



# Financial Reporting

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What companies need to know to cope with the wide range of situations and issues that can arise when conducting investigations into possible backdating of stock options.

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## SEC Staff Addresses Possible Restatements due to Backdating of Stock Options

**Timely guidance from the Office of the Chief Accountant sheds light on the accounting issues that can arise when investigating past practices.**

As one of his first official acts, SEC Chief Accountant Conrad Hewitt took aim at the accounting issues involved in the backdating of stock options. In a letter addressed to the Committee on Corporate Reporting of Financial Executives International and the AICPA's Center for Public Company Audit Firms, Hewitt explained the staff's views on the accounting consequences of various stock option granting practices.

The guidance covers a variety of situations. Examples:

- What if a company finds options were dated prior to the actual award?
- What if the individual award recipients were not all known at the time of the award?
- What if a company can't find its documentation for past awards, or the documentation is incomplete?
- What if a company discovers evidence that calls into question the validity of some of its past awards?

These situations can require considerable judgment. Early consultations can help. If your company finds any indication that past stock option awards may have been backdated, the most prudent plan of action is to immediately consult with your legal counsel and your independent accountant.

The letter is available on the SEC's web site at [http://www.sec.gov/info/accountants/staffletters/fei\\_aicpa091906.htm](http://www.sec.gov/info/accountants/staffletters/fei_aicpa091906.htm).

## Assessing Errors in Accounting for Options

**The SEC staff has indicated they won't be overly obsessive about legalistic analysis or record-keeping matters, unless there is evidence of abusive or opportunistic practices.**

The backdating of stock options has been very much in the public spotlight, prompting many companies to launch investigations into their own past practices, both governance and financial reporting. To their dismay, some have discovered that digging into old files can reveal troublesome and/or time-consuming accounting and reporting issues.

### Why are regulators looking so far back?

Lookbacks to several years ago are common because the risk of backdating was greater before the Sarbanes-Oxley Act of 2002 (SOX) introduced stricter financial reporting requirements.

- Prior to August 2002, option grants to officers and directors did not need to be reported to the SEC until 45 days after the close of the fiscal year during which the options were granted.
- Starting in August 2002, option grants to officers and directors must be reported within two days of the date they are granted.

The lookbacks are complicated by the use of old accounting standards. In the pre-SOX period when most backdating issues arose, the vast majority of registrants accounted for options using the now superseded accounting standard, APB Opinion No. 25, *Accounting for Stock Issued to Employees*. In response to the accounting questions raised by lookbacks, the SEC staff's letter predominantly addresses questions that pertain to Opinion 25.

### The two key questions to ask

When assessing whether a company made errors in applying Opinion 25, the SEC staff has identified two key questions that need to be asked:

- (1) Did the company accurately determine the measurement dates for its past awards of stock options?
- (2) If errors were made in determining those dates, what triggered the errors?

Signs of abusive or opportunistic practices, (e.g., errors that were intentional or the result of too much managerial discretion), are weighed heavily in the determination of whether restatements are required.

### What is the measurement date, and why is it so important?

Opinion 25 defined the measurement date as the first date on which the following two pieces of information are known: (a) the number of shares that an individual is entitled to receive, and (b) the option or purchase price, if any. The letter from the SEC staff emphasizes that both pieces of information must be known *with finality* to establish a measurement date.

The measurement date was generally, but not always, the grant date under Opinion 25. An accurate determination of the measurement date is critical under this standard because the calculation of compensation expense is based on values set or observed as of that date, (i.e., companies were

required to recognize compensation expense if the company's share price exceeded the exercise price of options on the measurement date).

Despite its apparent simplicity, the definition of the measurement date under Opinion 25 can raise contentious issues because a difference of just a few days can have a significant effect on the company's financial statements if there are significant variations in the price of the stock during those days.

### Red flags: What are the possible signs of a faulty measurement date?

Tell-tale signs of faulty measurement dates include the following:

- Evidence that the company extended the grant date through the use of administrative delays, while management retracted or changed the terms of awards.
- Missing or incomplete documentation of the grant date, combined with other factors that indicate patterns of abusive or opportunistic practices.

Depending on the facts and circumstances, other possible warning signs include:

- Reliance on allocations (rather than identities of individual employees) to determine the measurement date.
- Use of the dates on which grants were made by unauthorized personnel prior to formal approval by authorized directors.
- Evidence that options were granted on the date an employee accepted a job offer prior to the date his or her employment commenced.
- Evidence that options were never validly issued, (meaning there never was a valid measurement date).

## The need for restatements in seven key scenarios

The letter from the SEC staff analyzes a variety of situations that raise questions about the appropriateness of the measurement date used for accounting purposes. Following are seven key scenarios.

### **Scenario No. 1: What if documents related to an award were dated prior to the actual award?**

In digging through its past records, a company may find that some underlying stock option grant documents related to an award are dated prior to the actual award.

*Analysis by SEC staff.* The measurement date doesn't occur until the terms of the award and its recipients are actually determined or known. If the company used the dates on the documents as the measurement date, that was an error.

### **Scenario No. 2: What if there is evidence that the company extended the grant date through the use of administrative delays?**

A review of past practices may show that the company used an earlier measurement date than would otherwise be indicated on the grounds that all the terms and recipients were finalized and any time lags were due solely to administrative delays.

A common example might involve a time lag between oral approval by the board of directors and final paperwork. Another example is a delay in the ratification of a decision made by an authorized individual acting within established parameters.

*Analysis by SEC staff.* Companies with these questionable measurement dates should consider their overall experiences spanning a number of years and the consistency of their practices across different groups of

employees and categories of awards. The objective is to determine whether the administrative delays were used to provide undue discretion in managing awards.

Although the SEC staff states that each situation will be judged on its own facts and circumstances, there are some factors that are likely to draw scrutiny. Most notably, if the company's track record shows a pattern of retracting or changing the terms of awards, then the measurement date probably is the date when all granting requirements were fully met.

### **Scenario No. 3: What if investigations into past option grants call into question the validity of some awards?**

Some companies may uncover circumstances that call into question the validity of prior awards based on legal or governance restrictions in place at the time of the grants. For example, the compensation committee may have lacked the authority to make a certain type of award, or the needed board of directors' approval may not have been obtained.

*Analysis by SEC staff.* In these situations, the staff believes that questions about the appropriateness of the measurement date should be based on the underlying economic substance of the past options. In some cases, particularly those involving grants to senior officers who were involved in the option granting process, there may be uncertainty about whether the company will honor the grants. In these cases, further analysis is required to determine the proper accounting.

The general guideline for awards made to rank-and-file employees is that as long as the company has been honoring the awards and settling them in stock and it has the ability and intent to continue to do so, the grant date probably is the measurement date.

The SEC staff's view on the issue of potentially invalid awards to rank-and-file employees is a welcome sign that they intend to take a practical and common sense approach to assessing the intent of the parties, rather than a narrow, legalistic approach.

**The SEC staff's views are a welcome sign that they intend to take a practical and common sense approach.**

### **Scenario No. 4: What if the measurement date was set despite uncertainty over individual award recipients?**

The waters get murkier when companies find that measurement dates have been set at award approval dates despite uncertainty over individual award recipients.

*Analysis by SEC staff.* The staff's position indicates the key factors to consider here are: (1) the amount of discretion given to management to change the allocations to individual employees after the approval date, and (2) the reasons for any changes in allocations subsequent to the preparation of the initial list at the award approval date.

Here, too, the SEC staff has taken a common sense approach. If management had the discretion to determine the number of options awarded to each employee subsequent to the approval date, then the measurement date should be the date those allocations were finalized, not the date the award was approved. However, if a portion of the allocation was specified at the time the award was approved, then the measurement date can remain at the date of approval for that portion.

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### **Scenario No. 5: What if the documentation for past awards is incomplete or cannot be located?**

One of the most frustrating situations for many companies is the one in which past awards were not properly documented, or the proper documentation can no longer be located for awards made years ago.

Possible causes and characteristics of this situation include the following:

- The legal documents evidencing past grants do not exist in the company's records.
- Contemporaneous documentation was not prepared for a meeting or conference call of the compensation committee.
- Written documentation includes only "as of" dates, not the dates the documentation was actually prepared and approved.
- The company may have reason to believe the documentation is not accurate.

*Analysis by SEC staff.* In these situations, the SEC staff believes that companies must use all available relevant information to form a reasonable conclusion as to the most likely option-granting actions that occurred and the dates on which these actions occurred.

The relevant information should include any discernible patterns that might indicate an intent to manipulate the economics of the awards. For example, a pattern of issuing options with an exercise price equal to or near the lowest price of the entity's stock during the time period surrounding those grants could indicate that the terms of those grants were determined with hindsight.

On balance, the SEC staff's position reflects an emphasis on discretion and intent rather than record-keeping. Had the staff wanted to keep the focus on record-keeping, they could have taken

the position that an absence of complete documentation would result in a "default" to treating the exercise or expiration date as the measurement date, requiring "variable accounting."

As the SEC staff continues to consider the need for restatements in these and other situations, they encourage companies and their independent accountants to discuss the particular facts and circumstances with the Office of the Chief Accountant.

### **Scenario No. 6: What if the measurement date for awards to new employees was set prior to the start of their employment?**

It is not uncommon for companies to grant options to new employees at the commencement of their employment. Lookbacks at prior years indicate that some companies determined the terms and conditions of awards to new employees at the time the company extended them offers of employment.

*Analysis by SEC staff.* In these cases, the appropriate accounting depends on whether the employee provided services to the company prior to his or her employment. If the individual did not provide services as a non-employee, then no measurement date should occur prior to the date his or her employment commenced.

### **Scenario No. 7: What if options were granted just before releasing favorable news or just after releasing unfavorable news?**

The search for discernible patterns of past practice may indicate that the company has made grants either just before releasing favorable news or just after releasing unfavorable news.

*Analysis by SEC staff.* The measurement date is the date when the terms are known with finality. Opinion 25 clearly states that compensation should be measured based on the unadjusted market price of the stock on that date.

## Additional situations

The letter from the SEC's Office of Chief Accountant also examines other situations, (e.g., those involving an exercise price set by reference to a future market price, changes to option grants due to release of new information, and income tax benefits related to option exercises).

**Companies are encouraged to discuss their particular facts and circumstances with the Office of the Chief Accountant.**

## Guidelines on restatements when accounting errors exist

The letter provides guidance on what companies should do if they determine that they have used the wrong measurement dates for some past option grants.

*Analysis by SEC staff.* If accounting errors exist, a company needs to assess the materiality of the errors on all affected financial statements. Because compensation expense for most options is recorded over an extended period, errors in measuring compensation likely will affect multiple quarters and years. Materiality should be assessed using both quantitative and qualitative factors. The staff notes that deliberate errors are qualitatively more material than unintentional errors.

If financial statements are materially misstated, they should be restated by amending the affected past filings. Companies that propose to amend only their most recent filings, rather than all affected filings, are directed to consult with the staff of the Division of Corporation Finance.

### Other potential consequences

The SEC staff's letter focuses on the accounting consequences of any possible backdating of options, including the need for restatements of prior errors when the effects are material.

Other possible consequences include the following:

- The pro forma disclosures pursuant to FASB Statement No. 123 may have been incorrect, and the company may need to revise its footnote disclosures for prior periods.
- Errors in accounting for stock options or opportunistic timing of option grants can call into question the integrity of a company's management and directors and adversely affect the auditors' reliance on management representations.

- Invalid options that don't comply with plans approved by shareholders can expose the CEOs and CFOs who signed certification letters to civil or criminal sanctions.
- Executives and directors who are suspected of manipulating stock option practices in an effort to obtain compensation windfalls can find themselves named in securities action lawsuits.
- Companies that find backdating issues too time-consuming and distracting may be delisted from stock exchanges if they don't file their financial statements on time.
- Tax deductions may be limited for options granted to officers listed as among the top five in the proxy statement.
- Companies can also be subject to penalties for failure to withhold taxes upon exercise of options.

Considering the severity of the potential consequences, attorneys have advised companies to take the initiative and conduct their own investigations. Even with the benefit of the SEC's analysis, the findings from these investigations can require considerable judgment to assess the full range of implications.

**Even with the benefit of the SEC's analysis, considerable judgment may be required.**

### How BDO Seidman can help

Early consultations can help. If your company finds any indication that past stock option awards may have been backdated, the most prudent plan of action is to immediately consult with your legal counsel and your independent accountant.

## SEC Insights: Backdating of Options

*A Financial Reporting letter*



### For More Information

If you would like further information or to discuss the implications of the matters discussed in this Financial Reporting letter, please contact the BDO Seidman engagement partner serving you or one of the following partners: Ben Neuhausen or Wayne Kolins.

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Material discussed in this *Financial Reporting* letter is meant to provide general information and should not be acted upon without first obtaining professional advice appropriately tailored to your individual circumstances.

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