

Stock Options Healthcheck

“Apple’s Irregular Options.” “Stock Scandal Has Mercury Falling.” “Barnes and Noble Subpoenaed Over Stock Options Practices.” Are these the kind of headlines you want for your business?

Background

In 2004 the Securities and Exchange Commission (SEC) received a copy of a technical paper written by Dr. Erik Lie showing that corporate executives were either better at predicting the performance of the market for the granting of stock options than the top financial analysts and brokers, or there was a strong indication of option date/price manipulation.

The SEC responded with strong interest and in May 2006 announced its intention to investigate the possibility of stock options backdating. Since May, the SEC has confirmed investigations into over 50 companies. Many companies have also voluntarily entered into their own private investigations. At present nearly 200 companies have announced delays in issuing their second quarter results, pending investigations; many of these companies have also stated they may not be able to release their third quarter financials on time as investigations may not be complete in time.

Companies that don’t file quarterly reports within five days of their reports’ original deadlines are no longer in compliance with SEC rules. Potential consequences include defaulting on bank loans or having their stock delisted.

Types of Stock Options Backdating

The SEC is looking into several types of options backdating; these include:

- **Backdating Existing Grant Dates** – Changing option grant dates to favor better stock prices retroactively
- **Spring Loading Options** – Issuing options just prior to news that could increase the stock price significantly, resulting in higher gains
- **Manipulating Hire Dates** – Changing hiring dates to take advantage of option pricing
- **Issuing Grants Retroactively** – Approving grant issuances retroactively when an opportunity for optimal profits is seen
- **Creating Phantom Employees** – Granting additional options to phantom employees to create a slush fund for executives to draw on at a later date

The Stock Options Issue

Much of the options backdating could be in breach of securities laws or have associated tax and accounting implications where the necessary compensation expense has not been correctly disclosed.

At a minimum, companies who have been engaged in options backdating may face restatement and/or SEC or Department of Justice investigations.

All companies should consider performing limited procedures to ensure that options backdating is not an issue they face. Where such issues are uncovered, our recommendations would be to take steps to address them internally and independently with the SEC. It is widely expected that most Independent Accountants will conduct additional year-end audit procedures to address these issues.

The PCAOB sounded the alarm for Independent Accountants to be on the lookout for backdating related to the reporting of options-related costs in their clients’ financial statements. “Auditors planning or performing an audit should be alert to the risk that the issuer may not have properly accounted for stock option grants and, as a result, may have materially misstated its financial statements or may have deficiencies in its [internal controls over financial reporting],” the PCAOB said in the nine-page guidance, the first in a series of audit practice alerts. These audit procedures could result in significant additional audit costs.



Our Solution

Control Solutions has been a leading provider of internal audit services for over 15 years. Our proven methodology, which uses data analytics to identify areas requiring management's attention, is well suited to review your stock options program.

Our comprehensive Stock Options Healthcheck approach and audit program will provide comfort to management and the audit committee that options grants have been properly accounted for, recorded and disclosed.

Price Analytics

We compare stock options issuances and price points against stock price movements since 1996, including reviewing the dates chosen for evidence of backdating or spring loading.

Grant Type Analysis

We review both broad-based grants and one-off grants for evidence of price fixing or manipulation. This work focuses predominantly on grants that are considered higher risk, for example those to senior executives. Our effort includes detailed review of hire dates and grant dates for evidence of manipulation.

Approval Analysis

We review approvals associated with the grants to ensure that the approvals were obtained correctly and in a timely manner. We look for evidence of retroactive approvals and issuances.

Employee Analysis

We perform testing to ensure that grants were issued to valid employees; we also perform verification of existence for employees.

Verification of Appropriate Disclosure and Accounting

Where we identify any potential issues, we review the disclosure and accounting treatment for evidence of compliance with SEC rules.

Proactively performing a review of your options plan voluntarily and presenting the analysis to your Independent Accountants will, more than likely, reduce the costs associated with your auditors' review of these items and avoid the cost and chaos of finding the issue during an audit.

What Happens If We Find Something?

Our procedures are designed to be sufficiently thorough to provide comfort to management and the audit committee that the company has administered its stock options program appropriately, or to uncover instances where this has not been the case. In the event that we find any evidence of non-compliance, we will immediately raise this to management and the audit committee and discuss appropriate actions for management to consider. Companies may have to make improvements in their internal control procedures, improve processes for capturing information and adopt new stock options practices.

Cost

The Control Solutions Stock Options Healthcheck, including final summary report, requires 200–400 hours, depending on the size of your organization, number of option plans, number of grant issuances and the number of employees.

Don't risk becoming another headline. Contact Ben Daly (800) 627-0028 x115 or Steve Randall (866) 257-3337 x12 for more information.

Control Solutions is the leading global provider of independent internal audit, compliance, risk management and technology solutions. Since 1991, we have strategically partnered with leading public, private, nonprofit and government clients, offering a truly positive experience different from that of our competitors. Our team of 800 longtime and highly trained professionals delivers services in more than 35 countries. Our consultants apply a combination of deep industry knowledge and an average 15 years of professional experience to address your unique challenges. When you are ready to find out what true experience, professionalism, international presence and an integrated and flexible approach can do for you – look no further. With Control Solutions you will find a partner that is committed to you and measures its success based on your success. For more information visit www.controlsolutions.com.