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Financial Accounting Standards Board
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Dear Sir: Stock option gains comprise over 80% of executive compensation. However, most corporations use the **Black-Scholes Model** to expense stock options, allowing them to hide most of this expense from shareholders, because it is based on **estimates** (future interest rates, stock volatility, etc.), instead of the actual realized gain to executives from exercising their options (**market price** of stock minus **strike price** of stock options). This loophole in Generally Accepted Accounting Principles (GAAP) has allowed corporations to overstate earnings by omitting the majority of executive compensation from their income statements, which has inflated 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 use International Financial Reporting Standards. The failure of corporations to properly expense stock options impairs the integrity of financial statements, and could lead to a bailout of federally insured pensions, because most corporations combat the dilutive effects of stock options with stock repurchase plans, that use retained earnings to purchase stock from executives who have exercised their stock options. Therefore, I respectfully request that the Financial Accounting Standards Board (FASB), and the Securities and Exchange Commission (SEC), require corporations to expense stock options using the **market price** of the stock (minus strike price of underlying stock option), on the **exercise date** of the option, similar to how restricted stock is expensed under GAAP (The market price of a share of unrestricted stock is expensed on the grant date of restricted stock. However, the exercise date is better than the grant date for expensing stock options, because unlike restricted stock, stock options are worthless if the strike price on the grant date, is below the stock price on the exercise date.)

The following is a letter that I sent to Forbes Magazine in response to an article in 2005

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 combat the dilutive effects of stock options with stock repurchase plans, that use retained earnings to repurchase stock from executives who have exercised their options. However, fully diluted Earnings Per Share (EPS) only accounts for the increased number of shares issued through stock option grants, and ignores the expense of repurchasing stock from executives who have exercised their options, resulting in inflated earnings per share (revenues minus expenses/common shares outstanding). For example, to calculate fully diluted earnings per share, under current stock option accounting rules, the denominator is increased by the total number of outstanding stock options granted to executives. However, the subsequent expense of repurchasing stock from executives who have exercised their options (**market price** of stock minus **strike price** of corresponding stock options) is not deducted from revenues in the numerator as an expense. Instead, it is completely ignored in the EPS calculation (ex. If an executive exercises a stock option with a strike price of $20 per share, when the market price of the corresponding stock is $50 per share, the difference of $30 is not deducted from revenues under current stock option accounting rules.) Therefore, the majority of executive compensation is not even reported on the income statement, and omitting this expense, or any other expense, inflates reported earnings per share. This loophole in Generally Accepted Accounting Principles (GAAP) has allowed corporations to hide most executive compensation from stockholders, and has inflated executive pay to over 170 times that of the average employee, compared to about 15 times that of the average employee in other industrialized countries, that properly expense stock options. This deceptive accounting is harmful to shareholders, employees, and the government, because many corporations use retained earnings to fund stock repurchase plans, instead of 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 **market price** of the stock, and the **strike price** of the option, as an expense on their tax returns, even though they can ignore this expense on their financial statements (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 expense of repurchasing stock from executives who have exercised their stock options.) Failure to report other expenses, such as salaries and wages expense, would be fraud. Therefore, why does the Securities and Exchange Commission (SEC) allow corporations to ignore this expense on their financial statements (**market price** of stock, minus **strike price** of stock options on the **exercise date**), especially when stock option gains 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. As previously explained, corporations are allowed to deduct the difference between the **market price** of the stock, and the **strike price** of the corresponding stock options, as an expense on their tax returns. This realized gain should also be deducted from revenues as an expense on their income statements, on the **exercise date** of the options (The exercise date is better for expensing stock options, because unlike restricted stock, stock options are worthless if the strike price on the **grant date**, is below the stock price on the **exercise date**), resulting in an accurate EPS calculation. If companies 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 Model is currently used by most corporations to voluntarily expense stock options. However, this method is inaccurate because it is based on estimates (future interest rates, stock volatility, etc.), instead of the **market price** of the stock (minus the strike price of the option), which is the actual **realized gain** to executives who have exercised their options (ex. If an executive exercises a stock option with a strike price of $20, when the corresponding stock trades at $50, the net amount of $30 is the realized gain that should be expensed on the income statement, similar to how restricted stock is expensed under GAAP). Allowing corporations to omit this expense from their income statements impairs the integrity of financial statements, and inflates executive compensation, by hiding it from stockholders.

Finally, 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 directly back to the issuing corporation. This would create a liability that could be recorded on the balance sheet on the **grant date** of the options (**market price** of stock minus **strike price** of stock options), and subsequently expensed on the income statement when the options are exercised, resulting in an accurate EPS calculation on the income statement, and liability on the balance sheet.

Lax accounting for stock options 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. 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 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 loophole in GAAP could cause a bailout of federally insured pensions, because corporations use retained earnings to repurchase stock from executives, instead of fund employee pensions, many of which are federally insured. Therefore, in order to ensure the integrity of financial statements, and avoid a bailout of federally insured pensions, I recommend that stock options be expensed the same way as restricted stock, in which the **market price** of the stock (minus the strike price of the options) is expensed on the income statement, on the **exercise date** of the options. END of Letter.

Therefore, in order to ensure the integrity of financial statements, I respectfully request that the SEC, and the FASB, require corporations to expense stock options the same way as restricted stock, using the **market price** of the stock (minus strike price of underlying stock options) on the **exercise date** of the options (The **exercise date** is better than the **grant date** for expensing stock options, because unlike restricted stock, stock options are worthless if they are "underwater.") Furthermore, corporations should be required to purchase stock directly from executives who have exercised their options, because they would be required by GAAP to immediately record a liability on their balance sheets (**market price** of stock minus **strike price** of underlying stock options) on the **grant date** of the options. Finally, the Black-Scholes Model should be prohibited by GAAP, because it is based on estimates (future interest rates, stock volatility, etc.), instead of the actual realized gain to executives from exercising their stock options (**market price** of stock minus **strike price** of underlying stock options), which impairs the integrity of financial statements, by allowing corporations to omit most executive compensation from their balance sheets and income statements.

Respectfully Submitted,

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