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In-House News:

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By Jen Woods

Companies consistently backdate stock option grants, which may cost shareholders hundreds of millions of dollars, according to the findings of a recent study.

Backdating, or misdating, is a process that allows corporate executives to increase their personal earnings at the expense of their shareholders. Researchers at the University of Michigan estimated that stock option backdating between 2000 and 2004 increased the average executive's income by more than one-and-a-quarter percent, or about $600,000.

The findings, published in the Michigan Law Review, come at a time when stock option scandals are increasingly prevalent. Today more than 100 companies, from small start-ups to prominent corporations like Apple Computer, Inc., are being investigated by the government or are conducting their own internal reviews. Some executives are facing criminal charges, and dozens of companies have been forced to restate their earnings or prepare for new tax bills.

There are a number of rules that must be followed when granting stock options. Many of the regulations focus on whether or not stock options are issued at less than fair market value at the time of the grant.

Most stock option backdating is unintentional and occurs because of sloppiness, rather than fraudulent intent. This can happen if documents are not recorded properly or accurately, if compensation committee meetings are held without adequate preparation, or if other procedures are handled too casually. The U.S. Securities and Exchange Committee (SEC) has distinguished unintentional backdating from intentional backdating, but it is unclear whether auditors will be able to avoid restating earnings.

Backdating can also occur if companies are not well-educated on the rules regarding stock options. Procedures are sometimes set up under the notion that they are permissible, when, in fact, they are not.

Blatant backdating occurs when the compensation committee offers the stock option when the price is lower in order to give the executive an extra benefit. While this practice is legal, it must be accounted for as a discount option that generates a charge to earnings. It must also be disclosed in several public filings. Since this practice is likely to lead to serious issues with the SEC and the Department of Justice, it is generally not a common practice.

The most difficult type of backdating to address occurs when there is no documentation. This is when all of the procedures are followed, but the compensation committee does not keep a record of the meeting date and the grant.

Another grant option practice is known as springloading, or bullet dodging. Grants are sometimes issued in advance of good news, after expected bad news, or when a price is artificially low because of market conditions or for other reasons. Depending on whether or not the compensation committee has all of the same information as the executive, the company may not be in violation of insider trading. The SEC is currently reviewing such situations to determine whether the practice is illegal.

If backdating occurs, many issues must be addressed. One of the biggest concerns is whether the proper expensing of the discount option is material to the prior financial statements. If it is, then the financial statements have to be restated. Until they are restated, the financial records on file with the SEC are no longer considered current, and the S-8 registering shares are no longer valid. Also, certain types of equity-based grants may be limited, transfers of employee equity in employee benefit plans can't take place, and executives may not sell their companies' shares.

Even a nonmaterial discount can result in the loss of a tax deduction, trigger the issuances of amended W-2s to employees, require employees to file amended tax returns, and require financial statements to be restated.

Several investor groups, including the Council of Institutional Investors, the New York City Pension Funds, and the Connecticut Retirement Plans and Trust Funds, have petitioned the SEC for enhanced disclosure on corporate stock option grant practices. In response, the SEC has promised to address backdating issues when it adopts its final executive compensation disclosure rules. The SEC's new requirements will force all companies to examine their stock option administration procedures and disclose their award policies.

On the Net

U.S. Securities and Exchange Commission (SEC) www.sec.gov

Michigan Law Review
students.law.umich.edu/mlr/first_impressions.htm

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