



## CORPORATE GOVERNANCE

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# SEC Weighs in on Accounting For Past Stock Options Grants

IN ONE OF THE LARGEST CORPORATE SCANDALS since the fall of Enron Corp., concerns about stock-option backdating have rocked blue-chip to high-tech businesses and confused executives. The SEC's chief accountant recently issued an open letter telling companies how to account properly for these stock option grants. This letter should guide businesses that are undergoing internal reviews or responding to U.S. Securities and Exchange Commission or U.S. Department of Justice inquiries.

On Sept. 19, the SEC issued a press release limiting the advice in the letter to issues related to "accounting for stock options in the historical financial statements of public companies."

The Office of the Chief Accountant at the SEC issued the letter with heavy qualifications. It addresses only the proper treatment of corporate financial statements, not questions relating to the legal or regulatory violations. While the staff letter will guide those executives currently scrutinizing their companies' financial statements and deciding whether to restate earnings, it does little to clarify the legality of the disparate set of practices

that have come to be known as backdating.

The SEC letter addresses the accounting consequences of several factual scenarios. In these scenarios, a key focus is determining the measurement date for stock options. Under SEC Accounting Principles Board Opinion No. 25, the

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measurement date is defined as the date on which proper accounting occurs, determined by looking at the difference between the exercise price and the market price. According to Opinion 25, the stock option's measurement date is the first date on which an accountant can know the option price and the number of shares that an individual employee is entitled to receive.

The new SEC guidance letter indicates how companies can determine the measurement date in the context of several scenarios, including options awarded to predate the award date, options with administrative delays, options with questionable validity and spring-loaded options. The letter condemns instances of clear backdating, noting that the practice "does not affect the appropriate measurement date under Opinion 25."

One of the most helpful pieces of advice in the letter is the SEC's statement that, where a company made a final decision to bestow an option

### SCHOOL FOR SCANDAL

- THE SEC HAS ISSUED GUIDANCE TO HELP COMPANIES ACCOUNT FOR PAST GRANTS OF STOCK OPTIONS AND DECIDE WHETHER TO RESTATE FINANCIAL REPORTS.
- THE SEC'S LETTER INDICATES THAT FINALITY IS KEY IN DETERMINING THE MEASUREMENT DATE OF OPTIONS.
- THE LETTER MAY FUEL DEBATE ON THE PROPRIETY OF AWARDING SPRING-LOADED OPTIONS.



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grant, but unimportant administrative delays intervened, the company need not incur a compensation charge.

For example, the letter explains that in some instances, investigators found that companies accounted for options using a measurement date that fell before the company completed all required granting actions. One such administrative delay occurred when companies obtained oral authorization to grant the options from the board of directors but completed the documents at a later date. The letter resolves questions stemming from this scenario by focusing on finality: If the company operated as though the terms were not final, the measurement date should occur only after all the required actions occur. If, however, the company treated the terms as final, the measurement date could occur earlier, despite any administrative delays.

The letter again focuses on finality where some questioned the validity of past grants even though both parties technically complied with the option. For example, assuming that a cap exists on the number of options to be issued, how does a company properly account for options it awards

beyond the cap? The SEC letter states that if both parties honored those awards, the company can treat them as fixed with a measurement date on the date of the award grant, despite any uncertainty about the grant itself.

Perhaps most controversial, the letter also addresses what has become known as spring-loaded options, a situation in which companies time option grants just prior to announcing good news, giving the option recipient the benefit of the resulting rise in share price. Attorneys and politicians have hotly debated whether this practice is as illegal as backdating. Opponents of the practice say that it

deceives shareholders and unfairly manipulates the market. It is unclear, however, whether the SEC will pursue these cases.

The SEC letter explains the practice of spring loading and notes that such options do not require an adjustment to the market price of the stock to compute compensation cost. Despite the letter's qualifications as not addressing the legality of these practices, this accounting treatment will likely be read as to provoke further debate on the propriety of spring-loaded options.

This ambiguity about spring-loading demonstrates the still-unfolding nature of this scandal, which has been described as causing carnage to corporate America on an unprecedented level. *The Economist*, in its Oct. 19 review of the scandal, noted the fact that several companies have fired top executives without official charges and questioned whether this indicates a cultural change in corporate governance since the fall of Enron. All of this remains to be seen.

In terms of the nuts and bolts of deciding whether to restate financial reports, however, the SEC's letter undoubtedly will help many companies with their review.

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