November 16, 2012

Financial Accounting Standards Board
Attn: FASB Advisory Council
401 Merritt 7
Norwalk, Connecticut 06856-5116

Dear Sir: Stock option gains are not required to be expensed on corporate income statements even though they account for over 80% of executive compensation. This loophole in Generally Accepted Accounting Principles (GAAP) has allowed corporations to understate compensation expense and overstate earnings by omitting the majority of executive compensation from their financial statements (Warren Buffet estimates that corporate earnings are overstated by 10% due to lax accounting for stock options). This impacts the integrity of financial statements, and is responsible for inflating executive pay to over 350 times that of the average employee, compared to 10 times that of the average employee in Japan, Germany, and other industrialized countries that expense stock options. Omitting other expenses (such as salaries and wages expense or depreciation expense) from the financial statements would be considered fraud. Therefore, why does the SEC allow corporations to omit over 80% of executive compensation from their financial statements?

The following is a letter that I sent to Steve Forbes and the SEC in response to an article in Forbes Magazine in 2005. 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 recently printed in 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 use stock repurchase plans to combat the dilutive effects of stock options. However, the expense of repurchasing stock from executives (stock repurchase price - option strike price) who have exercised stock options is omitted on the income statement, even though this is the net amount of retained earnings used to repurchase stock from executives who have exercised stock options. Fully diluted earnings per share only takes into account the increased number of shares issued through stock option grants. However, it ignores the expense of repurchasing stock from executives who have exercised 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 by the additional number of stock option grants. However, the expense of repurchasing shares from executives who have exercised stock options (repurchase price-strike price) is not deducted from the numerator as an expense. Instead, this expense is 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 in the stock market through a stock repurchase plan) for $50, the difference of $30, which came out of retained earnings, is not considered an expense under Generally Accepted Accounting Principles (GAAP). Ignoring this expense inflates reported earnings per share, because the expense of repurchasing the stock is not deducted from revenues in the numerator to calculate EPS. Therefore, the majority of executive compensation (over 80%) is not even reported on the income statement, and omitting this expense, or any other expense, inflates reported earnings per share. This is where GAAP becomes harmful to shareholders, employees, and the government, because retained earnings are being used to pay executives through the merry-go-round of stock option grants and subsequent stock repurchase plans, instead of paying dividends and financing employee pensions, many of which are federally insured. It also costs the federal government tax revenue, because corporations are allowed to deduct the difference between the strike price of the
option and market price of the resulting stock as compensation expense on their tax returns, even though they can ignore this expense on their financial statements. Instead, corporations merely have to report the number of stock options granted to executives in a footnote on the financial statements, and calculate diluted earnings per share, which ignores the amount of retained earnings spent to repurchase stock from executives who have exercised stock options. Failure to report other expenses, such as salaries and wages, would be considered fraud. Therefore, why doesn't the SEC require corporations to expense stock options, especially when they account for over 80% of executive pay?

You also made the point that there is no way to accurately estimate the value of stock options. This is also not true. Companies can deduct the difference between the market price of the stock and the strike price of the option as an expense on their tax returns. This amount could also be used to estimate the cost of stock options on the balance sheet until the stock is repurchased, and the actual expense in known (stock repurchase price minus option strike price). If corporations are required to report the expense of stock options to the government on their tax returns, why shouldn't they also be required to report this expense to investors on their income statements? Furthermore, the Black-Scholes method is currently used by some corporations to voluntarily expense stock options. However, this method is inaccurate because it is based on estimates. The difference between the strike price of the option and subsequent repurchase price of the stock is the most accurate way to expense stock options, because this is the net amount of retained earnings used by a corporation to repurchase stock from executives who have exercised stock options (if an executive pays a strike price of $20 to exercise a stock option, and the corporation subsequently repurchases the resulting stock for $30, the net gain of $10 should be deducted from retained earnings and expensed on the income statement. However, corporations are permitted to omit this expense from their financial statements, which inflates reported EPS, and allows executives to inflate their compensation by hiding it from stockholders).

Finally, in order to account for stock options on the balance sheet, executives should not be allowed to exercise stock options and sell the resulting stock in the stock market. Instead, they should be required to sell the stock back to the corporation. This would create an estimated liability (market price of the stock minus strike price of the option) that could be recorded on the balance sheet until the option is exercised. This estimated liability would subsequently be adjusted (to equal the difference between the repurchase price of the stock and the strike price of the option), and expensed on the income statement, once the stock is repurchased (restricted stock grants are 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 results in an accurate EPS calculation, because unlike stock options, the expense of issuing restricted stock is not ignored on the financial statements. However, shareholders should approve all stock-based executive compensation packages, and be granted the power to nominate directors who oppose excessive stock option grants).

Not expensing stock options has allowed corporations to inflate reported EPS by omitting over 80% of executive compensation from their financial statements (Warren Buffett believes that EPS is overstated by 10% due to lax accounting for stock options). This has caused executive compensation to balloon to more than 170 times that of the average worker, compared to 22 in Great Britain, and 11 in Japan. Stock options have turned the stock market into a gambling casino, and the failure of the SEC to require companies to expense stock options has allowed executives to hide over 80% of their compensation from stockholders and collectively reap billions of dollars of unrecorded compensation. This deceptive accounting impair the integrity of financial statements, and could cause a bailout of federally insured pensions, because companies use retained earnings to combat the dilutive effects of stock options by repurchasing stock from executives instead of fund employee pensions. Therefore, I believe that stock options should be expensed as the difference between the repurchase price of the stock minus the strike price of the option (net retained earnings used to issue and repurchase stock issued for stock options), in order to ensure the integrity of financial statements and corporate pensions.

Concerned Investor,

Richard Golladay/CPA