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Backdating, SAB 108, Fair Value Updates

By Tammy Whitehouse — March 20, 2007

A new study suggests that stock option grant data being used to support allegations of backdating may not necessarily be as incriminating as first believed.

A group of consultants with NERA Consulting, an economic analysis firm, has published the third installment of a four-part series analyzing stock grant data to verify assertions that some companies may have illegally or inappropriately backdated stock option grants. The study, "Options Backdating: The Statistics of Luck," says that some grant patterns that may at first appear extremely unlikely, and therefore seem suspicious, actually are possible.

The report says that the large number of directors and officers in the United States who receive stock options would make the granting of options on days when the stock value is low a likely occurrence, even when no illegal activity is involved. It also says some early probability calculations have overlooked certain factors that may be important in estimating the likelihood of option grants for specific companies.

Three of the study's co-authors, Renzo Comolli, Branko Jovanovic, and Patrick Conroy, all consultants at NERA, say the academic literature available so far has been limited to methodologies designed to detect aggregate patterns—but not to analyze specific companies. As a result, the authors say, the data does not distinguish between legal and illegal practices.



Conroy

"The way the analysis was originally done, it generated incredibly small probabilities that someone could have generated grant dates randomly," Conroy says. "In fact, there's a chance that companies are trying to pick days when the price is low to grant stock options. If you're working for a company and the market falls, that might be great day to give stock options because the price is low."

Comolli says a random selection of data would show that, in fact, some people were quite lucky with their grants and some people were quite unlucky, with the majority falling somewhere between the two—a typical bell-curve distribution. "If thousands of directors and officers are receiving grants, even just at random, some people will do well and some people will do poorly," he says.



Comolli

Conroy says the NERA study's bell curve shows that more companies were lucky than unlucky, but even that can't be seen immediately as incriminating. "If you assume that the grants are not at random, that people were trying to pick days to grant options when the price was low, you'd expect the lucky tail to be bigger," he says. "The majority of companies are in the middle, not either lucky or unlucky."

Jovanovic emphasizes that the study is not meant to argue that backdating has not occurred. "We're trying to say that in a large number of companies you will find some companies were lucky and some were unlucky," he says.

The first two papers in the four-part NERA series served as a primer for stock options, backdating, and the accounting, tax, and economic issues related to backdating. The intended fourth installment will focus on an in-depth examination of related company statistics.

FASB Staff: Extend SAB 108 To Non-Registrants

The Financial Accounting Standards Board has issued a proposed staff position that would essentially codify the Securities and Exchange Commission's call last year for a more comprehensive approach to correcting lingering, accumulating financial-statement errors.

FASB issued a proposed staff position, "Considering the Effects of Prior-Year Misstatements When Quantifying Misstatements in Current-Year Financial Statements," to elaborate on the requirements of Financial Accounting Standard No. 154, *Accounting Changes and Error Corrections*.

The SEC issued Staff Accounting Bulletin No. 108 in September 2006 to require companies to follow a more comprehensive method for quantifying errors in financial statements as a basis for determining the materiality and making corrections. Previously, companies had been free to use one of two separate, accepted methods: the "rollover" approach and the "iron curtain" approach. The SEC's directive in SAB 108 was that companies should use both methods.

Now FASB's staff position says companies beyond the authority of the SEC should do likewise. "In effect, this FSP in conjunction with SAB 108 establishes a single approach for quantifying misstatements that could be material to users of financial statements," FASB writes in its proposal.

For large accelerated filers the tap dance with SAB 108 is finished, as those companies have passed their deadline for 10-K filings. But smaller companies or companies with later reporting dates might find useful some guidance offered by the Center for Audit Quality.



Scoles

The CAQ, an arm of the American Institute of Certified Public Accountants, published five frequently asked questions with answers to explain some of the finer point of SAB 108 implementation. Mark Scoles, a partner with the Accounting Principles Group of Grant Thornton, says the SEC answered questions early in the implementation process by meeting with AICPA officials. “There are always going to be some individual facts-and-circumstances questions that individuals will have to ferret out,” he says. “Generally, the large accelerated filers have applied the guidance that was out there.”

The CAQ document answers questions about the cumulative effect adjustment upon SAB 108 adoption, the effect of waived audit differences from prior years, the effect of prior period errors, materiality, and disclosures.

Survey Finds Investors Wary Of Fair Value

Professional investors like fair-value measures for liquid financial assets but aren’t eager to see fair value creep much deeper into financial statements, according to a recent survey by PricewaterhouseCoopers.

Investors are worried about how an increasing use of fair-value measures would affect the income statement, PwC says. Where fair value is used, investors want plenty of disclosure about the underlying assumptions to make financial statements fully comparable. They’re looking for meaningful, transparent disclosures about how assets and liabilities are measured and the inputs used by management in their valuation models, PwC says.

“On the surface, it seems like fair-value measures should be more relevant, especially on the asset side of the balance sheet, but we don’t know that it’s been tested,” says Mark LaMonte, senior credit officer for Moody’s. “We’ve run models for years with historical cost information and have found it to be reliable, but we haven’t run models with fair value to see what’s going on within a given company.”

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NERA
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