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Option Backdating Prompts PCAOB to Issue Staff Audit Practice Alert No. 1

Last Thursday, the Public Company Accounting Oversight Board (PCAOB) issued its first Staff Audit Practice Alert (APA), *Matters Related to Timing and Accounting for Option Grants*. APAs were developed to highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under **existing** PCAOB standards and relevant laws. The subject covered by the APA is certainly noteworthy — a recent internet search resulted in over one million hits for the phrase *option backdating*. The Wall Street Journal reports that over 80 companies are currently involved in SEC or Justice Department investigations.

Backdating and Spring-Loading Explained

The APA focuses on so-called *discount* or in-the-money options (i.e., the strike price is below the market price on the measurement date). These are more valuable than typical options that, at the measurement date, have a zero *intrinsic value* (a technical option term meaning the excess of the current market price over the exercise price). At issue are situations when an issuer fails to properly consider the impact of the discount on the original accounting. The APA points to a range of practices, not all-inclusive, that could result in discounting:

1. Plan provisions that allow for the selection of exercise prices based on prices earlier than the grant date,
2. Plan provisions that provide for an exercise price equal to the lower of the market price on the “grant” date or during a specified period of time after the grant date,
3. Preparation or subsequent modification of option documentation intended to indicate a lower exercise price than the market price on the actual grant date, or
4. Treating a date as a grant date when all of the prerequisites to a grant had not occurred.

Example (of situations 1 and 3 above):

On March 31, 20X3, the Board of Directors awards the COO of Company XYZ options on 5,000 shares of common stock. The Company had not adopted the provisions of Statement 123 and 123(R) and, accordingly, the options are accounted for pursuant to Opinion 25. The Option plan stipulates that the option exercise price will be the market price of the common stock on the date the options are awarded **or, if lower**, the lowest stock price in the 30 days prior to the date of the award.

As developments warrant, *Heads Up* is prepared by the National Office Accounting Standards and Communications Group of Deloitte & Touche LLP (“Deloitte & Touche”). For subscription information, see the back page.

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The market price of XYZ stock was as follows during March:

- March 12, 20X3: \$27 (the lowest price during the 30 days prior to the award)
- March 31, 20X3: \$37

Under Opinion 25, no compensation is recorded if, on the *measurement date*, the options have no intrinsic value. If Company XYZ incorrectly concludes that the March 12 date is the *measurement date*, it would fail to record the appropriate compensation cost over the vesting period. March 31 is the appropriate *measurement date* because that is the first date on which both the number of shares and the option price are known. Each option is in the money by \$10, representing the difference between the \$27 exercise price and the market price of \$37 of the stock on the *measurement date*.

While the recognition and measurement principles of Statements 123 and 123(R) differ from those of Opinion 25, the outcome is similar. An incorrect conclusion that discount options should be accounted for “at the money” will result in an understatement of compensation expense over the vesting period.

The APA only briefly mentions the practice known as option *spring-loading* or, in the words of the APA, purposefully granting options “immediately before the release of information that the issuer believed would be favorable to its share price.” While spring-loading doesn’t raise the same measurement questions as backdating, the PCAOB staff notes that the practice may create legal or reputation risks and raise concerns about the issuer’s control environment.

Auditing Considerations

The APA warns that auditors planning or performing an audit should be alert to the risk that the issuer may not have properly accounted for stock option grants. As a result, the issuer’s financial statements may be materially misstated or there may be deficiencies in ICFR (internal controls over financial reporting). In short, for current and future audits, the auditor needs to acquire sufficient information to permit an assessment of the nature and potential magnitude of these risks. The APA also addresses auditor involvement in registration statements and the effects of option-related matters on previous opinions.

The chart below addresses the following audit related topics covered by the APA — as they may be affected by option-related matters — and cross-references existing auditing literature:

Topics	Specifics (see Appendix for Details)	Authoritative Auditing Guidance (see Glossary of Standards)
Planned or Ongoing Audits of Financial Statements and ICFR	<ul style="list-style-type: none"> • Assess the nature and potential magnitude of risks associated with granting of stock options. 	
	<ul style="list-style-type: none"> • In planning and performing audits, appropriately address the assessed level of risk related to option granting practices. 	AU Section 311 AU Section 312.07 AU Section 316 AU Section 317 AU Section 319 AU Section 333 AU Section 337
	<ul style="list-style-type: none"> • Integrated audit considerations. 	Auditing Standard 2
Auditor Involvement in Registration Statements	<ul style="list-style-type: none"> • Subsequent event procedures to perform related to consent requests. 	AU Sections 711.10–13
	<ul style="list-style-type: none"> • Successor/predecessor situations. 	AU Sections 315.21 and 22 AU Sections 711.11–13
Previously Issued Opinions	<ul style="list-style-type: none"> • Subsequent discovery of facts existing at the date of the auditor’s report. 	AU Section 561 AU Sections 711.12 and 13

Of particular interest is the APA's discussion of the auditor's assessment of the nature and potential magnitude of risks. For example, *where appropriate*, the auditor's considerations should include patterns of transactions or conditions that might indicate higher levels of inherent risk. Such patterns or conditions may include a high level of stock-option-based compensation, highly variable grant dates, patterns of significant increases in stock prices following option grants, and high levels of stock price volatility.

Accounting and Other Related Guidance

The APA also refers to other appropriate guidance, advising auditors to be mindful of the following:

- Accounting requirements for stock based compensation (Opinion 25, Statements 123 and 123(R));
- Accounting and disclosure requirements for contingencies resulting from legal or other contingencies (Statement 5);
- Accounting for tax effects, particularly related to the issuer's ability to deduct, for tax purposes, expenses related to options;
- Materiality considerations, as discussed in AU Section 312.11 and SAB 99; and
- Possible Illegal Acts as discussed in AU Section 317 and Section 10A of the Securities Exchange Act of 1934.

Appendix: Auditors' Considerations on Option-Related Matters Per PCAOB APA No.1

Planned or Ongoing Audits		
Area	Considerations/Factors	APA Cites of Relevant Literature
Assess the nature and potential magnitude of risks of misstatement of financial statements and deficiencies in ICFR related to option granting practices	Where appropriate, consider: <ul style="list-style-type: none"> • Status/results of issuer or regulatory investigations; • Results of direct inquires of management and board members; • Public information related to option timing; • Terms of plans and policies, especially those that allow exercise prices not equal to grant date share price or that delegate authority for options to management (auditors should consider whether other policies adequately control the related risks); and • Patterns of transactions or conditions that may indicate higher levels of inherent risk (high level of option grants vs. number of shares outstanding, option-based compensation is a large component of executive compensation, highly variable grant dates, patterns of significant increases in stock prices following option grants, high levels of stock-price volatility). 	
In planning audits, the auditor should appropriately address the assessed level of risk	In addition to general planning considerations, consider implications of identified/indicated fraudulent illegal acts related to stock grants to assessed risks of fraud; the potential for illegal acts; the assessment of an issuer's internal control; and the scope of procedures applied to assess the potential for fraud.	AU Section 311 AU Section 312.07 AU Section 316 AU Section 317 AU Section 319
In performing audits, the auditor should appropriately address the assessed level of risk	Nature, timing, and extent of audit procedures to financial statement elements affected by the issuance of options, including consideration of: <ul style="list-style-type: none"> • The need for specific management representations and the nature of matters included in inquires of lawyers; • The results of tests of internal controls (where applicable); and • The need (based on risk assessment) for additional specific auditing procedures. 	AU Section 333 AU Section 337
Integrated audits as described in PCAOB Auditing Standard No. 2	<ul style="list-style-type: none"> • Consideration of the implications of identified or potential accounting and legal risks related to options in planning, performing and reporting on audits of ICFR. • Consideration of the results of the audit of ICFR in connection with the related financial statement audit (paragraphs 145–158 of Auditing Standard 2). 	Auditing Standard 2

Auditor Involvement in Registration Statements

Area	Considerations/Factors	APA Cites of Relevant Literature
Procedures to perform when an auditor is requested to consent to the inclusion of his or her report in a registration statement under the Securities Act of 1933	Consider performing inquires and obtaining representations specifically related to the granting and recording of option grants in performing subsequent procedures between the date of the audit opinion and the effective date of the registration statements.	AU Section 711.10
Successor/ predecessor situations	Successor auditor becomes aware of information that leads to a belief that the predecessor financial statements may require revision.	AU Sections 315.21 and 22 AU Section 711.11
	Successor or predecessor auditor discovers subsequent events that require adjustment or disclosure in the financial statements or becomes aware of facts that may have existed at the date of the report and might have affected the report.	AU Section 711.12
	Auditor concludes that unaudited financial statements or unaudited interim financial statements presented/incorporated by reference are not in accordance with GAAP.	AU Section 711.13
Previously Issued Opinions		
Effects of option-related matters on previously issued opinions	Auditor becomes aware of information, not known at the date of the report, that relates to previously audited financial statements and is of such a nature and from such a source that the auditor would have investigated it since it might have affected the report had the auditor been aware of such information.	AU Section 561 AU Sections 711.12 and 13

Glossary of Standards

Financial Accounting Guidance

APB Opinion No. 25, *Accounting for Stock Issued to Employees*

FASB Statement No. 5, *Accounting for Contingencies*

FASB Statement No. 123, *Accounting for Stock-Based Compensation*

FASB Statement No. 123(R), *Share-Based Payment*

Other Guidance

PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*

SEC Staff Accounting Bulletin Topic 1.M, "Materiality" (SAB 99)

AICPA Professional Standards, AU Section 311, "Planning and Supervision"

AICPA Professional Standards, AU Section 312, "Audit Risk and Materiality in Conducting an Audit"

AICPA Professional Standards, AU Section 315, "Communications Between Predecessor and Successor Auditors"

AICPA Professional Standards, AU Section 316, "Consideration of Fraud in a Financial Statement Audit"

AICPA Professional Standards, AU Section 317, "Illegal Acts by Clients"

AICPA Professional Standards, AU Section 319, "Consideration of Internal Control in a Financial Statement Audit"

AICPA Professional Standards, AU Section 333, "Management Representations"

AICPA Professional Standards, AU Section 337, "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments"

AICPA Professional Standards, AU Section 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report"

AICPA Professional Standards, AU Section 711, "Filings Under Federal Securities Statutes"

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