

# CHAPTER 34A

## THE FINANCIAL ILLITERACY DEFENSE: OPTIONS BACKDATING

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### 34A.1 INTRODUCTION

The Sarbanes-Oxley Act of 2002 holds senior business executives criminally liable for accounting errors and misstatements. To show criminal liability, the government must prove that the executives knew (or should have known) that they or their colleagues were breaking the rules, which we understand the courts to mean when they interpret the statute's word *reckless*.

This chapter presents the outline of a defense suitable for a known or should-have-known charge against senior corporate executives for their behavior. We refer to the charge as the "known-or-reckless charge."

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The defense has three basic tenets, which we refer to as the “financial illiteracy” defense:

### The Three Tenets of Financial Illiteracy Defense

1. During the time of the alleged wrongdoing, few accountants (within the firm) focused on the issues that would have led to correct accounting for items at issue, or
2. Had the accountants looked, they would have found ambiguous instructions and guidance that failed to clarify the ultimately correct accounting, or
3. Both of the above arguments.

If accountants did not focus on the rules or did not understand the rules or both, then don't expect non-accounting executives to have known them.

The chapter discusses the defense against the known-or-reckless charge involving so-called backdating charges for stock option accounting. The chapter proceeds as follows:

- We present the background and history regarding accounting for employee stock options, which led to hundreds of investigations, more than 100 restatements, and much adverse publicity for corporate executives.
- We introduce the notion of “as-of” employee stock option grants—the grants most people have in mind when they use the nondefined, nontechnical term *backdating* in this context.
- We discuss the generally accepted accounting principles (GAAP) that provided guidance, but not with respect to as-of grants. Even had an accountant addressed or focused on how the accounting rules applied to as-of grants, the guidance through 2005 was unclear.
- We show that prior to the 2006 Securities and Exchange Commission letter that clarified the accounting, training and education in accounting provided little or no instruction regarding the accounting rules for as-of grants.

### 34A.2 BACKGROUND

An employee stock option is an agreement between a company and its employee that provides the employee with the right to purchase shares of the company's common stock at a given price (the “exercise price”).<sup>1</sup> Accounting Research Bulletin No. 43 (ARB 43), issued in June 1953, provided accounting guidance for employee stock options.<sup>2</sup> In 1972, the Accounting Principles Board issued *APB Opinion No. 25: Accounting for Stock Issued to Employees* (APB 25). In the 1970s, most companies granted employee stock options once a year and only to a few senior executives. The grants were neither numerous nor complex. Over time, companies used options for compensation of executives of lesser seniority and made grants frequently throughout the year. The grants became more complex than the ones that standard setters had used as examples during the late 1960s and early 1970s.

Companies usually set the exercise price equal to the market price of the underlying share on the grant date. Employees can exercise these stock options after the options vest. Employees typically exercise only when the market price at the time of exercise exceeds the exercise price. When market price exceeds exercise price, the option is said to be “in the money.”

The lay literature has focused on the catch word *backdating* for practices that accountants have ultimately found violated GAAP. This chapter uses the term *as-of grants* to mean awards made effective as of a date earlier than the date the award was approved.<sup>3</sup>

To our knowledge, Professor Erik Lie first identified the practice of granting stock options made effective as of a date earlier than the decision date (i.e., as-of grants).<sup>4</sup> The accounting literature had failed to clarify the meanings of the technical terms *date of grant* and *measurement date*. This failure resulted in a lack of useful guidance regarding what dates in a company’s stock option grant approval process constituted appropriate grant and measurement dates for accounting purposes. As a result, the accounting guidance failed to clarify that accounting for an as-of grant violated GAAP if the applied accounting principle resulted in reporting it as having zero cost.

**(a) Development of Accounting Principles for Employee Stock Options.** Long-standing guidance—APB 25, issued in 1972—contained the relevant GAAP related to employee stock options until 2005. APB 25 provided that as long as the terms of an option grant were fixed, the company could avoid recognizing compensation expense—both at the grant date and in any subsequent periods—if the “quoted market price of the stock at the measurement date” equaled the option exercise price.<sup>5</sup> If, instead, the option plan provided variable terms of option grants that then depended on events after the grant date, APB 25 required that the company account for the option grant using variable accounting, discussed later in this section, until resolution of those events.<sup>6</sup> To capture these notions, APB 25 introduced the concepts of *fixed plans* (as of the date of grant, the option’s terms are “known or determinable”) and *variable plans* (if as of the date of grant, the option’s terms “[depend] on future events”).<sup>7</sup>

APB 25 defined *measurement date* as “the first date on which are known both (1) the number of shares that an individual employee is entitled to receive and (2) the option or purchase price, if any. That date for many or most plans is the date an option or purchase right is granted or stock is awarded to an individual employee. However, the measurement date may be later than the date of grant or award in plans with variable terms that depend on events after the date of grant or award.”<sup>8</sup> Section 34.4A discusses the ambiguities present in the definition (including its first sentence) that create a lack of clarity for one trying to deduce the rules.

Under variable plan accounting, “estimates of compensation cost are recorded before the measurement date based on the quoted market price of the stock at intervening dates. Recorded compensation expense between the date of grant or award and the measurement date may either increase or decrease because changes in quoted market price of the stock require successive computations of the estimated compensation cost.”<sup>9</sup>

To decide whether the company must record compensation cost for an option grant requires an understanding of APB 25’s definition of *measurement date*. Because

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the definition of *measurement date* provides it is in “many or most” cases “the date an option or purchase right is granted,” the term *measurement date* involves an understanding of the concept of *grant date*.<sup>10</sup> APB 25 provides guidance that “compensation cost [is] measured . . . at date of grant” for *fixed plans* and “compensation cost [is] measured at other than date of grant” for *variable plans*.<sup>11</sup>

APB 25 does not define *grant date* nor does it explain how the grant date relates to the timing of the company’s approval of the stock option grant, as we explain in the next section.

**(b) Evolution of GAAP from the Mid-1990s through 2007.** Accounting for employee stock options requires that one select (1) a date for measuring the cost of the option and (2) a method for measuring the cost. Accountants use two basic methods to measure an option’s implicit compensation expense:

1. *Intrinsic value method*, which measures compensation cost as “the excess, if any, of the quoted market price of the stock at grant date or other measurement date over the amount an employee must pay to acquire the stock”;<sup>12</sup>
2. *Fair value method*, which measures compensation cost as “the amount at which an asset [option] could be bought or sold in a current transaction between willing parties.”<sup>13</sup>

The remainder of this section summarizes the changes from the mid-1990s through 2007 in accounting guidance for employee stock options related to selection of the grant date and measurement date, given information regarding when the requisite authority approves an option.

Prior to 1995, APB 25 specified the GAAP for stock options; it defined the *measurement date* and referred to, but did not define, the *grant date*.

In 1995, *FASB Statement No. 123: Accounting for Stock-Based Compensation* (SFAS 123) supplemented APB 25.<sup>14</sup> Thus, from 1995 through mid-2005, GAAP for stock options comprised SFAS 123’s *fair value* recognition, measurement, and disclosure rules, supplemented with APB 25’s rule for measuring the cost of options with the intrinsic value method.<sup>15</sup> The recognition rules did not change as GAAP moved from APB 25 to SFAS 123. SFAS 123 allowed firms to continue to use the APB 25 *intrinsic value* method to measure the cost of options and required new *fair value* method disclosures that APB 25 did not require.

SFAS 123 provides a different definition of *measurement date* than that provided in APB 25 and defined *grant date* for the first time. One who studies SFAS 123 can conclude that one need not look further to APB 25, as SFAS 123 also summarizes the key features of APB 25, including how to compute intrinsic value, as required to implement APB 25. In applying SFAS 123, one would not recognize the importance of *measurement date*, as SFAS 123 focuses on *grant date*, even in explaining APB 25.

In March 2000, the FASB issued *FASB Interpretation No. 44: Accounting for Certain Transactions Involving Stock-Based Compensation (an Interpretation of APB Opinion No. 25)* (FIN 44), which elaborated on APB 25. In particular, FASB issued FIN 44 to “clarify the application” of APB 25 because “since its issuance, questions have been raised about its application and diversity in practice has developed.”<sup>16</sup> The Emerging Issues Task Force (EITF) of the FASB also issued EITF 00–23 to further clarify and provide examples on the application of certain parts of the guidance contained in FIN 44.<sup>17</sup>

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Although the new 2000 guidance did not amend APB 25's definition of *measurement date*, it did clarify the circumstances when a firm using APB 25 must use variable accounting.<sup>18</sup>

From 1995 through mid-2005, APB 25 and SFAS 123 (supplemented by FIN 44 and various EITF Consensuses) contained the relevant U.S. GAAP regarding stock-based compensation.<sup>19</sup> During this period, *measurement date* had two definitions (provided in Sections 34.4A (a) and (b) of this chapter).

In 2005, the FASB revised the prior guidance and designated the new guidance as SFAS 123(R), which superseded APB 25, SFAS 123, and FIN 44.<sup>20</sup> The main rule in SFAS 123(R) that differed from the earlier rules is that it prohibited APB 25's intrinsic value method and required fair value accounting for all stock option grants.

SFAS 123(R) gave a single, new definition of *measurement date*.

In 2006, in response to multiple published reports and investigations related to stock option backdating (a term still undefined in any of the publications) and the use of as-of grants, the SEC published a letter. The topics in the letter all address "whether a company's determination of the measurement date of past stock option awards was appropriate."<sup>21</sup>

This 2006 SEC guidance is the first we can find that clarifies the ambiguity regarding the definition of *measurement date* in the period 1995 through 2005. That 2006 guidance made clear that an as-of grant date could not be a proper measurement date under APB 25, so that the use of as-of grants resulted in a compensation charge (discussed in Section 34.3A (b)).

In early 2007, the SEC recognized a need to publish additional guidance on employee stock option restatements and noted that "the staff of the Office of the Chief Accountant is continuing to consider matters related to the accounting for stock options."<sup>22</sup>

### 34A.3 THROUGH 2005, NO CLEAR MEASUREMENT DATE IN APB 25 APPLIED TO AS-OF GRANTS

**(a) Review of Accounting Industry Guidance regarding the Accounting for Employee Stock Options.** From the mid-1990s through 2005, the accounting profession did not address or focus on how the definition of *measurement date* in either APB 25 or SFAS 123 applied to as-of options. To confirm this, we examined authoritative auditing guidance and audit firm publications during that period for discussion of the accounting for employee stock options.<sup>23</sup> We focused on whether these discussions addressed the meaning, interpretation, or proper application of the terms *grant date* and *measurement date* or resolved the ambiguity of these terms (Section 34.4A of this chapter discusses the ambiguity). Through this review, we also wanted to ascertain when the accounting profession first clarified that the practice of accounting for as-of grants as having zero cost violated APB 25.

Review of the accounting literature confirms that during the period from the mid-1990s to 2005, the accounting profession did not provide guidance beyond the bare-bones definitions, without helpful clarification, contained in APB 25, FIN 44, and SFAS 123. In particular, the publications did not explain how to account for as-of grants, specifically that the as-of date could not be a proper measurement date.

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No publication addressed whether the use of an as-of grant resulted in a compensation expense.

Clarity came only in September 2006, from the SEC.

**(b) SEC Guidance regarding Measurement Date.** On September 19, 2006, the SEC issued guidance that sharpened understanding of the meaning of measurement date and its application to as-of grants, while discussing issues surrounding the meaning of grant date. The SEC letter clarified that options where the exercise price was chosen after the day when the shares traded at a price equal to the exercise price violated the definition of *measurement date* in APB 25, ¶ 10(b):

Dating an Option Award to Predate the Actual Award Date

As noted previously, pursuant to paragraph 10(b) of Opinion 25, the measurement date for determining the compensation cost of a stock option is the first date on which both of the following are known: (1) the number of options that an individual employee is entitled to receive and (2) the option or purchase price. Thus, even if documents related to an award of options are dated as-of an earlier date, the measurement date cannot occur until the date the terms of the award and its recipient are actually determined. As such, dating the underlying stock option grant documents as-of a date prior to the date on which the terms of the award and its recipient are determined does not affect the appropriate measurement date under Opinion 25.<sup>24</sup>

In addition to “Dating an Option Award to Predate the Actual Award Date,” the SEC’s letter also addressed other common stock options topics that include:

- Administrative delays in preparing authorization documents or other required granting actions,
- Uncertainty as to individual recipients resulting from unallocated block grants or changes in grantee lists,
- Awards to new hires prior to employment commencement, and
- Incomplete granting documentation.<sup>25</sup>

All of these topics focus on “whether a company’s determination of the measurement date of past stock option awards was appropriate.”<sup>26</sup>

The fact that FASB and the SEC issued additional guidance in the forms of SFAS 123, FIN 44, *FASB Staff Position No. 123(R)-2*, and the SEC press release and letter in September 2006 functionally acknowledges that APB 25 did not provide sufficient guidance on the timing of measurement and grant dates of employee stock options or appropriate relevance to the correct accounting for as-of option grants. If the prior guidance had proved adequate, practitioners would not have needed these subsequent clarifications.<sup>27</sup> The January 2007 letter indicated that the SEC accounting staff was considering further elaboration.<sup>28</sup> We have found no further guidance from the SEC, so we conclude that sometime between 2007 and the time of this writing in 2013, the SEC saw no need to issue a clarification beyond its 2006 letter.

**(c) Pervasive Financial Illiteracy regarding Employee Stock Options.** We found no evidence that any executive of any company or any auditor or any regulator used the word *backdating* in the context of employee stock options until November 2004. The SEC’s letters of 2006 and 2007 never use this pejorative word, nor, hence, do they define it.

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The SEC began investigations of wrong accounting for options in 2005, but the accounting profession did not begin to clarify the definitions of *grant date* and *measurement date* (and their relevance to the correct accounting for as-of grants) until the SEC issued guidance in September 2006. By March 2007, 257 companies disclosed investigations into backdating issues and 129 companies had announced a backdating-related restatement.<sup>29</sup> A 2009 academic study estimated that 29.2 percent of the 7,774 firms—more than 2,000—in its sample advantageously selected the timing of option grants to top executives at some point between 1996 and 2005.<sup>30</sup>

An article published by Professor Erik Lie in the journal *Management Science* in May 2005 provided the first empirical evidence showing patterns that are consistent with the data that would result if companies were backdating employee stock option grants: “awards might be timed *ex post facto*, whereby the grant date is set to be a date in the past on which the stock price was particularly low.”<sup>31</sup> According to Professor Lie’s website, he “started [the study] in 2003, and disseminated [it] in the first half of 2004.”<sup>32</sup> Former SEC chairman Christopher Cox testified that the SEC worked with Professor Lie and other “academics to decipher market data that provided the first clues that something fishy was going on.”<sup>33</sup> The first instance of the term *backdating* in the options context appears in an article published in late 2004 in the journal *Corporate Counsel*.<sup>34</sup> The article noted that prior to the enhanced reporting requirements enacted by the SEC in the Sarbanes-Oxley Act, “it wasn’t that unusual for management to pick a low recent (e.g., within the past 30 days) stock price and have the board/compensation committee sign off on minutes memorializing option grants on that date.” The article did not comment on whether this “[not] unusual” practice complied with accounting rules.

On July 20, 2006, the SEC filed the first enforcement action primarily related to options backdating against executives of Brocade Communications Systems Inc. (*SEC v. Gregory Reyes, et al.*).<sup>35</sup> Representatives of the SEC stated publicly in 2006 and 2007 that the SEC’s Enforcement Division was investigating more than 100 companies concerning “potential abuses of employee stock options.”<sup>36</sup> According to the SEC’s website “Spotlight on Stock Options Backdating,” the SEC has filed enforcement actions against 34 companies (or those companies’ executives) related to stock options backdating.<sup>37</sup>

Government investigations and accounting restatements focused disproportionately on technology companies, using the proportion of tech companies compared to all companies as the base rate. A June 3, 2008, article in the *New York Times* stated, “The practice of backdating stock options was widespread in Silicon Valley during the dot-com boom of the late 1990s, but led to billions of dollars in financial restatements in the last two years.”<sup>38</sup> An August 8, 2007, article in the *San Francisco Chronicle* stated, “More than 200 companies—a quarter of them in Silicon Valley—admitted problems in their stock-option practices during the technology boom.”<sup>39</sup>

The first announcements of restatements for stock option backdating occurred in mid-2005. Glass Lewis published a study summarizing stock option backdating investigations and restatements announced as of March 2007.<sup>40</sup> According to the Glass Lewis analysis, 129 of the 257 companies investigating backdating issues had announced a restatement by March 2007—a remarkable number for a single accounting issue within such a short time.

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The Glass Lewis study also reports that 100 of the 257 companies under investigation were members of industries related to the service or production of computers, or software, or semiconductors.<sup>41</sup> The study lists another 39 companies in technology-related industries.<sup>42</sup> Furthermore, 63 of the 110 companies list their companies' headquarters as located in or around the Silicon Valley.<sup>43</sup> The results of the study therefore confirm the claims in the news articles referenced above that the backdating investigations focused disproportionately on technology companies.

That so many companies had restatements relating to backdating issues suggests that many managers, accountants, auditors, and regulators did not address or focus on the application of the *measurement date* rule and the proper accounting for as-of grants prior to 2006.

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Neither GAAP nor the accounting profession addressed the definition of *measurement date* under APB 25 or how to properly account for as-of grants prior to 2006. Even had one paid attention to this issue, the accounting guidance that existed through 2005 was ambiguous with respect to the definitions of *measurement date* and *grant date* and their application to as-of grants.

APB 25 does not clearly show or describe how one should apply the *measurement date* definition that it prescribes to a fixed stock option grant set as of a prior date; it relies on the concept of *grant date*, which it never defines. Later, SFAS 123 compounded the ambiguity by defining *measurement date* differently from the definition in APB 25. In addition, SFAS 123 defined *grant date* for the first time, creating an interaction of confusion between the uses of *measurement date* and *grant date*.<sup>44</sup> Furthermore, GAAP, during the period through 2005, provided no specific guidance on how to ascertain the timing of the measurement date (and its relation to the grant date) for as-of grants. Not until the SEC issued its September 2006 letter (discussed in Section 34.2A(b)) did GAAP tentatively clarify how the definitions of *measurement date* and *grant date* applied to as-of grants.

The next section of this chapter discusses the ambiguities in both definitions of *measurement date* and *grant date* during the period from the mid-1990s through 2005. As a result, even had an accountant addressed or focused on how accounting rules applied to as-of grants, these ambiguities in GAAP rendered unclear the accounting guidance relating to recording compensation expense under APB 25 for as-of grants.

#### (a) Ambiguous Definition of *Measurement Date* and No Definition of *Grant Date*.

APB 25 defined *measurement date* as a technical term and required an issuing company to use the intrinsic value method. The *measurement date* is the date used to ascertain whether an option grant generates a compensation charge. If the exercise price of an option equals the market price on the *measurement date*, one recognizes no compensation charge.

APB 25 provided an imprecise definition of *measurement date* (and the related use of the undefined term *grant date*) that would confuse an educated layman regarding the correct measurement date.

APB 25 ¶ 10(b) defines *measurement date* as "the first date on which are known both (1) the number of shares that an individual employee is entitled to receive and



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(2) the option or purchase price, if any.” At first blush, a technical application of this sentence (were one aware of it and focused on it) can lead one to conclude that an as-of grant (which selects a date in the past when the stock price was lower and uses the market price on that past date as the option’s exercise price) generates a compensation expense because that grant date and price in the past was not “known” until a later date, at which point the share’s market price was higher. That is not, however, the only reading of APB 25’s definition of *measurement date*.

This first sentence of APB 25 ¶ 10(b) is not the entire definition—and it commits an apposition ambiguity.

*Apposition Ambiguity*

Consider the following two sentences:

John or the Wild One took the motorcycle.

John, or the Wild One, took the motorcycle.

How many individuals do these sentences mean? The first implies that one of two different people—one with a name and the other with a nickname—did the taking. The second implies that one individual with both a name and a nickname did the taking. In the second sentence, the commas cause the reader to think of an apposition, or a modifier, for the first noun.

The first sentence of APB 25 ¶ 10(b) reads: “(2) the option or purchase price, if any.” By 2006, we know that GAAP means “or purchase” to be an explication of “option” as in “option price, sometimes referred to as purchase price.” But the omission of the commas leads the reader studying this material without further guidance to understand “the option price or the purchase price” as possibly different prices.

APB 25’s next sentence states that the *measurement date* “for many or most plans is the date an option or purchase right is granted or stock is awarded to an individual employee,” (i.e., the *grant date*), while “the measurement date may be later than the date of grant or award in plans with variable terms that depend on events after date of grant or award.”<sup>45</sup> Later, APB 25 explains the meaning of “many or most plans,” and provides that for them, the measurement date is the “date an option . . . is granted,” or grant date. APB 25 explains that one measures the compensation cost for “Typical Plans with Fixed and Determinable Terms . . . at the date of grant.”<sup>46</sup> APB 25 never defines the term *date of grant* (or the variant it sometimes uses, *grant date*).

In contrast, for “Typical Plans with Variable Terms” (e.g., plans based on the performance of the employee or the company), APB 25 provides that the “quoted market price used in the measurement is not the price at date of grant or award but the price at the date on which both the number of shares of stock that may be acquired by or awarded to an individual employee and the option or purchase price are known”<sup>47</sup> The language in APB 25 suggests, therefore, that only with respect to *variable* grants must one decide, as provided in the first sentence of paragraph 10(b), the “date on which both the number of shares of stock . . . and the option or purchase price are known.”

APB 25 draws a clear distinction between *fixed* and *variable* grants, stating that *fixed* grants measure compensation cost at the date of grant, while *variable* grants

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measure compensation cost at some later date on which (1) the number of shares and (2) the option price are known (i.e., once the terms of the grant become fixed). APB 25 supports the primacy of this distinction by adding language noting that the “Opinion is organized according to the most vital distinction in the Opinion—compensatory plans are divided between plans in which the cost of compensation is measured at the date of grant or award [for fixed grants] and those in which the cost of compensation depends on events after the date of grant or award [variable grants].”<sup>48</sup>

This “vital distinction” drawn by APB 25 suggests that if one is granting fixed options pursuant to “many or most plans,” the *measurement date* is the *grant date* (whatever that means), without need for further analysis. One could reasonably interpret APB 25 as providing that only when *variable* grants are at issue—performance-based grants, for instance—must one establish a “measurement date” that differs from the grant date, by applying the first sentence of paragraph 10(b) in order to decide “the first date on which are known both (1) the number of shares that an individual employee is entitled to receive and (2) the option or purchase price, if any.”<sup>49</sup>

One can reasonably read APB 25 in its entirety to provide that as long as the terms of an option grant are fixed (as opposed to variable), the company can avoid recognizing compensation expense as long as the “quoted market price of the stock at the date of grant” equals the option’s exercise price.<sup>50</sup> Because APB 25 defines neither *date of grant* nor *grant date* and nowhere specifies whether one can select a grant date in the past for a fixed grant, it is unclear both with respect to the definition of *measurement date* and the use of the undefined term *grant date*. It compounds the lack of clarity by not stating whether the measurement date for a fixed as-of grant should be the grant date or some other date.<sup>51</sup>

**(b) The Compounding Ambiguities of SFAS 123: Revised Definition of *Measurement Date* and Initial Definition of *Grant Date*.** SFAS 123 compounded the ambiguities present in APB 25. One plausible interpretation of SFAS 123 sanctions some of the practices of accounting for as-of grants, now known to have been wrong. APB 25 defines the *measurement date* as “the first date on which are *known* both (1) the number of shares that an individual employee is entitled to receive and (2) the option or purchase price, if any.”<sup>52</sup> SFAS 123 defines the measurement date as “the date at which the stock price that enters into measurement of the fair value of an award of employee stock-based compensation is *fixed*”<sup>53</sup>

Consider an option grant where the company’s board approved the grant on the 24th of the month and set the exercise price for the options as the closing price on the 10th of the month.

- The board decided on the 24th. It *fixed* the date of the exercise price on the 24th.
- The board decided the price to be that on the 10th. It *fixed* the date of the exercise price as the 10th.

How can a reader be sure which of the two interpretations of the word *fixed* the writers(s) of the SFAS 123 definition meant: the decision date (i.e., the 24th) or the date decided on (i.e., the 10th)? Under the second interpretation, choosing measurement dates with hindsight satisfies SFAS 123.<sup>54</sup> The confusion here results from

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SFAS 123's words. APB 25's earlier words do not illuminate the issue of how to account for an as-of grant.

As a consequence, through September 2006, when the SEC tentatively clarified the ambiguity, *measurement date* was ambiguous. The APB 25 definition is ambiguous, and it relies on the term *grant date*, which it does not define. By the mid-1990s, the FASB promulgated a different definition of *measurement date* in SFAS 123 that was also ambiguous. Moreover, the FASB did not state whether the old APB 25 definition remained operative for those using APB 25 accounting. Neither did it state whether the new standard's definition of measurement date replaced the old. Thus, during the period from 1995 through 2005, an additional ambiguity arises from SFAS 123, raising the question of which definition to apply. In any event, both definitions lack clarity and fail to provide definitive guidance on how to account for as-of grants.

Although the FASB initially intended for SFAS 123 to replace APB 25, political compromise led to a final version of SFAS 123 that supplemented APB 25 in part (with respect to accounting for stock options) and replaced it in part (with respect to disclosures). As a result, a registrant who used the intrinsic value method of APB 25 to measure the cost of its option grants could not disregard SFAS 123. Why? Although SFAS 123 allows a company to continue to use APB 25 in measuring the cost of options, it must apply a fair value method under SFAS 123 to derive supplemental disclosures.<sup>55</sup> The instructions regarding how to make that computation refer directly to the new SFAS 123 definition of *measurement date*, as well as the concept of *grant date*:

The measurement date for equity instruments awarded to employees is the date at which the stock price that determines the measurement of the transaction is fixed. The Board decided to retain the provisions of the Exposure Draft that the measurement date for equity instruments awarded to employees (and subsequently issued to them if vesting conditions are satisfied) and the related compensation cost is to be measured based on the stock price at the grant date.<sup>56</sup>

SFAS 123 purports to summarize the key features of APB 25, including how to compute intrinsic value as required to implement APB 25. In so doing, the language of SFAS 123 further muddies the waters. SFAS 123 supports and even compounds the ambiguous interpretation of APB 25, which results in the reasonable conclusion that the measurement date for a fixed option grant is the grant date, so that one need not recognize compensation cost if the option's exercise price is the market price on the grant date:

Under the fair value based method, compensation cost is measured at the grant date based on the value of the award and is recognized over the service period, which is usually the vesting period. Under the intrinsic value based method, compensation cost is the excess, if any, of the quoted market price of the stock at grant date or other measurement date over the amount an employee must pay to acquire the stock. Most fixed stock option plans—the most common type of stock compensation plan—have no intrinsic value at grant date, and under Opinion 25 no compensation cost is recognized for them. Compensation cost is recognized for other types of stock-based compensation plans under Opinion 25, including plans with variable, usually performance-based, features.<sup>57</sup>

Thus, SFAS 123 repeats the guidance in APB 25 that *fixed* options accounted for with the intrinsic value method result in no compensation charge for options

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granted “at-the-money,” whereas compensation cost is measured at a date other than the *grant date* only for *variable* options.<sup>58</sup> SFAS 123 thus noted that “the requirements of Opinion 25 typically result in the recognition of compensation cost for performance [variable] options but no cost is recognized for fixed options that may be more valuable at the grant date than performance options”<sup>59</sup> SFAS 123 even refers to “Opinion 25’s method for fixed plans” as providing for “grant date-intrinsic value accounting,” which if extended to other types of grants “would result in recognition of no compensation cost for all options that are at-the-money when granted”<sup>60</sup>

During this period, the accounting guidance followed by most companies to record compensation expense (APB 25 and FIN 44) did not define the term *date of grant* or *grant date*.<sup>61</sup> Therefore, no accounting guidance clarified whether the term meant:

- The date selected by a company representative with requisite authority and appearing on an agreement between an employee and the company, or
- The date that a company representative with requisite authority approves or ratifies the grant.

Several additional examples of the lack of clarity of the term *grant date* come from SFAS 123, which defines *grant date* as “the date at which an employer and employee have a mutual understanding of the terms of a stock-based compensation award.”<sup>62</sup>

First, imagine that an employer said to an employee on the day before employment starts, “If you start work tomorrow, we will give you options on 10,000 shares of our common shares. Your exercise price will be the lowest closing price for any trading day next month. Your right to receive these options will vest by the end of next month.” A reasonable person could conclude that the “employer and employee have a mutual understanding.” While the FASB issued subsequent guidance clarifying certain issues with respect to APB 25, the accounting guidance that applied until 2006 did not prohibit a grant date that preceded the approval date.<sup>63</sup> Although the guidance after 2006 did not prohibit it either, it did clarify that the stated grant date of an as-of grant cannot be the measurement date.

Second, SFAS 123 states, “Awards made under a plan that is subject to shareholder approval are not deemed to be granted until that approval is obtained unless approval is essentially a formality, for example, management and the members of the board of directors control enough votes to approve the plan.”<sup>64</sup> SFAS 123 does not address the case of an employee stock option plan that has already been approved by shareholders and that delegates the granting of individual options to the board of directors. FIN 44, issued in March 2000, addressed the timing of the grant and measurement dates for companies applying APB 25, but only for awards that require shareholder approval. It provided the same guidance as SFAS 123.<sup>65</sup>

Only in October 2005 did the FASB issue guidance to clarify the grant date in cases where a company’s stock option plan does not require stockholder approval for individual grants. *FASB Staff Position No. 123(R)-2*, an interpretation of the newly issued SFAS 123(R) (which ended the ability to use intrinsic value accounting under APB 25), states that “practice has developed such that the grant date of an award is generally the date the award is approved in accordance with an entity’s

### 34A.6 FINANCIAL LITERACY 25

corporate governance provisions, so long as the approved grant is communicated to employees within a relatively short time period from the date of approval.<sup>66</sup> The guidance concluded that this practice was acceptable as long as the terms of the grant were fixed on approval and not subject to negotiation or change.<sup>67</sup>

Thus, until the SEC's guidance in September 2006 provided tentative clarity, the accounting guidance related to the definitions of *measurement date* and *grant date* and their application to accounting for as-of grants was ambiguous. As a result, even had an accountant addressed or focused on how APB 25 applied to as-of grants, SFAS 123 compounded the ambiguities in the terms *measurement date* and *grant date*, which made the appropriate accounting treatment for as-of grants unclear.

### 34A.5 EVALUATION OF ACCOUNTANT TRAINING FOR AS-OF GRANTS

We reviewed the accounting course materials, textbooks, contents of the CPA examinations, and professional publications for CPAs. We focused on whether publications that discussed accounting for employee stock options addressed the meaning, interpretation, or proper application of the terms *grant date* and *measurement date* or provided any clarification of the ambiguity of these terms (discussed in Section 34.4A). We reviewed these publications to also ascertain when the accounting profession first clarified that the practice of recognizing zero cost for as-of grants violated APB 25.

The undergraduate financial accounting courses from the late 1970s through 2005 focused on the topics covered in the Uniform CPA Exam.<sup>68</sup> We analyzed the questions on CPA examinations administered from 1977 through 2005 and saw nothing that would motivate a textbook writer or a course designer to address backdating issues. The CPA exam questions focused on the mechanics of recording compensation expense under APB 25 or SFAS 123(R), related disclosure requirements, and the potentially dilutive effect of options on earnings per share calculations—not on the timing of grant and measurement date issues that determine the proper accounting for as-of grants. Not a single CPA examination question addressed measurement dates as they might apply to as-of grants.

We reviewed two prominent publications for CPAs, the *Journal of Accountancy* and the *CPA Journal*, during the years 1997 through 2005.<sup>69</sup> We searched articles on the accounting for employee stock options that frequently mentioned the term *grant date* from the mid-1990s through 2005. None, however, mentioned the timing of an option grant's approval in relation to the grant or measurement date. Similarly, we found no guidance on accounting for as-of grants in these publications.

Thus, our examination of these materials shows that the education and training for accountants from the mid-1990s through 2005 did not address accounting for as-of grants.

### 34A.6 FINANCIAL LITERACY

We have reviewed research on the issue of financial literacy. Research from the early 2000s shows many executives who sit on the audit committees of boards of

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directors, as well as chief financial officers (CFOs), who do not demonstrate even basic accounting literacy. Coates, Marais, and Weil write:<sup>70</sup>

In the course of our work, we have learned that not all CFOs demonstrate accounting literacy. There are several career paths to the position of CFO, some of which are from within the company, including controller, treasurer, general counsel, and operative executive. Other CFO career paths, from outside the company, include public accountant (auditor) and investment banker.

Only the controller and public accountant have career paths ensuring accounting literacy. The treasurer understands corporate finance, such as how to raise funds and how to talk to the financial press or analysts, but typically hasn't had a need to understand accounting. The investment banker understands how to raise funds, but aside from some knowledge (now obsolete) of purchase and pooling issues, typically hasn't had a need to understand accounting.<sup>71</sup>

The most common career path to CFO has been through the position of corporate treasurer, which does not require knowledge of GAAPs at the level a controller needs. As a result of conversations with such CFOs and others who work with them, we see a distinct difference in the potential for financial (meaning accounting) literacy between treasurers and controllers. Similarly, we think former investment banker CFOs have had less exposure to accounting issues than controllers have in their career paths to CFO. As little substantive exposure to accounting issues as the treasurer or the CFO may have had, the CEO likely has had less. Hence, we score CEOs who have not had experience as a financial executive a notch below the financial executive.<sup>72</sup>

To confirm our observation that many CFOs do not have backgrounds that would ensure accounting literacy (and thus, familiarity with employee stock option accounting rules), we reviewed the biographies listed in the "Executive Officer" section of the Form 10-K filing for each company in the "Silicon Valley 150" listing published in April 2002 by the *San Jose Mercury News*.<sup>73</sup> We categorize the CFO as having an accounting background if the biography mentions that the CFO is a CPA or worked for a public accounting firm or in an accounting position (e.g., as a controller). This analysis finds that 66 of the 152 CFOs of companies in the Silicon Valley 150 listing for 2002 for which we could find background information (43 percent) do not report having an accounting background.<sup>74</sup>

Our review of articles discussing the backgrounds of CFOs found that the educational background, training, and career paths of CFOs are not uniform, and that firms frequently hire nonaccountant CFOs with operational, corporate finance, or business strategy experience and skills.<sup>75</sup> The results of these analyses thus confirm that many practicing CFOs from the mid-1990s through 2005 did not have backgrounds that would ensure accounting literacy.

We reviewed a leading publication for finance executives, *CFO Magazine*, during the period 1997 to 2005. That review identified few articles that discussed accounting for employee stock options and *no* guidance on the relation between the approval of an option grant and its grant date and measurement date. In particular, we found *no* articles that discussed accounting for employee stock options that also contained the term *measurement date*. None.

Regarding chief executive officers (CEOs), Coates et al. observed, "As little substantive exposure to accounting issues as the treasurer or CFO may have had, the CEO likely has had less."<sup>76</sup> Executives untrained in accounting would not have received instruction in accounting for employee stock options.<sup>77</sup>

## CONCLUSION

Our review of the accounting guidance and literature on the financial literacy of business executives shows that accountants did not address or focus on how to account for as-of grants until 2006, and the accounting literature failed to clearly define the technical terms *date of grant* and *measurement date*. This failure resulted in a lack of useful guidance regarding which dates in a company's stock option grant approval process constituted appropriate grant and measurement dates for accounting purposes. The accounting rules remained unclear until the SEC provided tentative guidance in 2006 that the as-of grant date could not be a proper measurement date.

The courts should not expect anyone to have followed "rules" that the accounting profession failed to clarify.

The lack of clarity in the general case—where we would defend senior executives from charges of known or reckless behavior with respect to accounting issues—stems either from lack of focus on the GAAP at issue during the years when the practice of granting as-of options was common, or from the ambiguity in the rules themselves, or from both.

## APPENDIX

### Evolution of the Accounting Guidance for Employee Stock Options from the Mid-1990s to 2006.

Employee Stock Option Accounting Guidance Comparison of Contemporaneous GAAP (1995–2005) with SEC Guidance in 2006	
Table 1: Timing of Measurement Date, Grant Date and Approval Date	
Contemporaneous GAAP (1995–2005)	SEC Guidance in 2006
<ul style="list-style-type: none"> <li>• "Compensation for services that a corporation receives as consideration for stock issued through employee stock option, purchase, and award plans should be measured by the quoted market price of the stock at the <i>measurement date</i> less the amount, if any, that the employee is required to pay." (Emphasis added) (APB 25, ¶10)<sup>78</sup></li> <li>• The <i>measurement date</i> is "the first date on which are known both (1) the number of shares that an individual employee is entitled to receive and (2) the option or purchase price, if any. That date for many or most plans is the date an</li> </ul>	<ul style="list-style-type: none"> <li>• <b>"A. Dating an Option Award to Predate the Actual Award Date:</b> As noted previously, pursuant to paragraph 10(b) of Opinion 25, the measurement date for determining the compensation cost of a stock option is the first date on which both of the following are known: (1) the number of options that an individual employee is entitled to receive and (2) the option or purchase price. Thus, even if documents related to an award of options are dated as of an earlier date, the measurement date cannot occur until the date the terms of the award and its recipient are actually determined. As such,</li> </ul>

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option or purchase right is granted or stock is awarded to an individual employee and is therefore unchanged from Chapter 13B of ARB No. 43. However, the measurement date may be later than the *date of grant* or award in plans with variable terms that depend on events after date of grant or award." (Emphasis added) (APB 25, ¶10(b))

- **Grant Date:** "The date at which an employer and an employee have a mutual understanding of the terms of a stock-based compensation award. The employer becomes contingently obligated on the grant date to issue equity instruments or transfer assets to employees who fulfill vesting requirements. Awards made under a plan that is subject to shareholder approval are not deemed to be granted until that approval is obtained unless approval is essentially a formality, for example, management and the members of the board of directors control enough votes to approve the plan. The grant date of an award for current service may be the end of a fiscal period instead of a subsequent date when an award is made to an individual employee if (a) the award is provided for by the terms of an established formal plan, (b) the plan designates the factors that determine the total dollar amount of awards to employees for that period (for example, a percentage of net income), and (c) the award is attributable to the employee's service during that period." (SFAS 123, Appendix E: Glossary)<sup>80</sup>
- **Measurement date:** "The date at which the stock price that enters

dating the underlying stock option grant documents as of a date prior to the date on which the terms of the award and its recipient are determined does not affect the appropriate measurement date under Opinion 25." (SEC September 2006 Letter, p. 2.)<sup>79</sup>

- **"B. Option Grants with Administrative Delays . . .** If a company operated as if the terms of its awards were not final prior to the completion of all required granting actions (such as by retracting awards or changing their terms), the staff believes the company should conclude that the measurement date for all of its awards (including those awards that were not changed) would be delayed until the completion of all required granting actions.

On the other hand, in certain instances where a company's facts, circumstances, and pattern of conduct evidence that the terms and recipients of a stock option award were determined with finality on an earlier date prior to the completion of all required granting actions, it may be appropriate to conclude that a measurement date under Opinion 25 occurred prior to the completion of these actions. This would only be the case, however, when a company's facts, circumstances, and pattern of conduct make clear that the company considered the terms and recipients of the awards to be *fixed and unchangeable* at the earlier date." (*Id.*, pp. 3–4.)

- **"D. Uncertainty as to Individual Award Recipients**  
We understand that some companies may have approved option awards before the number of options to be granted to each



Employee Stock Option Accounting Guidance Comparison of Contemporaneous GAAP (1995–2005) with SEC Guidance in 2006	
Table 1: Timing of Measurement Date, Grant Date and Approval Date	
Contemporaneous GAAP (1995–2005)	SEC Guidance in 2006
<p>into measurement of the fair value of an award of employee stock-based compensation is fixed.” (SFAS 123, Appendix E: Glossary)</p> <ul style="list-style-type: none"> <li>• “Generally, awards granted under a plan that is subject to shareholder approval shall not be deemed granted (and, therefore, no measurement date can occur) until that approval is obtained. However, if management and the members of the board of directors control sufficient votes to approve the plan, a <i>grant date</i> (and a <i>measurement date</i>) may be deemed to occur prior to shareholder approval because such approval is essentially a formality. Consequently, in most cases, required shareholder approval must be obtained in order to conclude that a grant (and a measurement) date for an award has occurred under Opinion 25.” (Emphasis added) (FIN 44, ¶87)<sup>81</sup></li> <li>• <b>Grant Date for Awards Requiring Shareholder Approval:</b> “Generally, awards granted under a plan that is subject to shareholder approval shall not be deemed granted (and, therefore, no measurement date can occur) until that approval is obtained. However, if management and the members of the board of directors control sufficient votes to approve the plan, a grant date (and a measurement date) may be deemed to occur prior to shareholder approval because such approval is essentially a formality. Consequently, in</li> </ul>	<p>individual employee was finalized. For example, the compensation committee may have approved an award by authorizing an aggregate number of options to be granted prior to the preparation of a final list of individual employee recipients. In these cases, the allocation of options to individual employees was completed by management after the award approval date, or the unallocated options were reserved for grants to future employees. Pursuant to paragraph 10(b) of Opinion 25, no measurement date can occur until “the number of shares that an individual employee is entitled to receive” is known.</p> <p>In certain circumstances, the approved award may contain sufficient specificity to determine the number of options to be allocated to individual employees, notwithstanding the absence of a detailed employee list. If management’s role was limited to ensuring that an allocation was made in accordance with definitive instructions ([e.g.], the approved award specified the number of options to be granted based on an individual’s level within the organization), the measurement date could appropriately be the date the award was approved. However, if management was provided with discretion in determining the number of options to be allocated to each individual employee, a</p>

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most cases, required shareholder approval must be obtained in order to conclude that a grant (and a measurement) date for an award has occurred under Opinion 25.” (FIN 44, ¶87)

- “The Board concluded that awards made under a plan that is subject to shareholder approval should not be deemed granted until that approval is obtained, unless approval is essentially a formality. Some respondents requested that the Board explicitly address various implementation issues that arise concerning the definition of *essentially a formality*. The Board concluded that it was not practical to address those implementation issues in this Interpretation. The Board believes, however, that approval is not essentially a formality unless management and the members of the board of directors control enough votes to approve the plan. An assessment that it is probable that the shareholders will approve the plan is not sufficient to make approval essentially a formality.”

measurement date could not occur for such options prior to the date on which the allocation to the individual employees was finalized. If the allocation of a portion of the award is specified at the award approval date with the allocation of the remainder left to the discretion of management, the measurement date could appropriately be the date the award was approved only for those options whose allocation was specified.” (*Id.*, pp. 6–7.)

## NOTES

1. See C. P. Stickney and R. L. Weil, *Financial Accounting: An Introduction to Concepts, Methods, and Uses*, 8th ed. (Fort Worth, TX: Dryden Press, Harcourt Brace College Publishers, 1997), pp. 645–647.
2. In the United States, accountants began codifying GAAP in the late 1930s in the form of the Committee of the Accounting Procedure (CAP) of the American Institute of Accountants, now called the AICPA—American Institute of Certified Public Accountants. The CAP issued Accounting Research Bulletins, ARBs. In 1959, the AICPA replaced the CAP with the Accounting Principles Board (APB), which issued GAAP in the form of Opinions. Then, in 1973, the Financial Accounting Standard Board, FASB, replaced the APB as the standard setter. The FASB provides GAAP through its Statements and Interpretations. In 1973, the FASB made clear that ARBs and APB Opinions continued to have the full weight of GAAP until the FASB specifically said otherwise in one of its Statements.
3. Other instances that invoke the term *backdating* include (1) “straggler grants,” wherein a plan already in place with named individuals and share amounts adds new names or

new shares to the existing ones; and (2) “later-paper grants,” wherein board members sign unanimous written consents on a given day, memorializing actions that occurred on an earlier day.

4. Erik Lie, “On the Timing of CEO Stock Option Awards,” *Management Science* 51, no. 5 (May 2005).
5. APB 25, ¶ 10
6. Id. ¶ 28. For example, a plan might specify the number of shares the employee receives as a function of the company’s earnings—the greater the earnings, then the greater the number of shares. The earnings in question could be the earnings of the employee’s division, not necessarily of the entire company. Similarly, the number of shares awarded at the end of a budgeting period might be a function of a salesman’s gross sales during that period.
7. Id. ¶ 4.
8. Id. ¶ 10(b).
9. Id. ¶ 28.
10. APB 25 uses primarily the term *date of grant*, with occasional uses of the synonymous term *grant date*. Later, GAAP refers almost always to *grant date*. GAAP uses the terms interchangeably, as does this chapter.
11. APB 25, ¶¶ 23–26 (in the original, this is a section head and appears in boldface type with initial capitalized letters); Id., ¶¶ 27–32 (in the original, this is a section head and appears in boldface type with initial capitalized letters).
12. SFAS 123, Summary.
13. SFAS 123, ¶ 395.
14. FASB issued SFAS 123 in October 1995, effective for fiscal years beginning after December 15, 1995. The SFAS 123 accounting treatment uses the fair value method for measuring compensation expense, rather than the intrinsic value method of APB 25, as of the grant date. Under SFAS 123, “[t]he fair value of a stock option . . . granted by a public entity shall be estimated using an option-pricing model. . . . The fair value of an option estimated at the grant date shall not be subsequently adjusted for changes in the price of the underlying stock or its volatility, the life of the option, dividends on the stock, or the risk-free interest rate” (¶ 19).
15. In this context, “recognition” refers to the form of accounting journal entry and the date when the firm makes the entry, but not the amount for the debits and credits. “Measurement” refers to the amounts in the entry.
16. FIN 44, Summary.
17. EITF 00-23: Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25 and FASB Interpretation No. 44, first discussed by the EITF in September 2000.
18. Note, however, that while FIN 44 provides guidance with respect to when certain situations render an option grant variable (e.g., when a company re-prices or exchanges previously granted options or both, shortens the vesting schedule of previously granted options, or provides a full-recourse loan with a below-market interest rate to its employees to facilitate the exercise of their options), this guidance does not bear on the accounting requirements for selecting an option’s *grant date* and thus has no bearing on the accounting for an as-of grant.
19. The EITF reached consensus on new aspects of options accounting on several dates during the period 1987 through 2001. A thorough understanding of accounting for options required constant vigilance for new rules. (See Appendix-D.) Few accountants, and no business executives of whom I’m aware, followed the evolution of the rules.
20. FASB issued SFAS 123(R) in December 2004, but public companies could not adopt the new standard until the first interim or annual reporting period beginning after June 15, 2005.
21. SEC September 2006 Letter, Introduction.

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22. SEC Division of Corporate Finance, "Sample Letter Sent in Response to Inquiries Related to Filing Restated Financial Statements for Errors in Accounting for Stock Option Grants," January 16, 2007 ("SEC January 2007 Letter"), [www.sec.gov/divisions/corp-fin/guidance/oilgasltr012007.htm](http://www.sec.gov/divisions/corp-fin/guidance/oilgasltr012007.htm).
23. In particular, we searched for guidance issued by the American Institute of Certified Public Accountants (AICPA), which issued the applicable generally accepted auditing standards (GAAS) in the form of AICPA Professional Standards through 2005. The AICPA did not issue any guidance specifically related to employee stock options. The Sarbanes-Oxley Act of 2002 granted the authority to issue auditing standards to the Public Company Accounting Oversight Board (PCAOB). The PCAOB did not issue any guidance related to employee stock options until it issued an Audit Practice Alert titled "Matters Related to Timing and Accounting for Option Grants" on July 28, 2006 ("PCAOB Audit Practice Alert No. 1"). We could not locate any major audit firm guidance related to auditing employee stock options. Arthur Andersen (Andersen), KPMG LLP (KPMG), Ernst & Young (E&Y), and PriceWaterhouseCoopers (PwC) did publish reference guides on accounting for stock compensation during the relevant time period.
24. SEC September 2006 Letter, Section A.
25. SEC September 2006 Letter, Sections B, D, F, and G.
26. SEC September 2006 Letter, Introduction.
27. The Appendix to this chapter contrasts the accounting guidance regarding employee stock options before 2006 with that in 2006.
28. SEC January 2007 Letter.
29. Glass Lewis *Yellow Card Trend Alert*, Appendix A: "Stock-Option Backdating Scandal," March 2007 (hereafter "Glass Lewis Study").
30. Randall A. Heron and Erik Lie, "What Fraction of Stock Option Grants to Top Executives Have Been Backdated or Manipulated?" *Management Science* 55, no. 4 (April 2009): 513–525.
31. Erik Lie, "On the Timing of CEO Stock Option Awards," *Management Science* 51, no. 5 (May 2005) (Lie [2005]); "Academic studies have long noted suspiciously favorable patterns related to the timing of option grants. Those patterns were largely attributed to companies planning option grants in advance of significant releases of information, until a 2005 study by University of Iowa researcher's [sic] Erik Lie." Testimony of Mark W. Olson, PCAOB chairman, before the Committee on Banking, Housing, and Urban Affairs, United States Senate, September 6, 2006. Several business press articles and testimony by SEC officials also cite the Lie (2005) study as the first evidence of potentially improper timing of option grants and as the impetus for the SEC's investigation into employee stock option timing issues. See, for example, Mark Maremont, "Authorities Probe Improper Backdating of Options—Practice Allows Executives to Bolster Their Stock Gains; A Highly Beneficial Pattern," *Wall Street Journal*, November 11, 2005, p. A1; Charles Forrelle and James Bandler, "The Perfect Payday—Some CEOs Reap Millions by Landing Stock Options When They Are Most Valuable; Luck—or Something Else?" *Wall Street Journal*, March 18, 2006, p. A1; Christopher Cox, Chairman, Testimony Concerning Options Backdating, before the U.S. Senate Committee on Finance, Washington, D.C., September 6, 2006; Lie (2005) at 803. Lie does not use the term *backdating*. He mentions that he spoke to three compensation experts who told him they were aware of "cases in which the grant date preceded the decision date."
32. Available at [www.biz.uiowa.edu/faculty/elie/backdating.htm](http://www.biz.uiowa.edu/faculty/elie/backdating.htm).
33. Christopher Cox, Chairman, Testimony Concerning Options Backdating, before the U.S. Senate Committee on Finance, Washington, D.C., September 6, 2006.
34. "Granting Options When Favorable Information Is Undisclosed—Thoughts," *The Corporate Counsel* XXIX, no. 6 (November–December 2004): 11.
35. *Securities and Exchange Commission v. Gregory L. Reyes, Antonio Canovo, and Stephanie Jensen*, Complaint, United States District Court, Northern District of California, July 20, 2006. The joint SEC/Department of Justice press release announcing the charges stated,

- "The actions, which are among the first cases involving manipulation of stock option grants in violation of the federal securities laws and other criminal statutes, are the result of 18-month investigations by the Commission and the FBI." U.S. Securities and Exchange Commission Press Release 2006-121, "U.S. Attorney's Office and SEC Separately Charge Former Brocade CEO and Vice President in Stock Option Backdating Scheme," July 20, 2006.
36. Linda Chatman Thomsen, Director, Division of Enforcement, Speech: "Options Backdating: The Enforcement Perspective," Washington, D.C., October 30, 2006. *See also* Christopher Cox, Chairman, Testimony Concerning Options Backdating, before the U.S. Senate Committee on Finance, Washington, D.C., September 6, 2006.
  37. Available at [www.sec.gov/spotlight/optionsbackdating.htm](http://www.sec.gov/spotlight/optionsbackdating.htm) (last modified 07/19/2010). The earliest two cases, *SEC v. Peregrine Systems, Inc.* (filed June 30, 2003) and *SEC v. Symbol Technologies, Inc., et al.* (filed June 3, 2004), involved multiple counts of securities and/or financial fraud, and options backdating was not the primary charge. Only one of these two litigation releases (*SEC v. Symbol Technologies*) mentioned options accounting issues, although in both cases the SEC's complaint contained allegations of options backdating.
  38. Reuters, "Brocade Settles Suit Over Timing of Options," *New York Times*, June 3, 2008.
  39. Jessica Guyunn, "Legal Drama as Backdating Trial Ends in 'Guilty,'" *San Francisco Chronicle*, August 8, 2007, p. A-3.
  40. Glass Lewis Study.
  41. We classify in this group the companies in the industries that the study labels as follows: software and programming (43), semiconductors (37), computer networks (6), computer services (6), computer hardware (4), and computer storage devices (4). The study reports the industry as "Other" for 43 of the 257 companies (*Id.*, p. A10).
  42. We classify in this group the companies in the industries labeled as follows: biotechnology and drugs (18); electronic instr. and controls (7); medical equipment and supplies (6); scientific and technical instr. (5); and aerospace and defense (3) (*Id.*, p. A10).
  43. The study lists the following cities in or near the Silicon Valley: San Jose, CA (17); Sunnyvale, CA (14); Santa Clara, CA (10); Mountain View, CA (7); San Francisco, CA (4); Cupertino, CA (3); Alameda, CA (2); Fremont, CA (2); Milpitas, CA (2); and Redwood City, CA (2). The study reports the headquarters as "Other" for the remaining 147 companies (*Id.*, p. A10).
  44. SFAS 123 explained that "under the intrinsic value based method, compensation cost is the excess, if any, of the quoted market price of the stock at *grant date or other measurement date* over the amount an employee must pay to acquire the stock" (SFAS 123, Summary; emphasis added).
  45. *Id.*
  46. *Id.* ¶¶ 23, 24.
  47. *Id.* ¶¶ 27, 29. For example, a plan providing for variable grants could specify the number of shares the employee receives as a function of the company's earnings: the greater the earnings, then the greater the number of shares. The earnings in question could be the earnings of the employee's division, not necessarily of the entire company. Similarly, the number of shares awarded at the end of a budgeting period could be a function of a salesman's gross sales during that period. Standard option plans, however, provide for fixed grants: "Under traditional stock option . . . plans an employer corporation grants options to purchase a fixed number of shares of stock of the corporation at a stated price during a specified period" (APB 25, ¶ 1).
  48. *Id.* ¶ 22.
  49. APB 25, ¶ 10[b]. This interpretation is strengthened by other portions of APB 25, such as paragraph 11(b), which notes that the "measurement date is *not changed from the grant or award date to a later date solely by provisions*" relating to the effect of termination of employment (emphasis added). This language implies that in most other circumstances, the measurement date *is* the grant date. Similarly, Appendix B (¶ 10) of APB 25 notes,

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“The committee therefore concludes that in most cases, including situations where the right to exercise is conditional upon continued employment, valuation should be made of the option as-of the date of grant.”

50. APB 25, ¶ 23.
51. In addition, the word *known* is ambiguous as used in paragraph 10(b). Other portions of APB 25 use the phrase “known or determinable” (APB 25 ¶¶ 4, 29) and although the price of an as-of grant may not have been “known” on that selected date in the past, the share’s market price on that date was certainly “determinable” on that date. Once again, this indicates that APB 25 was drawing a distinction between fixed grants (for which the measurement date is the grant date) and variable grants, for which certain terms are not yet determinable (because they “depend on future events” [Id. ¶¶ 2, 4]), such that a later date when the terms become fixed must be used as the measurement date.
52. ¶ 10[b].
53. SFAS, ¶ 395 (emphasis added).
54. Later, in 2005, the FASB issued SFAS 123(R), which changed the definition of measurement date, but the expansion of the definition did not remove the ambiguity regarding which date is being fixed. SFAS 123(R) defines *measurement date* as “the date at which the equity share price and other pertinent factors, such as expected volatility, that enter into measurement of the total recognized amount of compensation cost for an award of share-based payment are fixed” (SFAS 123[R], Appendix E).
55. “This Statement defines a *fair value based method* of accounting for an employee stock option or similar equity instrument and encourages all entities to adopt that method of accounting for all of their employee stock compensation plans. However, it also allows an entity to continue to measure compensation cost for those plans using the *intrinsic value based method* of accounting prescribed by APB Opinion No. 25, *Accounting for Stock Issued to Employees*. . . . Entities electing to remain with the accounting in Opinion 25 must make pro forma disclosures of net income and, if presented, earnings per share, as if the fair value based method of accounting defined in this Statement had been applied.” (SFAS 123, Summary). *See also*, ¶ 5: “An entity that continues to apply Opinion 25 must comply with the disclosure requirements of this Statement, which supersede the disclosure requirements of paragraph 19 of Opinion 25.”
56. SFAS 123, ¶ 119.
57. SFAS 123, Summary.
58. SFAS 123, ¶¶ 56, 67, 137–138; Id., ¶ 3 (“Opinion 25 specifies different dates for the pertinent quoted market price of the stock used in measuring compensation cost, depending on whether the terms of an award are fixed or variable, as those terms are defined in Opinion 25”) (internal footnote omitted).
59. SFAS 123, ¶ 56.
60. Id. ¶ 137.
61. In discussing GAAP during the period 1995–2005, when SFAS 123 allowed companies to use APB 25, one needs to understand that APB 25 did not define *grant date*. Yet although APB 25 did not define it, SFAS 123, which did not apply to a company using APB 25 to recognize compensate cost, did.
62. SFAS 123, Appendix E.
63. The term *approval date* is not a GAAP term of art. We use it as shorthand to mean when the board or its delegated committees approve the award to employees.
64. SFAS 123, Appendix E.
65. “The Board concluded that awards made under a plan that is subject to shareholder approval should not be deemed granted until that approval is obtained, unless approval is essentially a formality. . . . The Board believes, however, that approval is not essentially a formality unless management and the members of the board of directors control enough votes to approve the plan.” (¶ 149). Similarly, FASB’s EITF issued EITF 00-23, first discussed in September 2000, which addresses the issue of whether the measurement date can occur prior to shareholder approval if that approval is voluntarily sought.

The EITF concluded that FIN 44 “addresses this issue. If an award is subject to a contingency, [FIN] 44 requires that the number of shares and exercise price cannot be fixed and, therefore, a measurement date cannot occur until the contingency is resolved” (EITF 00-23 ¶10).

66. *FASB Staff Position No. 123(R)-2* ¶ 3. U.S.GAAP does not define the term *date of approval*, as described here. In this chapter, that term means “The date when the procedures specified by the entity’s corporate governance policies approve an award, provided the benefited employee learns of the grant within a relatively short period.” In this context, a relatively short period is approximately one month. The guidance does not say when is the “date of approval” if the entity tells the benefited employee only after a “relatively short time.”
67. *FASB Staff Position No. 123(R)-2* ¶ 5. In September 2006, the SEC issued guidance that reiterated this position: “There may also be situations where an at-the-money grant was actually decided with finality, but there were unimportant delays in the completion of administrative procedures to document the grant that did not involve misrepresentation of the option granting actions. In those situations, if compensation cost would not have otherwise been recorded pursuant to Opinion 25, short delays in completing the administrative procedures to finalize the grant would not result in an accounting consequence.” SEC Press Release 2006-156, “Office of the Chief Accountant Issues Letter Expressing Its Views on the Appropriate Application of the Stock Option Accounting Literature,” September 19, 2006 (SEC September 2006 Letter).
68. “The Uniform Certified Public Accountant (CPA) Examination is the examination that an individual must pass in order to qualify for licensure as a Certified Public Accountant (CPA) in any of the 55 U.S. jurisdictions. . . . The Uniform CPA Examination is one of the ‘Three Es’—Education, Examination, and Experience—that constitute the requirements for CPA licensure. . . . Until the end of 2003, the Uniform CPA Examination was administered twice a year in the paper-and-pencil format.” AICPA website, [www.aicpa.org/BecomeACPA/CPAExam/ExamOverview/PurposeandStructure/Pages/default.aspx](http://www.aicpa.org/BecomeACPA/CPAExam/ExamOverview/PurposeandStructure/Pages/default.aspx).
69. “Published continuously since 1905, the *Journal of Accountancy* is the flagship publication of the American Institute of Certified Public Accountants. Our articles and features cover a wide variety of subjects including accounting, financial reporting, auditing, taxation, personal financial planning, technology, business valuation, professional development, ethics, liability issues, consulting, practice management, education and related domestic and international business issues. With 386,000 paid subscribers, the *JofA* reaches more financial decision makers than all other accounting publications combined”; [www.journal-of-accountancy.com/About/](http://www.journal-of-accountancy.com/About/). According to the *CPA Journal’s* website: “For over 70 years, this monthly magazine has been one of the leading national accounting publications delivering comprehensive and timely coverage of the issues facing today’s CPAs.” The journal reaches more than 36,000 subscribers; [www.cpajournal.com/adinfo.htm](http://www.cpajournal.com/adinfo.htm).
70. We note regarding chief executive officers (CEOs): “As little substantive exposure to accounting issues as the treasurer or CFO may have had, the CEO likely has had less.” Douglas J. Coates, M. Laurentius Marais, and Roman L. Weil, “Audit Committee Financial Literacy: A Work in Progress,” *Journal of Accounting, Auditing & Finance* (March 2007): 180.
71. *Id.*, p. 177.
72. *Id.*, p. 180.
73. “How to Get in Touch with the SV150,” *San Jose Mercury News*, April 15, 2002. We examined the proxy or Form 10-K filed closest in time to the publication of the SV150 listing in April 2002. In the one case where the company’s SEC filings did not provide sufficient detail on the CFO’s background (e.g., either past positions or education), we searched for further information on that individual on the company’s website or in the bio issued by a subsequent employer or other online source.
74. Two of the companies provided information in their SEC filings for two CFOs during that fiscal year.

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75. See, for example, Matthew Quinn and Alix Stuart, "Not Just Bean Counters," *Wall Street Journal*, July 31, 2002, p. B1; Robert A. Howell, "CFOs: Not Just for Finance Anymore," *Wall Street Journal*, February 21, 2012; Spencer Stuart, "The Global 50: The New Finance Leader: Lessons from and Advice for Today's CFO," (2009), p. 3; David McCann and Lois Calabro, "Wanted: Strategic CFOs. Again," CFO.com, September 28, 2009; David McCann, "CPAs Give Way to MBS: As CFOs Get More Strategic, so Do Their Teams," CFO.com, October 26, 2011; Michele Heid, "What's Expected Now of CFOs?" March 1, 2010, [www.heidrick.com/Blogs/Pages/WhatsexpectedofCFOs.aspx](http://www.heidrick.com/Blogs/Pages/WhatsexpectedofCFOs.aspx) (accessed on August 16, 2012).
76. Coates et al., p. 180.
77. For example, an executive who received an MBA during this period could have taken courses that addressed the accounting for employee stock options with broad-brush principles, not details of guidance and implementation. MBA courses emphasized the economics of employee stock options—that they impose a cost on the issuing company and provide a benefit to the recipient, which for various reasons differs from the cost to the company. During most of the period from 1973 to 1995, all of the teaching involved sparring over then-current rules, which treated options as having no cost. Similarly, an executive trained as a lawyer (or practicing as general counsel) would not have been instructed in accounting for stock options. If a general counsel were to have received instruction about the accounting for stock options, it would have come from continuing education or from professional publications. We also reviewed continuing legal education (CLE) materials and publications for practicing general counsels published during years 1997–2005. We found no materials that explained how the mechanics of the stock option grant approval process should function or provided meaningful clarification of existing GAAP for employee stock options.
78. *APB Opinion No. 25: Accounting for Stock Issued to Employees* ("APB 25"), Issued October 1972.
79. SEC Press Release 2006-156, "Office of the Chief Accountant Issues Letter Expressing Its Views on the Appropriate Application of the Stock Option Accounting Literature," September 19, 2006, p. 2.
80. *FASB Statement No. 123: Accounting for Stock-Based Compensation* ("SFAS 123"), Issued October 1995, effective for fiscal years beginning after December 15, 1995.
81. *FASB Interpretation No. 44: Accounting for Certain Transactions Involving Stock Compensation* (an interpretation of APB Opinion No. 25) ("FIN 44"), issued March 2000. "The Board concluded that awards made under a plan that is subject to shareholder approval should not be deemed granted until that approval is obtained, unless approval is essentially a formality. Some respondents requested that the Board explicitly address various implementation issues that arise concerning the definition of essentially a formality. The Board concluded that it was not practical to address those implementation issues in this Interpretation. The Board believes, however, that approval is not essentially a formality unless management and the members of the board of directors control enough votes to approve the plan. An assessment that it is probable that the shareholders will approve the plan is not sufficient to make approval essentially a formality." (FIN 44, ¶ 149)