Backdating Employee Stock Options: Accounting and Legal Implications: Certified Public Accountant

Alexander, Raquel Meyer;Hirschey, Mark;Scholz, Susan

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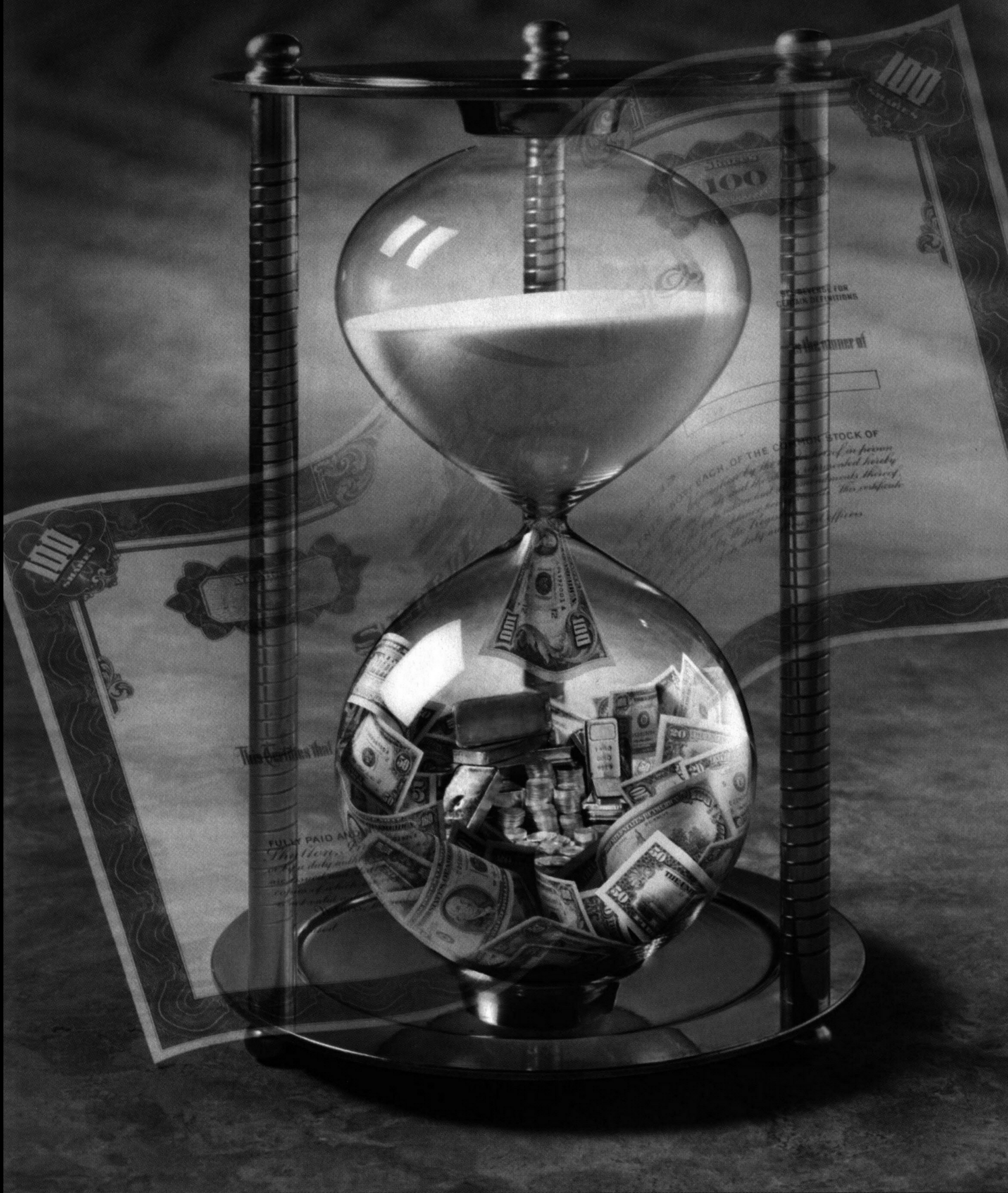

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Backdating Employee Stock Options

Accounting and Legal Implications

By Raquel Meyer Alexander, Mark Hirschey, and Susan Scholz

Until recently, financial research has been puzzled by an unusual pattern of stock returns during the period surrounding stock option grant dates for CEOs and other top executives. David Yermack ("Good Timing: CEO Stock Option Awards and Company News Announcements," *Journal of Finance*, vol. 52, no. 2, June 1997) and Keith W. Chauvin and Catherine Shenoy ("Stock Price Decreases Prior To Executive Stock Option Grants," *Journal of Corporate Finance*, vol. 7, no. 1, March 2001) first documented that stock prices tend to fall in the period before, and rise in the period following, employee stock option grant dates. Such circumstantial evidence suggested that companies withhold good news or publish bad news prior to long-term employee stock option awards to reduce stock prices. Erik Lie ("On the Timing of CEO Stock Option Awards," *Management Science*, vol. 51, no. 5, May 2005) dug deeper into this phenomenon, documenting an unusual pattern of negative returns prior to option-award grant dates that reversed in the post–grant date period. Lie concluded: "Unless executives have an informational advantage that allows them to develop superior forecasts regarding the future market movements that drive these predicted returns, the results suggest that the official grant date must have been set *retroactively*" (emphasis added). In solving this financial puzzle, Lie touched off a firestorm with immediate and far-reaching public-policy implications.

The U.S. Attorney's Office, the SEC, the FBI, and the IRS are conducting investigations into stock option grant manipulations. In one of the first cases involving stock option grant manipulation, the U.S. Attorney's Office, the SEC, and the FBI filed criminal and civil securities fraud charges against former Brocade Communications executives on July 20, 2006.

Although researchers may have been puzzled by this phenomenon, jurists are not. On August 7, 2007, former Brocade CEO Gregory Reyes was convicted of 10 counts of conspiracy and securities fraud. Reyes, once listed on the *Forbes* 400 list, now faces 20 years in prison and a $5 million fine. Because prosecutors view Brocade as a litmus test for future backdating litigation, this article begins by examining the Brocade case's legal complexities and the severe consequences of backdating stock options.

The authors discuss the accounting treatment of stock options under Accounting Principles Board (APB) Opinion 25, "Accounting for Stock Issued to Employees," and SFAS 123(R), *Share-Based Payment*. Next, the authors examine Sarbanes-Oxley Act (SOX)–related problems that arise from

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backdated stock options. The article concludes by presenting the potential financial implications of backdating for investors.

Case Study: Brocade Communications Systems, Inc.

The U.S. Attorney's Office, the SEC, and the FBI concluded 18-month investigations of Brocade Communications Systems, Inc., by filing charges against former CEO Gregory Reyes, former human resources vice president Stephanie Jensen, and former CFO Antonio Canova on July 20, 2006. The charges alleged that Reyes and Jensen regularly caused Brocade to grant "in-the-money" options to both new and current employees between 2000 and 2004, but backdated documents so that it appeared the options were "at-the-money" when granted. Because of accounting treatment differences between in-the-money and at-the-money option grants, backdating resulted in materially understated employee compensation expenses and overstated operating income and company performance. Brocade executives were charged with concealing millions of dollars in employee compensation expense from investors. The SEC filed a civil complaint against Canova, alleging that he had received written notification of option-paperwork forgery but took no action, failed to advise Brocade's auditors and audit committee, and signed false and misleading financial statements and SEC filings. On August 12, 2006, Reyes and Jensen were indicted on eight charges of conspiracy, securities fraud, mail fraud, and false entries in the company's books. In addition, Reyes was indicted on four counts of making false statements to the company's accountants.

The criminal complaint also charged Reyes and Jensen with securities fraud. The SEC's civil complaint, filed in federal court, charged Reyes, Canova, and Jensen with fraud and other violations of federal securities laws. These include violations tied to books and records, internal controls, misrepresentations to auditors, and SOX certification provisions. The maximum statutory penalty for securities fraud in this matter is 20 years in prison and a fine of $5 million, plus restitution.

The Brocade executives' troubles extended to taxes. The IRS filed charges of aiding and abetting personal income tax evasion related to stock options from 1999 to 2004. On September 7, 2006, U.S. Attorney Kevin V. Ryan announced that the IRS's criminal investigation unit would join the local stock options–backdating task force. It is likely the IRS is also interested in Brocade's corporate tax return and the personal tax returns of other top executives. Publicly traded companies are limited to $1 million in tax-deductible executive compensation for each of the five highest-paid officers. While at-the-money options are excluded from the cap, in-the-money stock options generally count toward the $1 million limit. By concealing its granting of in-the-money stock options, Brocade may have deducted excess executive compensation expense on its corporate tax return, and underreported the affected employees' wages for personal income tax purposes. (For further details, see "Backdating Employee Stock Options: Tax Implications," page 24.)

Especially troubling for regulators, auditors, and investors were the criminal and civil complaints alleging that Brocade executives repeatedly postdated employment offer letters and falsified compensation committee minutes to conceal the in-the-money grants. While no laws or regulations prohibit the grant of properly authorized in-the-money employee stock options, these grants must be accurately recorded for financial reporting and tax purposes. Brocade's option-backdating scheme led to two separate restatements totaling $351 million for financial statements spanning 1999 through 2004. Aided by overstated performance, Brocade's stock price soared from May 1999's split-adjusted price of $8.06 to $133.72 in October 2000, a stunning 1,659% rise. After Brocade's restatement, the stock price fell to $3.34 in November 2005, a breathtaking 97.5% collapse.

Employee Stock Option Accounting

Financial accounting and reporting standards clearly define the appropriate accounting treatment when employees receive stock-based compensation. Examples of stock-based employee compensation plans include stock purchase plans, stock options, restricted stock, and stock appreciation rights. Since 2005, accounting principles for awards of stock-based compensation to employees have required a fair-value method of accounting for employee stock options under SFAS 123(R). Under the fair-value method, compensation cost is measured at the grant date based on award value and is recognized over the service period, which is usually the vesting period. Most options-backdating problems, however, occurred before 2005, when companies were encouraged, but not required, to record employee option grants as compensation expenses.

Under SFAS 123, companies had discretion to use the intrinsic-value method of accounting prescribed by APB Opinion 25. Under the intrinsic-value method, compensation cost is any excess of the quoted market stock price at measurement date over the employee's purchase price. Thus, compensation expense corresponds to the total dollar amount by which employee stock options are in-the-money at the time of the stock price measurement date. Because at-the-money stock options have no intrinsic value when measurement and grant dates are identical, there is no employee compensation cost to be recognized under APB Opinion 25. Furthermore, APB Opinion 25 requires compensation-cost recognition for other stock-based compensation plans, such as those with variable exercise prices or those that allow changes in the number of options granted.

The important concept of a "measurement date" for stock-option grants under APB Opinion 25 is discussed in a September 19, 2006, letter to the AICPA and Financial Executives International (FEI) from then–SEC Chief Accountant Donald T. Nicolaisen. He states that, under paragraph 10(b) of APB Opinion 25, the measurement date for determining the compensation cost of a stock option is the first date on which both of the following are known:

- The number of options that an individual is entitled to receive; and
- The option strike price (or stock purchase price).

Even if documents related to an employee-option award are dated earlier, the measurement date cannot occur until the terms of the award and its recipients are fully determined.

In most instances, determining the measurement date is not difficult because corporate governance provisions, stock option

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plans, and applicable laws specify the required granting actions that would confirm the stock option grant and establish the measurement date. Some backdating companies used incorrect stock-option measurement dates because all required granting actions were not complete. In some cases, companies awarded stock options after obtaining oral authorization from their board of directors or compensation committee, and finalized documents later. Other backdating companies delegated options-awarding authority to a manager who obtained appropriate approvals later. To be valid, the delegation of option-granting authority to managers requires specific mention in the option plan approved by the shareholders. Otherwise, the required granting actions would not be met and the measurement date would not be established until all documents were finalized.

Under accounting guidelines, stock option terms are considered unknown and subject to change until those empowered to make grants have determined, with finality, the terms and recipients of those awards. Nicolaisen's opinion was that employee stock-option award measurement dates should be delayed until all required granting procedures have been completed. If, however, facts, circumstances, and patterns of conduct suggest that the terms and recipients of a stock option award were known with finality before the completion of all required granting actions, it may be appropriate to conclude that a measurement date occurred before the completion of these actions. In summary, the facts, circumstances, and pattern of conduct must make it clear that the company considered the terms and recipients of the awards to be fixed and unchangeable on that earlier date.

SOX-Related Problems Caused by Backdating

Backdating occurs when an employee stock-option grant reflects a grant measurement date earlier than the true grant measurement date. Such misrepresentation allows the option recipient to take advantage of a lower stock price, which translates into greater profit when the option is exercised. While accounting rules allow companies wide discretion in the granting of in-the-money, at-the-money, or out-of-the-money employee stock options, backdating practices frequently conflict with employee stock-option grant procedures. Specifically, many shareholder-approved option plans permit only at-the-money grants. Therefore, the compensation committee typically lacks the authority to properly authorize an in-the-money grant. In such cases, backdating can invalidate an option award.

From an accounting perspective, backdating practices that involve the concealed award of in-the-money stock options result in misleading financial statements because employee-compensation expenses are hidden. If the amount is material, accounting principles require that any in-the-money stock options granted to employees be recorded as an employee-compensation expense. Failure to do so results in an understatement of compensation expenses and an overstatement of net income. Therefore, option-backdating practices present significant problems for corporate CEOs, CFOs, and their auditors under SOX.

SOX addresses financial accounting problems and reporting issues exposed by corporate scandals such as Enron and WorldCom. Penalties under SOX sections 302, 304, 802, 906, and 1102 are intended to deter corporate fraud. Sections 302 and 906 require corporate CEOs and CFOs to certify quarterly and annual reports filed with the SEC. With their certification, the CEO and the CFO attest to the following:

- They have reviewed the report.
- Based on their knowledge, the report is truthful and does not omit material information.
- Based on their knowledge, the financial statements fairly present, in all material respects, the financial position, results of operations, and cash flows.
- All material weaknesses in internal controls have been disclosed to the audit committee and the independent auditors. All known instances of fraud, material or not, that involve internal controls personnel have also been disclosed.
- Significant changes to internal controls subsequent to the most recent evaluation have been disclosed, including any corrective action.
- The CEO and the CFO are responsible for disclosure controls and procedures, and have reviewed those procedures within the 90 days preceding the report filing date.

These certifications were required as early as 2003, prior to the change in option accounting rules. Any executive intentionally violating the certification process is subject to severe criminal penalties. Moreover, under section 304, if a company must restate its financial reports due to material noncompliance with financial reporting requirements, the CEO and the CFO must personally reimburse the company for any bonus or incentive-based or equity-based compensation received 12 months following issuance of the financial statements. The CEO and the CFO must also disgorge any profits realized from selling company securities during that 12-month period. Sections 802 and 1102 create severe penalties for those who disrupt any official investigation of potential SOX violations.

Prior to the passage of SOX in July 2002, white-collar criminals seldom received stiff jail sentences. Under SOX, executives involved with options-backdating are personally liable for certification of false corporate financial statements. As noted previously, former Brocade CEO Gregory Reyes was convicted of conspiracy and securities fraud on August 7, 2007.

Exposure for Investors

Investors should expect backdating problems to be expensive for affected companies. As noted above, penalties may be imposed under SOX section 302 for false certifications. Investors should also expect higher fees for accounting and legal work related to correcting accounting mistakes and restating financial statements. Zoe-Vonna Palmrose and Susan Scholz ("The Accounting Causes and Legal Consequences of Non-GAAP Reporting: Evidence from Restatements," *Contemporary Accounting Research*, vol. 21, no. 1, Spring 2004) found that restatements are often associated with costly shareholder litigation. Companies involved in options-backdating scandals may be subject to class-action lawsuits alleging that financial statements were materially misstated in violation of federal securities laws. Indirect costs from correcting accounting problems and financial restatements will also be significant. Recent studies find a negative stock-price reaction and an increased cost of capital for companies disclosing poor controls over financial reporting. (See Zoe-Vonna Palmrose, Vernon Richardson, and Susan

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Scholz, "Determinants of the Market Reaction to Restatement Announcements," *Journal of Accounting and Economics*, vol. 37, no. 1, February 2004; Jacqueline S. Hamersley, Linda A. Myers, and Catherine Shakespeare, "Market Reactions to the Disclosure of Internal Control Weaknesses and to the Characteristics of those Weaknesses Under Section 302 of the Sarbanes Oxley Act of 2002," *Review of Accounting Studies*, forthcoming 2008; and Hollis Ashbaugh-Skaife, Daniel Collins, William Kinney, and Ryan LaFond, "The Effect of Internal Control Deficiencies on Firm Risk and Cost of Equity Capital," working paper, University of Wisconsin–Madison, February 2006.) Such companies are also more likely to experience costly auditor resignations. Therefore, resolving accounting and legal problems tied to options backdating promises to be a costly drain on management and corporate resources.

When options backdating involves obvious self-dealing and malicious obstruction of justice by top management, the CEO, CFO, and others may be replaced. Anticipating stock-price reactions to forced CEO departures stemming from an options-backdating scandal is made difficult by the fact that forced CEO departures are relatively rare. Most CEO successions are customary retirements that cause no significant stockholder reaction. Mark Huson, Robert Parrino, and Laura T. Starks ("Internal Monitoring Mechanisms and CEO Turnover: A Long-term Perspective," *Journal of Finance*, vol. 56, no. 6, December 2001) reported that only about one in six (16.2%) of all CEO departures represent forced departures. Because severe options-backdating problems can be expected to result in SOX violations, forced departures of CEOs are apt to result in similarly forced departures of CFOs and other members of top management. It seems likely that forced departures of CEOs and other top executives may result in a new CEO from outside the company, and the appointment of outside CEOs is far from customary. Huson, Parrino, and Starks found that 53.5% of forced CEO departures result in the appointment of an outsider as CEO.

Because options-backdating problems are most obvious when companies have experienced robust increases in stock price, investors may view forced CEO departures as both surprising and negative. Stewart D. Friedman and Harbir Singh ("CEO Succession and Stockholder Reaction: The Influence of Organizational Context and Event Content," *Academy of Management Journal*, vol. 32, no. 4, December 1989) studied CEO succession and found that stockholder reactions to CEO replacements tend to be positive when the company's prior performance was poor and the board of directors was responsible for initiating the replacement of a poorly performing CEO. CEO departures that occur following good company performance tend to have modestly negative stock market repercussions, as do unplanned CEO departures due to death or disability. In short, immediate negative returns are apt to reflect a one-time deadweight loss from accounting fees, legal expenses, and potential civil sanctions. There appears to be little reason for shareholders to fear long-term damage.

The Fallout of Backdating

At this point, the full scale and ultimate ramifications of the developing option backdating scandal are not yet known. According to Steve Stecklow and Peter Waldman ("Brocade Ex-CEO Found Guilty in Backdating Case—Criminal Trial Victory for U.S. Likely to Serve as Model for Prosecutors," *Wall Street Journal*, August 8, 2007): "Some 140 companies have come under federal investigation for backdating, and about 70 executives have lost their jobs as companies conducted internal probes." Scores of other companies have undertaken or disclosed internal probes. Even more companies have been implicated on the basis of circumstantial statistical evidence (see Randall Heron and Erik Lie, "Does Backdating Explain the Stock Price Pattern Around Executive Stock Option Grants?," *Journal of Financial Economics*, vol. 83, no. 2, February 2007).

Although external auditors are not yet the clear focus of popular outrage, the fallout from the backdating scandal will likely affect them as well. By definition, most backdating activities have included creating fraudulent documentation designed specifically to deceive external parties. While frauds involving high-level collusion are notoriously difficult for auditors to discover, the public maintains an expectation that auditors are at least somewhat responsible for identifying such illicit activities.

The outrage over backdating will likely influence future regulatory policies as well. In December 2006, the SEC issued an interim rule (SEC Release 33-8765, "Executive Compensation Disclosure") adjusting certain option disclosures from grant date to vesting date. According to the SEC, the purpose of the change is to avoid exaggerating compensation and to more closely track the compensation expense mandated under SFAS 123(R). Absent backdating, such a modification would likely have been unremarkable. In the current environment, however, the change has outraged both commentators and legislators, who perceive it to be a relaxation of disclosure rules at a time when corporate officers appear to need more, not less, oversight.

There is also speculation that attempts to relax some of the more onerous provisions of SOX will be slowed by these backdating activities. A key argument of those who propose rolling back SOX is that only a few companies and bad actors were responsible for the earlier wave of accounting scandals. Backdating activity, however, appears to be widespread, and criticism can be expected to grow as investigations continue.

It is ironic that all this havoc was created trying to conceal what can be a perfectly legal method of compensation. Had the companies in question appropriately acknowledged the grants of in-the-money options and recorded the noncash expense, there would be no scandal. Indeed, the coverup is often worse than the crime. ❑

***Raquel Meyer Alexander, PhD,** is an assistant professor; **Mark Hirschey, PhD,** is the Anderson W. Chandler Professor of Business; and **Susan Scholz, PhD,** is an associate professor and the Harper Faculty Fellow, all in the School of Business of the University of Kansas, Lawrence, Kan.*

Note: Alexander's article "Tax Shelters Under Attack" (coauthored with Randall K. Hanson and James K. Smith, The CPA Journal, *August 2003) received an Honorable Mention in the area of taxation in the Max Block Outstanding Article Award program for 2003.*

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