

The Sound Investor Series #72

Yes, They Are Stealing Your Money

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Sometimes when I read the business press I want to scream. The other day The Wall Street Journal (WSJ) carried a story on the resignation of yet another corporate executive caught in the burgeoning options scandal. But what really got my blood boiling was a story headlined “Cheney Echoes Recent Concerns On Sarbanes-Oxley” detailing a growing chorus of Bush administration officials proclaiming we are too hard on corporate executives.

What’s going on? Last I looked executives at over 130 companies are under investigation for stealing us blind. Why are business leaders along with their pals in the administration arguing our regulations are too tough and that we hold accounting firms too accountable!

Just in case some readers haven’t had time to keep up with the options scandal, let’s review some of the high-points (actually, low-points would be a better description).

Many companies legitimately grant executives and employees call options on the company’s stock as an incentive to grow the company and increase the stock price. These call options give the owners the right, but not the obligation, to purchase stock at a certain price (referred to as the Strike Price) for a set period of time. Typically the options last for 5 to 10 years and have a vesting period of a few years before the employee has full control.

Free options like these are a no-lose proposition for employees. If the company’s stock is above the strike price, they can exercise the options and pocket the gain. If the stock falls, they walk away without any loss.

A little options terminology may be helpful here. If a stock is at \$50 and the option’s strike price is also \$50, the option is said to be “at-the-money.” If the strike price is below the stock’s price, let’s say \$40, the call option is worth more and is “in the money.” If a call option’s strike price is above the stock at \$60, the option is worth less and called “out of the money.”

Companies can issue options with any strike price they want, although most options awarded as incentives have strike prices at or out of the money. Issuing in-the-money options raises eye brows as the company is giving the executive an immediate real gain which leads to substantial accounting and tax consequences.

To avoid the problems of issuing in-the-money options, unethical executives manipulated the system to make in-the-money option grants appear to be at-the-money options. A partial tally of the money stolen from stockholders is already over \$5 billion.

The most popular form of thievery was backdating option grants to periods when the stock was low and pretending an at-the-money award was made at that time. Here's an example - suppose a company's executives decide to issue options at the end of August when their stock price is \$50. They might look back and see the stock closed at \$40 on August 3 and decide to fake or backdate the documents to that date. This then allows them to use \$40 as the strike price with the result being the options are already \$10 in-the-money; and worth substantially more.

According to the WSJ, at least 130 companies are facing federal investigations and over 40 executives have been fired or resigned due to option related abuses. So far five executives have been criminally charged and more are likely to be. Well-known companies involved in the scandal are Apple Computer, Home Depot, McAfee and UnitedHealth Group.

The wrong doing is so wide-spread the SEC doesn't have staff to investigate every allegation. In many cases it is relying on company investigations to identify problems. Not surprisingly, executives are waking up to this reality and starting to refuse to help these internal probes. Just a few days ago, Andrew McKelvey, the Chairman of Monster resigned for refusing to cooperate with his board's query.

It appears the SEC and Federal prosecutors have been aware of problems for a few years, but it wasn't until the March publication of the WSJ's own investigative report that the inquiries stepped up. The WSJ identified a few companies where the probability of having their option grants at such favorable prices was literally over a billion to one.

This brings us back to the question of should business regulation and the responsibilities of the accountants be lowered? In hindsight, it turns out that the 2002 enactment of the Sarbanes-Oxley Act (SOX) significantly curtailed the back-dating problem as companies were forced to report option grants within two days. While I am sure there are a few technical problems with SOX, with executives continuing to steal shareholder's money, I question the need for a wholesale regulatory retreat.

As far as accounting firms go, I am not sure what they were doing when so many companies systematically stole from shareholders. I can understand if they are hoodwinked from time to time (i.e. WorldCom), and do not think the standard should be that they be perfect or be put out of business. But what good is a "certified" report without some responsibility for systematic fraud?

Remember to Vote next week so that whatever makes you "scream" will be thrashed out in Washington and state capitols across this great land!

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