CEASA Comments

Accounting and the Backdating of Employee Stock Options

The recent stock option backdating scandal raises a number of corporate governance and auditing issues. Indeed, the Public Company Accounting Oversight Board (PCAOB) has issued its first Staff Audit Practice Alert to auditors on the matter. While not primarily accounting driven, the episode also raises accounting issues.

Under FASB Statement 123R, effective this year, the cost associated with stock options is recognized at the date that options are granted. This cost – based on an option pricing formula – is actually incurred only if the options are exercised. If the options are not exercised, the (amortized) cost remains as a charge against income under FASB Statement 123R, even though no cost was realized. There is no truing-up in the accounts on the final settlement of the option contract. Similarly, if options go into the money and are exercised, there again is no truing-up to report the additional (realized) cost to shareholders of issuing shares at less than the market price. Accounting always faithfully settles up transactions – usually to cash – but not in this case where the settlement is at the expense of shareholder's stock value.

This breach has ramifications when it comes to option backdating. Backdating effectively resets the strike price so that the realized loss to shareholders at exercise date is higher, dollar-for-dollar, by the amount of the reset. If the accounting were to recognize the truing up at exercise date, the cost to shareholders of the backdating would (ultimately) appear in the financial statements. As it is, backdating typically has considerably less than a dollar-for-dollar effect on the grant date expense under Statement 123R, for the Black-Scholes-type option value is based primarily on estimated volatility, not the strike price. For non-qualifying options, the backdating also results in a higher tax benefit at exercise date, providing additional incentive to game the accounting. If the settling-up cost (that gives rise to the tax deduction) were recognized in the accounts along with the tax benefit, this incentive would disappear.

Of course, if backdating is discovered and the at-the-money option is consequently treated as an in-the-money option, the discount for backdating is recognized in the grant date expense. However, backdating is only one way managers can game the 123R accounting. They can award options when they know (with their superior information) that the share price is low, to the detriment of the shareholders. They can underestimate estimated volatilities and expected option lives; both lead to an understatement of Statement 123R option expense. Indeed research indicates that this happens.[1] A combination of a low price and low volatility at the date selected for the grant magnifies the problem. Truing up in the accounts at exercise date corrects for any under-estimate of the grant date expense, much like actual bad debts correct under-estimates of allowances for those bad debts.

CEASA White Paper Number 1, **"Debt vs. Equity: Accounting for Claims Contingent on Firms' Common Stock Performance with Particular Attention to Employee Compensation Options"** covers the accounting for employee stock options and other contingent claims on equity. Access this paper online at:

http://www.gsb.columbia.edu/ceasa/policy/contingent.html

[1] See, for example, D. Aboody, M. Barth, and R. Kasznik, "Do Firms Understate Stock Option-based Compensation Expense Disclosed under SFAS 123?" Review of Accounting Studies Journal, Volume 11, Issue 4 (December 2006); E. Bartov, P. Mohanram, and D. Nissim, "Stock Option Compensation Expense. Forward-looking Information, and Implied Volatilities of Traded Options," paper presented at the 2004 Journal of Accounting Research Conference; and D, Yermack, "Companies Modest Claims about the Value of CEO Stock Option Awards," Review of Quantitative Finance and Accounting 10 (1998), pp. 207-226.