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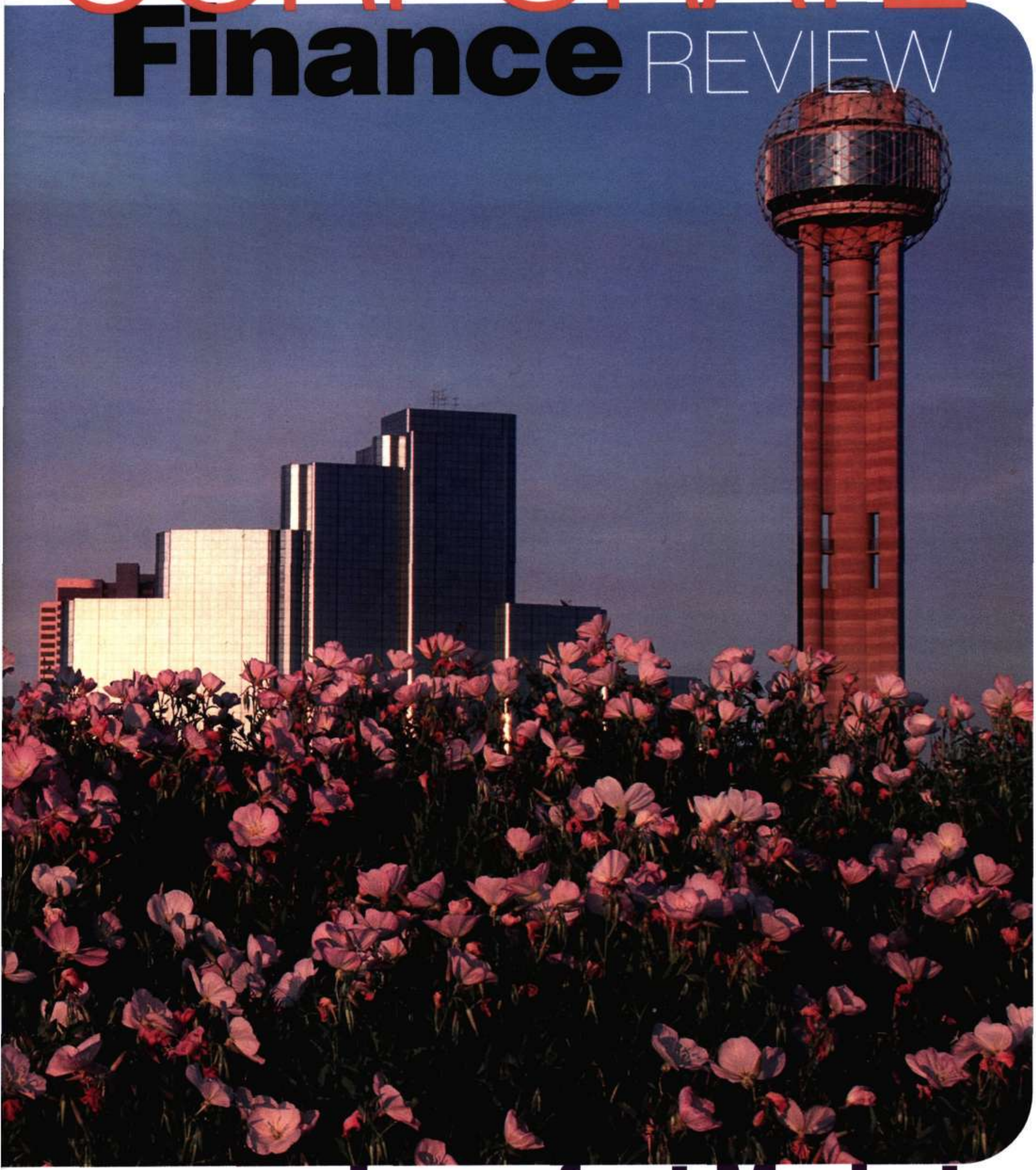

Imperfect Market
or Imperfect Theory?

Is Equity Pricing for Newly Public Firms Related to Real Changes in Value?

Time Travel: Backdating Stock Options

CORPORATE Finance REVIEW

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TIME TRAVELERS: BOARDS BACKDATING STOCK OPTIONS

Time travel — we're all fascinated with the fantasy of being able to travel back and forth in time. Imagine whisking back in time to correct mistakes or fast-forwarding to watch the events of your life in 2026. In the 1985 movie *Back to the Future*, slacker teen Marty McFly is transported back to 1955 in a dilapidated DeLorean time machine created by mad scientist Doc Brown. Of course, this is all fiction. Or is it?

According to prosecutors and corporate governance experts, more than 100 public company CEOs and boards may have figured out a form of time travel with huge financial windfalls for the lucky travelers — and no fancy machines were needed. With the scratch of a pen or a few clicks on a keyboard, hundreds of millions of dollars were allegedly shifted around in time. This is fraud, says the Securities and Exchange Commission (SEC), if improperly disclosed (or not disclosed at all).

"This" is the practice of backdating lucrative executive stock options — the latest corporate scandal that emerged in March with a *Wall Street Journal* page-one story and gathered momentum all summer. Here are the basic facts as of the end of summer 2006:

Professor Erik Lie, an academic at the University of Iowa's Henry B. Tippie College of Business published a journal paper in May 2005 (in *Management Science)* expressing the view that company boards were approving stock options for senior executives that were intended to be pay-for-performance but were more often deliberate manipulations of grants for the purpose of maximizing CEOs' rewards. In his summary, Professor Lie wrote, "This study documents that the abnormal stock returns are negative before unscheduled executive option awards and positive afterward____predicted returns are abnormally low before the awards and abnormally high afterward. Unless executives possess an extraordinary ability to forecast the future . . . the results suggest that at least some of the awards are timed retroactively."[1]

By shifting grants to dates when the share price of the grant was most favorable (i.e., back to a lower-priced date), the executives enjoyed more profits. By not disclosing these facts, the companies (and individuals involved) may have subjected themselves to accounting, tax, and criminal fraud consequences. Bad news for a growing number of well-known firms. How widespread was the practice? Significant, judging from the statements of experts.

The *Wall Street Journal* picked up Professor Lie's study and made it front-page news (March 2006).[2] The SEC tuned in immediately and began investigating a small number of companies (as a first step). (Professor Lie provided the paper to the SEC two years ago, but it was ignored until the *Journal's* story.)

The logic of Lie's study, entitled "On the Timing of CEO Stock Option Awards," was simple: Looking at reams of data for 5,977 CEO stock options from 1992 through 2002, he determined that 1,688 were "unscheduled" and 1,426 "scheduled" — and "abnormal" stock returns occurred around both types but were much more pronounced around the former, indicating the manipulation of grants by boards and some CEOs.

The *Wall Street Journal* editors saw the results as proof of a contrived "perfect payday" for CEOs and have since kept up a drumbeat of coverage around the theme of "companies under scrutiny for options," including publishing an online "Options

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WE COULD SEE AN EPIDEMIC OF CORPORATE RESTATEMENTS OF EARLIER RESULTS—WHAT MIGHT THE IMPACT ON THE MARKET BE?

Scorecard" with details about specific companies.[3] The SEC began immediate investigations into at least a half dozen companies. Federal prosecutors weighed in. Grand juries were convening and companies were under the microscope. Other media sniffed *scandal* and began their own enterprising coverage.

With the passage of the Sarbanes-Oxley Act in July 2002, a wide range of corporate governance reforms were launched—including new listed company rules for the 6,000+ companies on the NYSE and NASDAQ exchanges (both self-regulating organizations) that required corporate disclosure of stock option grants within forty-eight hours of board action.

As the media coverage of the initial backdating issue broadened, Professor Erik Lie and colleague Professor Randall Heron were completing *another* peer-reviewed study, to be published soon in the *Journal of Financial Economics.* In an unusual step, the professors posted this study on a University of Iowa website in July, before journal publication.[4] This second study looked at forty-eight-hour filing data in the Thomson Financial Insider database—which uses as its sources SEC forms 3, 4, 5, and 144—from August 29,2002 to November 30,2004. They found that when option grants were required to be disclosed within forty-eight hours, there was no immediate increase in the value of the grant. Original suspicions seemed to be verified. Media coverage intensified; so did regulator and prosecutor interest. (The pair looked at 39,888 stock option grants at 7,774 companies.)

Before August 29, 2002, when the SEC approved the forty-eight-hour disclosure rule, up to 30% of companies were backdating unscheduled grants; after this date, the number declined to 10%.

The SEC has reportedly been looking at options grants at more than 100 companies; and "hundreds more companies," according to the *The Economist,* "are quietly conducting internal inquiries to see whether their option-granting processes were up to scratch."[5]

The SEC does not prosecute in criminal cases; these are turned over to the US Department of Justice. The Department of Justice investigation is centered in the Northern District of California (San Francisco), which now has a "Stock Options Backdating Task Force" that is "aggressively investigating" dozens of companies—especially firms in Silicon Valley, long a center of focus for the office under the direction of US Attorney Kevin Ryan. In the announcement of federal investigations, Attorney Ryan explained, "We will investigate whether individuals and companies may have deliberately backdated stock options with the intent to defraud. It is integral to the public trust in our financial markets that books and records are maintained honestly, and that the true financial condition of public companies is disclosed accurately. . . . We will evaluate the facts of each case, and we will bring criminal charges when appropriate."[6]

Stay tuned to the spreading stain of the options backdating "scandal." The actions to come will include high-profile criminal prosecutions; dramatic print headlines; biting comments of TV talking heads about "more" errant corporate behavior; a run of pronouncements from regulators and prosecutors spotlighting individual companies; drafts of bills out of Congress; banks and lenders looking at the impact on loan covenants; delayed financial filings by a growing number of companies; and stepped-up requirements for disclosure from the SEC. We could see an epidemic of corporate restatements of earlier results—what might the impact on the market be?

All these forces and more will continue to drive this issue toward major scandal status and will have varying effects on the companies involved. Already, a number of senior executives have left companies, and plaintiff law firms are chatting up major shareholder lawsuits. Large public employee pension funds have begun filing lawsuits over stock options' timing issues. Directors' and officers' insurers are looking at "exclusions" for certain past actions if lawsuits are filed. Executives and companies are exposed to tax consequences as well.

Stay tuned to more experts weighing in. The analysts at Audit Integrity—a risk management consulting organization specializing in corporate accounting and governance fraud—accessed a database of 9,000 US public companies and found that an analysis of 50+ public companies named in the *Wall Street Journal's* online "Options Scorecard" showed these common characteristics: (1) persistently aggressive accounting behaviors; (2) frequent unusually high levels of insider selling; (3) unusually high levels of options exercised; and (4) unusually high short-term compensation practices. Looking at these four "tests," 60% of companies in the *Journal's* scorecard failed three or more and 82% failed two or more.

Audit Integrity says its analytical tools now indicate that more than 500 companies are likely to be cited for backdating options in the current investigations, based on predictive corporate behaviors. The company is circulating a list of specific firms to its clients, including investors and analysts—"Companies at Increased Risk for Stock Option Backdating." More experts will be weighing in with their own analyses as the scandal unfolds.

Stay tuned to the SEC. In July, it issued guidelines to expand executive compensation disclosure (proxies filed after December 14 will have to include "total" compensation for the five highest paid top executives in one chart). More stringent standards could be in the works if the scandal engulfs a large number of brand-name companies. The timing and pricing of options will have to be disclosed in greater detail. Companies that mislead or fail to disclose will face enforcement action.

Stay tuned to the Public Company Accounting Oversight Board (PCAOB) instructions on the treatment of options to public company auditors. Any guidance issued by the PCAOB on options accounting practices will have broad impact on public companies of all sizes. (The SEC told the PCAOB that it wants to focus on the future, not on auditors reviewing past practices.)

Stay tuned to the Internal Revenue Service looking at a growing list of companies' tax filings; the difference between taxation at the corporate gains rate and for ordinary income could mean millions of dollars in tax levies and penalties for CEOs involved in backdating practices. Companies could have to disgorge tax benefits.

Stay tuned to Professor Erik Lie, who started all this. His research continues.[7] In his latest paper, written with Professor Heron, the projection is that up to 30% of firms manipulated grants to top executives between 1996 and 2005. The paper concludes as follows: "To eliminate backdating, it appears that the requirements need to be tightened further, such that grants have to be reported on the grant day or ... on the day thereafter. In addition, the SEC naturally has to enforce the requirements."[8] Watch for these arguments to gather steam as the stain of the scandal spreads to involve more companies, resulting in more prosecutions, more media headlines, and probably more action by the SEC and/or Congress. •

NOTES:

1 E. Lie, "On the Timing of CEO Stock Option Awards," *Management Science* (Vol. 51, No. 5, May 2005): 802-812.

2 C. Forelle and J. Bandler, "The Perfect Payday," *Wall Street Journal* (March 18, 2006): A1.

3 The *Wall Street Journal's* online "Options Scorecard" is available at http://online.wsj.com/public/resources/documents/info-optionsscore06-full.html.

4 R. Heron and E. Lie, "Does backdating explain the stock price pattern around executive stock option grants?" *Journal of Financial Economics* (forthcoming).

5 "Dates from hell: The scandal over backdated share options goes from bad to worse," *The Economist* (July 20, 2006), available at http://www.economist.com/business/PrinterFriendly.cfm?story_id=7194711.

6 The Department of Justice's July 13, 2006 press release is available at http://www.usdoj.gov/usao/can/press/2006/2006_07_13_Stock%20Options%20Local%20TF.htm.

7 Professor Erik Lie's research papers can be viewed in their entirety at http://www.biz.uiowa.edu/faculty/elie/research.asp.

8 Heron and Lie, op. cit. note 4, page 30.

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Statistical accounting and governance analysis from Audit Integrity is available at www.auditintegrity.com. For views and excellent reference materials, see Pearl Meyer & Partners at www.pearlmeyer.com. The company's August webcast on final SEC compensation disclosure rules and related materials is available at www.pearlmeyer.com/finalsecwebcast. Advice from SEC's Office of the Chief Accountant on proper accounting for options is available at http://www.sec.gov/news/press/2006/2006-156.htm.