

Forensic Evidence-Gathering Procedures for Employee Stock Options

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Employee stock options (ESOs), as an integral component of long-term compensation plans, are usually offered to directors, senior executives, and key personnel to align their interests with those of shareholders, provide incentives to improve sustainable performance, and retain productive directors, officers, and employees. The value of ESOs is a function of the underlying stock, which is typically influenced by the company's long-term performance. Relaxing some restrictions of ESOs, such as the vesting period specified in the option grant, early termination, and transferability, could increase the option value. Alternatively, the timing of option grant dates could be managed in a manner to increase the potential value of ESOs which would have significant governance, legal, ethical, tax, and accounting consequences. The Securities and Exchange Commission (SEC) is closely scrutinizing option backdating practices as more than 120 cases are being investigated. This investigation is expected to intensify as: "The SEC staff has stated that it views options backdating cases as accounting fraud/disclosure matters, particularly given that the backdating resulted in the under-reporting of compensation expense and that correcting the misstatements has required a number of companies to restate their financial statements."¹

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¹ PricewaterhouseCoopers (PwC). 2007. PwC Advisory Crisis Management: 2006 Securities Litigation Study (May). Available at: 10b5.pwc.com/PDF/070918%20SEC%20LIT%20STUDY%202006_FINAL_66948_V2_CT.PDF.

Managing the timing of an option grant date can be accomplished in three ways: the backdating practice of retroactively setting the grant date as the day when the underlying stock price was low; the spring-loading practice of setting the grant date shortly before disclosing good news, or withholding good news until after options are granted; and the bullet-dodging practice of setting the option grant date shortly after bad news is reported. Any of these practices can lead to misstatements in financial statements, but backdating schemes have come under the most scrutiny by federal authorities, investors, and the media. The number of companies implicated for their backdating practices is 264 as of April 16, 2007, and grows daily.² Sidebar 1 summarizes the option backdating probes and attributes of these 264 implicated companies. The question being asked is: “Is it within the scope of the audit to examine all legal documents to determine the legitimacy and accuracy of grant dates of ESOs?” If the answer is yes, then why did independent auditors not find false grant dates? Forensic accountants and particularly forensic departments within public accounting firms can be of significant help in addressing these questions and gathering and assessing evidence to substantiate the legitimacy of their client’s option backdating practices.

The wave of recent backdating practices and related probes has for the second time raised the question of “where were the gatekeepers,” including the board of directors and auditors, in preventing, detecting, and correcting them. Weak corporate governance and ineffective internal control provide opportunities for backdating practices, and the persistence of such practices affects the reliability of financial statements. Thus, independent auditors must provide reasonable assurance that financial statements are free

² Glass Lewis & Co. 2007. Stock-Option Backdating Scandal. Yellow Card Alert (April 13). Available at: www.glasslewis.com.

from material misstatements and those ESO policies and practices are in compliance with applicable tax rules, auditing and accounting standards, and SEC filing requirements. Generally accepted auditing standards (GAAS), particularly Statements on Auditing Standards (SAS) Nos. 99, 114, and Public Company Accounting Oversight Board (PCAOB) Practice Alert, provide sufficient guidance for independent auditors to audit ESOs in general and backdating practices in particular. This article examines auditors' responsibilities regarding ESOs and backdating practices. Investors are concerned about the seemingly pervasive ESO backdating practices of public companies and expect independent auditors to be skeptical in substantiating proper valuation, measurement, recognition, and disclosures of option plans and grants.

SIGNIFICANCE OF ESOs

Stock option awards are considered as long-term incentive plans granted to executives and key personnel to reward superior performance and to align their interests with those of shareholders. ESOs grant holders the right—but not the obligation—to buy stock in the future, and thus create costs to the granting company that should be recognized as an expense on the income statement according to the provisions of the Statement of Financial Accounting Standards (SFAS) No. 123(R).³ ESOs can be classified as either qualified or nonqualified stock options. While the accounting method for recognizing the compensation expense for these two ESOs is similar, the tax treatment is different. Qualified ESOs are those options with a strike (exercise) price of at least 100 percent of the market price of the underlying stock on the grant date and are so-

³ Financial Accounting Standards Board (FASB). 2004 Statement of Financial Accounting Standards No. 123 (Revised in December). Available at: cpcf.aicpa.org/Resources/Accounting/Statement+of+Financial+Accounting+Standards+No.+123R+Resource.htm.

called “at-the-money” or “out-of-the-money” options. There is no grant date tax implication for qualified options and no realization of income or deduction when employees exercise them. The exercise price becomes the employee’s basis in the stock for future capital gain or loss recognition and the employer does not receive any tax deduction.

Qualified options may receive favorable tax treatment when employees hold the stock acquired via the options for at least one year. In this case, employees pay taxes as capital gain income which is at a lower rate than ordinary income. Alternatively, when employees make a disqualifying disposition for not holding the stock for at least one year, the profit is taxed as ordinary income and the company is entitled to a tax deduction for the amount included in ordinary income on the employee’s tax return.

The majority of ESOs are nonqualified with no grant date tax implications.⁴ Upon exercising the option, the employee recognizes income for the difference between the fair market value and the exercise price of the option which is commonly referred to as the intrinsic value. The intrinsic value is taxable to the employee as ordinary income and the fair value becomes the employee’s basis in the stock for the determination of any future capital gain or loss upon the disposition of the stock. Nonqualified stock options enable the company to recognize a tax deduction equal to the amount of ordinary income realized by the employee on the exercise date. The recorded value of ESOs is a function of market value of underlying stock on the grant date and the specified exercise price. Profit from the sale of stocks acquired by exercising nonqualified ESOs is recognized as a capital gain or loss regardless of when those stocks are sold, and thus, the company is

⁴ Maremont, M. and C. Forelle. 2006. How backdating helped executives cut their taxes. *The Wall Street Journal* (December 12). Available at: online.wsj.com/public/article/SB116589240479347248-OZ4xiP5gzR_1VmSRBPKzZxwy5v4_20070223.html.

not entitled to any tax deduction. Furthermore, tax rules limit the corporate tax deduction for nonperformance-based compensation (nonqualified options) to \$1 million per year for each of the top five highest-compensated employees.

BACKDATING OF ESOs

The backdating of stock options is a practice by which grant dates and exercise prices of stock options are managed retroactively to precede a run-up in underlying shares to maximize the options' value. The backdating of ESO grants involves recording option grants on a date when the underlying stock price was low, which is typically prior to the actual date of the grants. In the best scenario they can be regarded as improper accounting, and, in the worst scenario, as fraud or inside trading. Whether the company does this intentionally or unintentionally, the end result is an understatement of stock option expenses in their financial statements.

Backdating practices of ESOs can be done in several ways. First, management can track stock price trends, identify the date on which the price was the lowest, and intentionally choose this date as a grant date to establish the exercise price for ESOs. This type of backdating practice is undertaken to manipulate the grant process, which can potentially be troublesome for those involved. Second, backdating of ESOs is also possible through ineffective corporate governance in terms of sloppy documentation, ineffective use of an objective compensation consultant, and delays associated with the grant approval process. Third, the improper accounting methods or misapplication of accounting standards can cause inadvertent backdating of ESOs. Fourth, a company can manage the timing of option grants to take advantage of expected positive stock price changes resulting from the occurrence or nonoccurrence of unpublished company events.

Backdating of ESOs is largely regarded as a pre-SOX phenomenon for two reasons: (1) provisions of SFAS No. 123(R) reduce the company's management incentives to engage in backdating practices that cause in-the-money options for which the compensation expense should be recognized; (2) SOX and SEC-related rules reduce opportunities for backdating practices by requiring directors' and officers' changes in beneficial ownership, including stock options, be filed with the SEC on Form 4 within two business days, as opposed to the annual filing requirement on Form 5 in the pre-SOX period. Option backdating can cause a variety of corporate governance, internal control, accounting, and tax concerns as illustrated in the following paragraphs.

Backdating of ESOs, either intentionally or inadvertently, may result in incorrect recognition of a compensation expense. If the effect of the misstatement is material, the financial statements should be restated. This restatement process can delay timely filings of annual or quarterly financial statements. Such practices may cause the following accounting and governance issues: (1) intentionally mispricing ESOs by retroactively choosing the grant date when the stock price was at or near the low; (2) recognizing inappropriate amounts of stock option expenses by treating in-the-money options as at-the-money options; (3) understating compensation expenses resulting in overstated earnings; (4) recording ESO grants when made by unauthorized company personnel (executives) prior to formal approval from the board of directors or the compensation committee; (5) violating the books and records provisions under Section 13(b)(2) of the Securities Exchange Act of 1934; (6) mispricing ESOs based on the employee's offer-of-acceptance date rather than the commencement of their employment; and (7) failing to substantiate the stated measurement and grant dates of ESOs.

There are several tax issues regarding ESO backdating practices. The first issue is public violation of Section 409A of the Internal Revenue Code (IRC), adopted as part of the American Jobs Creation Act of 2004. Section 409A substantially changed the tax treatment of deferred compensation, including discount stock options, by requiring that these options have a fixed exercise date or otherwise be subject to a 20 percent penalty tax. The second issue relates to the possible failure of ESOs to qualify under the rules governing incentive stock options (ISOs). ISOs are required to be granted at an exercise price at least equal to the fair value of stock on the date of grant. Any backdating option granted at a discount may not qualify as an ISO. Qualified options under ISOs are not subject to income tax and FICA withholding upon exercise. Third, backdating ESOs may be subject to exceeding the compensation deduction limits of Code Section 162(m). IRC Section 162(m) limits the tax deduction for certain types of executive compensation to \$1,000,000. Only performance-based compensation, including at-the-money options, in excess of this threshold may be deductible. Finally, corporate executives may reduce their taxes by exercising their options at a relatively low stock price. Nonetheless, the IRS in its 2007 program provides relief for employees other than directors and officers affected by their companies' issuance of backdated and other mispriced stock options. Employers can now pay the additional 20 percent tax plus interest tax on behalf of their employees if they exercise backdated options.

AUDITING CONSIDERATIONS OF ESOs

In the pre-SOX era, auditors did not pay sufficient attention to their client's backdating practices for several reasons. First, accounting standards prior to the issuance of SFAS No. 123 (R) did not require companies to recognize their compensation cost as

an expense and often when items were not reported on financial statements, they did not receive adequate audit consideration. Second, although auditors are responsible for reviewing footnotes to the financial statements to ensure they are consistent with financial items, footnotes are usually not subject to the same scrutiny as financial statement amounts. Third, auditors' financial ties and dependence on nonaudit consulting fees hindered auditors from being adequately skeptical concerning the director and executive involvements with option backdating practices. Fourth, auditors were not required to report on internal control over financial reporting (ICFR), which could have uncovered weaknesses in companies' internal controls concerning backdating policies and practices. Fifth, companies were allowed to file changes in option grants for weeks and months in the pre-SOX period, providing opportunities to manipulate option grant dates.

On July 28, 2006, the PCAOB issued its Audit Practice Alert No. 1 titled "Matters Related to Timing and Accounting for Option Grants."⁵ This practice alert advises independent auditors that backdating practices may have implications for integrated audits of both financial statements and ICFR and discusses the possible audit associated with such practices. Independent auditors should consider ESO grants and backdating practices in all three phases of an integrated audit engagement, namely, the planning, evidence gathering, and opinion phases. The pervasiveness of option backdating allegations necessitates that auditors be more skeptical and use the guidelines provided in both SAS Nos. 99 and 114 in discovering and reporting potential misstatements.

Planning an Integrated Audit

⁵ Public Company Accounting Oversight Board (PCAOB). 2006. Staff Audit Practice Alert No 1: Members Related to Timing and Accounting for Option Grants (July 24). Available at: www.pcaob.org.

During the planning phase of the integrated audit, auditors should assess the risk of how the improper valuation, recognition, and timing of stock option grants may affect ICFR and the reliability of financial statements. To assess such a risk auditors should: (1) review compensation policies, including stock options, with the company's compensation committee; (2) consider applicable regulations regarding stock options, including SOX, SEC rules, and SFAS No. 123 (R); (3) review the company's Compensation Discussion and Analysis (CD&A); (4) discuss with management accounting practices regarding stock options, discounted options, variable plans, tax effects, and contingencies; (5) review with the auditing committee stock option accounting policies; and (6) review public information, internal investigations, and external inquiries by regulators and legal authorities relevant to stock options and possible backdating practices.

The SAS No. 99 fraud triangle should be used by auditors to gather and assess evidence about their client's: (1) incentives or pressure to engage in option backdating; (2) opportunities for backdating practices; and (3) rationalization as depicted in Sidebar 2.⁶

1. Incentives

Companies may be motivated by two goals of engaging in backdating practices. The first goal is to make options more attractive and beneficial to executives, directors, and key personnel by granting them options with a strike price lower than the stock price by managing the timing of grants to make "in-the-money" options (strike price lower than the stock price) appear as "at-the-money" options for reporting purposes. The

⁶ American Institute of Certified Public Accountants. 2006. Statement on Auditing Standard No. 99. Consideration of Fraud in a Financial Statement Audit (June). Available at: www.aicpa.org/download/members/div/auditstd/AU-00316.pdf.

second goal is to take advantage of accounting standards and tax rules by granting options with a strike price equal to the stock price on the grant date.

Management integrity and trustworthiness are essential in the fair presentation of financial statements in conformity with generally accepted accounting principles (GAAP). Thus, the integrity of executives of implicated companies who engaged in and benefited from backdated options is challenged when certifying both internal controls and financial statements that are affected by backdating practices. Management makes representations to independent auditors regarding the proper use of accounting policies and practices including accounting for ESOs and related backdated options. Management is also in violation of disclosure requirements of securities laws and regulations (SEC rules) for engaging in option backdating practices, failing to properly account for related compensation expenses and tax treatments, and failing to notice such practices and their effects on the fair presentation of financial statements in its certifications to investors.

Independent auditors should be skeptical and pay special attention to: (1) legal issues arising from backdated options, particularly those that were neither approved by the company's board of directors nor properly disclosed to shareholders; (2) ethical issues when the integrity of executives involved in backdated options is questioned, affecting the reliability of financial statements; (3) tax issues of different tax treatment of in-the-money backdated options as discussed in the previous section; (4) accounting and disclosure issues of misleading financial statements caused by backdated options that lead to restatements and late filings; and (5) corporate governance issues of departures of directors, officers, and legal counsel of implicated companies and reported material weaknesses in their internal controls.

2. Opportunities

Ineffective corporate governance, including lack of a vigilant board of directors and board committees, can create opportunities for the manipulation of stock option timing. SEC disclosure requirements and favorable accounting guidance in the pre-SOX era provided opportunities for management to engage in such practices. In the pre-SOX period, SEC rules gave companies more than a year to disclose certain option grants to their executives, during which companies could choose the most favorable grant dates. SEC rules required disclosure of option activity including the number of ESO grants, cancellations, exercises, average strike prices, and terms in annual filings. In addition, directors, officers, and owners of more than ten percent of the company's outstanding shares were required to file changes in their option grants on SEC Forms 3, 4, and 5, where the deadline for filing Form 4 was ten days after the month-end and for Form 5, 45 days after the year-end. This gave companies the opportunity to backdate their ESO grants to any date in the prior fiscal year.

In the post-SOX period, the previously exempt Form 5 transactions (option grants approved by a shareholder vote or two independent directors) should be reported on Form 4, whose filing deadline was shortened to two days after a reportable event. Independent auditors should pay attention to this change in disclosure requirements intended to eliminate the opportunity for option backdating practices. Independent auditors, however, should be more skeptical about other ESOs manipulative schemes, such as spring-loading and bullet-dodging, which are not affected by these expedited filing requirements.

Prior to the adoption of SFAS No. 123(R) in 2005, accounting standards allowed companies to compensate their employees without using cash or even recording any compensation expense by granting at-the-money ESOs. Similarly, companies could backdate grant dates for their at-the-money options. The adoption of SFAS No. 123(R) has effectively eliminated this favorable accounting treatment for ESOs by requiring companies to: (1) determine the fair value of ESOs when granted using option pricing models adjusted for their unique characteristics (e.g., nontransferability); (2) estimate the number of ESOs that will ultimately vest; and (3) record compensation expenses for the vested ESOs during the vesting period. Independent auditors should be skeptical about ESOs, particularly executive options, even after the adoption of SFAS No. 123(R) because: (1) companies can use questionable assumptions in determining compensation expenses; (2) there is still some flexibility provided by SFAS No. 123 (R) and SEC disclosure rules in using assumptions; and (3) the use of a grant date accounting model ignores employees' and executives' behavior in exercising their stock options.

The tax rules related to ESOs affect both companies that grant options and the employees who receive them. Employees realize ESO profits as either ordinary or capital gain income, and companies are only allowed to take tax deductions for the amount realized by their employees as ordinary income. Companies are also required to withhold income taxes for compensation paid to their employees and remit the withholdings to the U.S. Treasury. Any restatements of backdated ESOs may bring about recognition of compensation subject to withholding and a resulting liability to the IRS for under withholdings along with related penalties. When employees exercise backdated options, they may owe an additional 20 percent tax plus an interest tax.

3. Rationalization

Companies may attempt to justify their option backdating practices by making options more beneficial and attractive to executives, directors, and key employees to facilitate the hiring and retention of such individuals. A report from the SEC's economist concludes there is robust evidence that corporate executives manipulated the timing of their option grants with the intention of cutting their taxes.⁷ These tax-dodging schemes are adding to the severity of backdating practices. IRS rules require that executives who sell their option shares pay ordinary income tax and payroll taxes for their in-the-money options for the difference between the exercise and strike price of options determined on the grant date. However, executives who choose to hold their exercised shares for at least one year may pay a lower capital gain tax of 15 percent compared with the highest federal marginal income tax of 35 percent.

The IRS ruled that employees who innocently cashed in backdated options in 2006 should pay extra tax, which may increase their effective tax rate from 35 percent of the profits to 55 percent. The IRS gave companies until February 28, 2007, to provide notification if they would pay these excess taxes for their employees.⁸ Another rationalization for executives to engage in backdating practices is to manage earnings in an attempt to generate positive prices and thus increase the value of their options.

Forensic Evidence-Gathering Procedures

The assessed risk of option backdating should be incorporated into the auditor's risk model to determine the timing, nature, and extent of tests of controls pertaining to

⁷ Maremont, M., and C. Forelle. 2006. How backdating helped executives cut their taxes. *The Wall Street Journal* (December 12). Available at: online.wsj.com/article/SB116589240479347248.html.

⁸ Internal Revenue Service (IRS). 2007. Compliance Resolution Program for Employees Other than Corporate Insiders for Additional 2006 Taxes Arising Under § 409N Due to the Exercise of Stock Rights. Announcement 2007-18.

ICFR and substantive tests of accounting balances and classes of transactions. The audit evidence gathered through tests of controls determines the effectiveness of the client's ICFR, whereas evidence obtained through substantive tests indicates whether material misstatements may have occurred pertaining to stock option backdating practices. Although reforms, rules, and standards of ESOs are emerging, auditors can still assess their impact on the reliability and fair presentation of financial statements.

The company's shareholders or its board of directors typically approve ESO plans. The board of directors may assign the administration of those plans to the compensation committee, which officially determines the size and timing of ESO grants. The company's executives, including the CEO, do not have the legal right to grant ESOs without the preapproval of the board of directors. Executives can influence the timing of executive option grants by setting the grant date either before an anticipated stock price increase or after an anticipated or actual stock price decrease. Traditionally, independent auditors have communicated relevant accounting, financial reporting, and audit information to the audit committee. Recently, auditors have been working more closely with the audit committee as the committee is directly responsible for the appointment, retention, compensation, and oversight of independent auditors. However, the independent auditor's working relationship with other commonly formed board committees, particularly the compensation committee, has yet to be addressed. Independent auditors should consult with the compensation committee to substantiate the recognition, proper value, and timing of ESO grants.

Auditors should communicate with the audit and compensation committees and report on the company's:

1. Current compensation policies and practices. SEC rules require public companies to furnish the new Compensation Discussion and Analysis (CD&A). The CD&A requires companies to disclose their compensation policies and the role that executive officers play in the compensation process. The primary purpose of the CD&A is to accurately disclose the board's process of determining executive compensation and to make executive compensation transparent to shareholders. Auditors should work with compensation committees in assessing whether the company's compensation practices are in compliance with the new rules. The auditor should determine whether the compensation committee has: (1) reviewed and discussed the CD&A with management; and (2) recommended that the CD&A be included in Form 10-K. This report is "furnished to"—not "filed with"—the SEC and as such it is not covered by executive certifications.
2. Disclosure of perquisites. Auditors should review with the compensation committee the required disclosure of dollar thresholds for perquisites to ensure that they are completely and appropriately disclosed. The SEC reduced the threshold on the disclosure of perquisites by requiring the disclosure of executive perks of more than \$10,000.
3. Related-person transaction. Auditors should review with the compensation committee the company's policies and procedures for the review, approval, or ratification of related-person transactions.
4. Employees covered under Section 162(m)-compliant plans. Section 162(m) of the IRC limits the deductibility of compensation paid to "covered employees" unless the

compensation is “performance based.” Auditors should ensure that covered employees are in compliance with IRS rules.

5. Corporate governance and tax issues and problems that might have been caused by option backdating practices as discussed in the previous sections.
6. Financial reporting consequences of option backdating practices as the majority of implicated companies restated their financial statements (see Sidebar 1).
7. Legal implications of option backdating practices as two recent court rulings suggest that both option backdating and spring-loading could be illegal and could create significant liability for directors, particularly those serving on compensation committees.⁹

This communication with the audit and compensation committees should assist auditors in gathering sufficient competent evidence regarding: (1) the effectiveness of ICFR; and (2) the fair presentation of the financial requirements of ESOs, including fair value of options, recognized compensation costs, disclosures of ESO grants, and appropriate tax treatments of ESO grants. The auditors should also consult with the company’s legal counsel regarding option grants, grant dates, and any possible backdating or spring-loading practices.

Reporting Phase

Auditors should use the evidence obtained through performing audit procedures as a basis for expressing their opinion on the fair presentation of ESOs in conformity with GAAP. In expressing such opinions, auditors should carefully assess the sufficiency and competency of evidence pertaining to ESO grants and possible backdating practices.

⁹ Morrison and Foerster. 2007. Delaware Court Issues Ruling in Spring-loading Case (February 6). Available at: www.mofo.com/news/updates/files/update02325.html.

Indeed, SAS No. 114 provides guidance on the auditor's communication with those charged with governance in connection with a financial statement audit. SAS No. 114 defines "those charged with governance" as the individual(s) with oversight responsibility, including the company's board of directors and its board committees. Specifically, SAS No. 114 requires: (1) communication of the responsibilities of the auditor in relation to the financial statement audit; (2) an overview of the planned scope and timing of the audit; (3) acquisition of information relevant to the audit; and (4) communication of significant audit findings.¹⁰ Auditors should also properly address questions that investors may raise about the company's ESOs, characteristics of companies that may present a high risk of option backdating, legal liability associated with potential backdating practices, and any antifraud programs and forensic accounting techniques designed to prevent and detect timing manipulation of ESOs.

CONCLUSION

Independent auditors, by expressing an opinion on their clients' current and prior year financial statements, are required to discover and report material misstatements, including errors, irregularities, illegal acts, and fraud. Independent auditors should communicate with both the audit committee and the compensation committee regarding all aspects of ESOs including the value, measurement, recognition, and timing of stock option grants. If auditors have a heightened awareness of financial problems or illegal acts, they must make reasonable efforts including the use of forensic accounting techniques and procedures to gather satisfactory and persuasive evidence to resolve the problem. The SEC and the DoJ are currently investigating the ESO grant practices of

¹⁰ American Institute of Certified Public Accountants. 2006. Statement on Auditing Standard No. 114 (Summary). The Auditor's Communication with Those Charged with Governance (December). Available at: www.aicpa.org/download/members/div/auditstd/riasai/Recently_Issued_Standards_SAS_No_114.

more than 264 companies to determine whether grants were backdated or awarded ahead of favorable news to provide recipients the opportunity to profit from exercising their options. These probes have resulted in criminal charges against former executives, restatement of financial statements, and delay in regulatory filings, and have raised very serious concerns as to whether auditors can legitimately rely on representatives from the implicated companies.

Independent auditors should be skeptical of the likelihood of backdating and spring-loading practices of their clients and pay particular attention to the disclosures of ESO plans and grants. Auditors should be also skeptical that management may intentionally withhold critical information on ESO grants from them. All corporate gatekeepers are responsible for collaborating to prevent further option backdating scandals, especially when top executives engage in backdating and spring-loading practices. Investors and other users of audited financial statements may have the perception that ESOs are awarded at fixed dates and the exercise price of options equals the market value of the underlying stock on the same date. This perception may not hold true in the case of backdated options granted to executives at below-market prices. Auditors should use appropriate forensic accounting techniques and procedures to ensure investors receive relevant, reliable, and transparent information on ESOs.

SIDEBAR 1
OPTION BACKDATING PROBES AND ATTRIBUTES OF 264 IMPLICATED COMPANIES (AS OF APRIL 16, 2007)

Panel A: Tally of events	
Companies that have disclosed:	
Internal investigations	259
SEC investigations	132
DoJ investigations	59
Shareholder suits	133
Criminal cases	6
Executive departures	48
Restatements	139
Late filings	165
Material weaknesses	60
Accelerated vestings	63

Panel B: Current auditor	
Audit firms	
Ernst & Young	67
PricewaterhouseCoopers	69
Deloitte & Touche	53
KPMG	39
BDO Seidman	13
Grant Thornton	7
Other	16
Total	264

Panel C: Company size	
Market values	
Less than \$75 Million in Market Capitalization	21
\$75 Million to \$749 Million in Market Capitalization	87
\$750 Million to \$7.49 Billion in Market Capitalization	117
\$7.5 Billion or More in Market Capitalization	39
Total	264

Source: Glass Lewis & Co. 2007. YELLOW CARD Trend Alert: Stock Option Backdating Scandal (April 16). Available at: www.glasslewis.com.

SIDEBAR 2
SAS No. 99 & ESOs

Conditions for Financial Statement Fraud	As Related to ESOs
Incentives/Pressures	<ol style="list-style-type: none"> 1. Short-term earnings management 2. CEO with a sizeable amount of “in-the-money” stock options 3. Personal tax savings, particularly for executives
Opportunities	<ol style="list-style-type: none"> 1. Weak corporate governance 2. Ineffective internal controls 3. Insufficient documentation 4. Inappropriate use of compensation consultants 5. Inadequate grant approval policies and processes 6. Lack of robust accounting, tax, and disclosure guidance
Attributes/Rationalizations	<ol style="list-style-type: none"> 1. Compensation structure which links management compensation to stock option value rather than performance 2. Possible positive stock price reactions 3. Understatement of compensation expenses and resulting overstatement of earnings

The opinions of the authors are not necessarily those of Louisiana State University, the E.J. Ourso College of business, the LSU Accounting Department, or the Editor-In-Chief.