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I believe that stock options should be illegal, because they could cause a bailout of federally insured corporate pension plans. Corporations with federally insured pension plans are spending billions of dollars to repurchase stock from executives who have exercised their stock options. As an example, if a corporation issues a stock option to an executive with a strike price (price an executive must pay the corporation to exercise a stock option) of $20, and subsequently repurchases the same share for $50 after the stock option is exercised, then $30 of retained earnings are being used to pay executives salaries, instead of being used to fund employee pensions. Furthermore, this expense is not even recorded in the financial statements. The Financial Accounting Standards Board allows companies to use the Black-Scholes method to record the expense of issuing stock options, instead of the difference between the strike price and the repurchase price of the stock, which is the true cost of the stock option, because this is the net amount that a corporation spends to issue and repurchase the same share of stock.

The following is a letter that I sent to Steve Forbes in response to an article in Forbes Magazine. This letter reflects my opinion on accounting for stock options.

Dear Mr. Forbes:

I would like to point out several misconceptions in your article entitled, "Stock options? Leave the options open," which was printed in the Sept. 29, 2003 issue of Forbes Magazine.

You stated that, "Investors have long been given, up front, fully diluted earnings, which are what profits per share would be if all options were exercised." Nothing could be further from the truth. Most companies combat the dilutive effects of stock options by instituting a stock repurchase plan, which is used to repurchase stock that was issued as a result of executives exercising their stock options. Fully diluted earnings per share only takes into account the increased number of shares issued through stock option grants. However, it completely ignores the money spent by the company to repurchase the stock from executives who have exercised their stock options. Earnings per Share (EPS) = revenues minus expenses/number of common shares outstanding. Under current stock option accounting rules, to calculate fully diluted earnings per share, the denominator is increased for the number of additional shares granted through stock options. However, the expense of repurchasing shares from executives after they have exercised their stock options is not deducted from the numerator as an expense. Instead, this expense is completely ignored in the EPS calculation. For example, if an executive exercises a stock option with a strike price of $20 per share, and the company subsequently repurchases the same share, either directly from the executive, or on the open market through a stock repurchase plan, for $50 per share, the difference of $30 is not considered an expense under current stock option accounting rules. This inflates reported earnings per share, because the expense of repurchasing the stock is not deducted from revenues as an expense in the numerator. Therefore, the biggest part of executive compensation is not even reported on the income statement, and omitting this expense, or any other expense, inflates the earnings per share calculation. This loophole has allowed executives to pay themselves billions of dollars of unreported compensation. This is harmful to shareholders, employees, and the government, because retained earnings are being used to pay executives through stock option grants and subsequent stock repurchase plans, instead of being used to pay dividends to shareholders and finance employee pensions, the majority of which are federally insured. It also costs the federal government corporate income tax revenue, because corporations are
allowed to deduct the difference between the strike price of the option and the market price of the stock on their income tax returns when options are exercised.

Failure to report other expenses, such as salaries expense, selling, general & administrative expense, etc., as WorldCom did, would be considered fraud. Therefore, why do we allow the expense of issuing stock options to be ignored?

You also made the point that there is no way to accurately estimate the value stock options. This is also not true. Companies are allowed a tax deduction on their income tax return for the difference between the market price of the stock and the strike price of the option when the stock option is exercised, and companies regularly deduct this amount as an expense on their income tax returns, even though they are still allowed to ignore this expense on their income statements. I believe that this amount should also be deducted from revenues on the income statement just as it is on the tax return. If companies are required to report the expense of stock options to the government on their tax returns, then why shouldn't they also be required to report this expense to investors on their income statements? However, the difference between the strike price of the option and the repurchase price of the stock is the most accurate measure of stock option compensation expense, because this is the actual amount paid to the executive from retained earnings. For example, if an executive pays $20 to exercise a stock option (strike price), and the corporation subsequently repurchases the stock for $50, then the net expense to the corporation is $30. The difference between the strike price of the option, and the market price of the stock should be listed on the balance sheet as a liability until the option is exercised and the stock is repurchased. After the stock is repurchased by the corporation, the liability on the balance sheet should be transferred to the income statement as compensation expense. However, I believe that the difference between the strike price of the option and the market price of the stock on the date the option is exercised could also be used to calculate the expense of issuing stock options, because this amount is already used to report stock option expense to the government on the corporate tax return, and it can be charged against revenues on the income statement immediately, instead of in the future, when the actual repurchase price of the stock is known.

Restricted stock grants would be a better way to reward executives for good performance, because the market price of the stock is charged against revenues on the income statement as compensation expense. This gives investors accurate earnings per share calculations, because unlike stock options, the expense of issuing restricted stock is not ignored on the financial statements. However, I believe that shareholders should approve all stock based executive compensation packages in order to avoid excessive executive compensation.

However, investors' control over executive pay is limited, because shareholders can't vote directly against board members. When a company nominates a board member, shareholders can either vote for the candidate or withhold their vote. Therefore, a prospective board member who receives just 10% "yes" votes and 90% "withhold" votes is the winner. Shareholders need to be able to vote directly for both board members and executive pay packages.

Lax accounting for stock options has allowed American CEO's salaries to balloon to more than 170 times the average worker's pay, compared to 22 in Great Britain, and 11 in Japan. The median salary for CEOs of the 100 largest U.S. companies hit 17.9 million dollars in 2005, which is up 25% since 2004. Stock options have turned the stock market into a gambling casino, and have allowed executives to reap billions of dollars in unrecorded compensation. This could cause a federal bailout of federally insured pensions, because companies are using retained earnings to repurchase stock issued after executives have exercised their stock options, instead of funding employee pensions. Therefore, I believe that stock options should be illegal in order to ensure the accuracy of financial statements, and avoid a bailout of federally insured pensions by the Pension Benefit Guaranty Corporation.

Concerned Investor,

Richard Golladay