public company known as Maxim Integrated Products, Inc., but many other similar examples could have been cited here, as this situation is very widespread. Cypress Semiconductor recently authorized (without shareholder approval) 20 million additional options for its option program raising the option overhang level to an astoundingly high level of 50%+ of the outstanding shares (the highest I have ever seen). One may wonder if they would be so generous if the entire cost of these options had to be reflected in their financial statements.

These arguments should be equally applicable to stock grants as well. In the second quarter of this year, Broadcom 'awarded' 8.6M shares of stock to their employees (in exchange for some number of existing stock options), valued at $162 million. Combining this amount with other non-cash stock based compensation raises the cost up to $220 million, per Barron's, which is more then the company's projected pro-forma Net Income for the whole year! But the company wishes shareholders to ignore these costs, referring to them as 'non-cash charges', and stating as a benefit, 'getting rid of option overhang'. But they are issuing shares to do that! That is the problem of the options, that they turn into shares; so now here they are. Plus, the company is free to buyback all those shares in the market to negate the dilutive impact (a real cash cost!), thus squandering over 100% of the Net Income for the entire year, but the Board still wishes to report a net pro forma *profit*?

Think about it—what does the term, 'Net Income Available to Common' really mean, if over 100% of the company's Earnings for an entire year can be handed out the back door to employees via stock options and buybacks and stock grants without it affecting Net Income, let alone it being fully and clearly reported to the company's owners? Isn't it time for U.S. shareholders and lawmakers to acknowledge that when a company sells/awards/gives away its valuable equity for less than its fair market value, that this event creates a loss of value to shareholders that needs to be fully disclosed and expensed on our company's financial statements?

Private company owners know that the shares of their company are probably among their most valuable assets, and are parted with very judiciously. When will public companies begin to treat shareholder's equity similarly? What is it going to take to stop these massive injustices?

[1]Generally, Diluted EPS takes into consideration the number of shares that would be the monetary equivalent of the in the money options that could be exercised at the end of a reporting period, and then adds this number to the average shares outstanding over the period.