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# Option Price Backdating Appears Widespread

▶ A new study titled “Lucky CEOs” presents the investigation of the opportunistic timing of stock option grants from 1996 through 2005 using regression analysis and other statistical methods. The results of the analysis are astounding, and they indicate that the

ethics and governance reforms initiated by the Sarbanes-Oxley Act (SOX) may need to be strengthened, rather than weakened, which many corporate critics have demanded of the Securities & Exchange Commission (SEC) and Congress. The authors—Lucian Bebchuk, a Harvard Law School professor; Yaniv Grinstein of Cornell University; and Urs Peyer of INSEAD—believe that manipulative grants were more prevalent in corporations where SOX reforms were most necessary—those that had a minority of independent directors and/or where the CEO had longer tenure.

The study identifies possible opportunistic manipulation of dates on which option grants were priced. “Lucky grants” were defined as grants that were priced at the very lowest of the price distribution in the month granted. Of the nearly 20,000 un-

scheduled option grants that were made by about 6,000 firms during the 10-year period, the study estimates that 2,330 grants (12.2%) fit the definition of “lucky.” Of this number, about 1,160 (49.8%) are estimated to be associated with the manipulative backdating practice. The authors conclude that the pricing manipulations resulting in lucky grants were substantially due to backdating rather than the practice of spring-loading based on inside information. Backdating took place both before and after the enactment of SOX.

The authors found that approximately 42% of the lucky grants were actually “super-lucky,” which they define as grants priced at the lowest price during the calendar quarter in which they were awarded. Of these, the authors estimate that about 62% of them were the result of price manipulation. An interesting finding is

that lucky grants seemed to be concentrated in some companies. The likelihood that a company would award a lucky grant was nearly twice as great for a company that had previously awarded one compared to companies that had not.

The authors found no evidence to support the widely held belief that companies providing backdated options reduced compensation paid through other means. On the contrary, total reported compensation from normal sources was higher for firms awarding lucky grants than for those that didn’t. Further, in contrast to the common impression that grant price manipulation was largely concentrated in new economy firms, the practice appears to be widespread in old economy firms as well. A majority of the estimated manipulated lucky and super-lucky grants were awarded by old economy firms, reflecting the larger number of old economy companies. This finding seems to conflict with evidence from disclosures of actual grant pricing difficulties, which is discussed next.

The average gain from the lucky grants was more than 20% of the reported value of the grant, increasing the CEO’s reported compensation

for the year by more than 10% on average. In summary, with significance at the 1% level, the study showed that lucky grants were:

- More common when the CEO had a preceding grant that was lucky;
- Less frequent in companies whose board of directors contained a majority of independent directors;
- More frequent among CEOs with longer tenure and larger ownership stakes;
- More frequent among new economy firms;
- More frequent among smaller firms;
- Less frequent after SOX was adopted; and
- More frequent when the stock price was volatile during the month.

It seems evident that only vigorous enforcement action by the SEC and Department of Justice (DOJ) will allow the governance reforms contained in SOX to achieve their objectives and be effective. Any attempts to weaken SOX provisions or reduce their enforcement effort are misguided.

As of this column's writing, *The Wall Street Journal Online* (WSJ) Options Scorecard lists 133 companies that have come under scrutiny for past stock option grants. The companies listed have all made public disclosures involving government probes by the SEC or DOJ, the existence of misdated options, restatement of a financial statement to correct expense recognition of option grants, and/or departures of executives because of option practices. Most companies listed have disclosed activity in more than one of the four categories. A number of CFOs have announced their resignation or retirement as a result of stock option pricing probes. The WSJ notes that some companies may not be includ-

ed on the Scorecard if they undertook or disclosed internal probes without providing any further detail.

Of companies listed on the Scorecard, 41 (30.8%) are in the *Fortune* 1,000, 18 (13.5%) are in the *Fortune* 500, and four (3%) are among *Fortune's* 100 largest. Among the *Fortune* 1,000 companies listed, 20 (48.8%) are in computers, software, IT services, or semiconductor and other electronic components. The names of companies and WSJ commentary indicate that a significant number of the smaller companies are in similar fields, which appears to conflict with the findings of the Harvard study. Silicon Valley companies have been the most active in opposing the expense recognition of stock option grants, so it seems logical that they would continue to try to push the limits of GAAP. Seven of the 41 companies listed (17.1%) on the Scorecard, however, are specialty retailers and certainly not new economy firms.

The most frequently disclosed evidence of government enforcement activity in options pricing was the 100 cases of SEC inquiry or formal investigation, representing 75% of the companies on the Scorecard. About 29% were companies in the *Fortune* 1,000. DOJ district attorney activities involved 52 companies, roughly half the number of SEC probes. Twenty of those (38.5%) involved *Fortune* 1,000 companies. There were 71 instances of financial statement restatement or disclosure of special charges for additional recognition of stock option expense. Nineteen (26.8%) of these were *Fortune* 1,000 companies.

Observers of the widespread phenomenon of backdating grants and awarding lucky or super-lucky grants are asking several questions, includ-

ing: Why weren't the internal control improvements and ethics and compliance provisions mandated by SOX more effective in preventing or detecting these unethical actions earlier? Perhaps future research will show that too many companies adopted a rules-based legalistic code of conduct in response to SOX instead of a principles-based program to inculcate an ethical culture in the organization.

Questions must be raised about the ethics of using GAAP-oriented measures that provide management with opportunities to bend the rules in order to manage quarterly earnings and, thus, maximize the value of their compensation from options. Questions must also be raised about the involvement (or lack thereof) of the internal and external auditors. For instance, in the *Accounting Today* article, "The Option Dating Game: It's Bad Ethics All Around," Paul B.W. Miller and Paul R. Bahnson speculate that external audit firms may have communicated this "opportunity" to their clients, adding, "We have substantial concern that the idea [of backdating] may have been conceived by somebody's auditor and then passed on to other clients." And, finally, why was the oversight provided by audit committees and boards of directors inadequate?

We must also wonder what the next ethical scandal will be. ■

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