Testimony Concerning
Certain Issues Related to
Companies' Stock Option Granting Practices

PCAOB

Public Company Accounting Oversight Board

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Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee:

I am pleased to appear today on behalf of the Public Company Accounting Oversight Board to discuss the PCAOB's response to concerns relating to certain stock option granting practices.

The PCAOB oversees the auditors of public companies, in order to protect the interests of the investing public in the preparation of informative, accurate and independent audit reports on public company financial statements. The PCAOB does not regulate accounting or disclosures by public companies; rather, the PCAOB's role is to enhance the quality of the audits of such financial statements. Simply put, the PCAOB's job is to improve the quality and reliability of public company audits, so that investors can have more confidence in audited financial statements.

The Board has a variety of tools with which to promote improved audit quality. While those tools include meaningful enforcement and disciplinary authority – important authority backing up all of our other authority – the Board has focused on implementing a supervisory model of regulation intended to focus firms on the need for high quality auditing, by helping them see where they are falling short and providing feedback and guidance that facilitates their efforts to improve. The PCAOB's approach to the audit issues that arise in connection with companies' stock option granting practices is an example of the PCAOB's emphasis on real-time improvements in audit quality.

I. Stock Option Granting Practices Have Raised Concerns About Companies' Accounting for and Disclosure of Compensation Costs.

Before describing the PCAOB's response to concerns about some companies stock option granting practices, I will briefly describe the history of these concerns and certain regulatory changes that appear to have reduced the opportunity and incentive for some of the practices at issue.

A. Employee Stock Options Can Be a Useful Tool, but Concerns Have Arisen Whether Companies Have Properly Disclosed Their True Costs.

As we all know, many companies issue stock options as a form of compensation and to give employees vested interests in improving their companies' performance and share prices. Such options usually give employees the right to buy shares in the future, at the price of the stock on the date of the grant. The higher the share price rises relative to the exercise price, the more valuable the options are. Well managed, stock options can be a useful and appropriate tool to attract and retain employees.

Companies' financial statements, of course, must account for and disclose options consistent with applicable accounting and regulatory requirements, and recently concerns have arisen that some may not have done so. More than 120 companies have announced they are involved in civil or criminal investigations, or internal reviews, of possible problems in the way they have granted, accounted for and disclosed stock option compensation to senior executives and other employees. 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 Erik Lie, who I understand will discuss his work in the second panel of this hearing.[1] That study suggested that the favorable granting patterns could be attributable to companies having retroactively assigned option grant dates on dates their stocks hit relative lows, when the options were in fact granted weeks or months later.

B. Changes in Regulatory Requirements Appear to Have Reduced the Incidence of Suspiciously-timed Option Grants.

While the extent of the problems arising from backdating and other stock option granting practices is not yet clear, two significant changes in the disclosure and accounting for stock option grants in recent years – the first initiated by, and the second supported by, this Committee – seem to have significantly reduced companies' opportunity and incentive to backdate grants.

First, the Sarbanes-Oxley Act appears to have significantly reduced the incidence of backdated option grants. Specifically, the SEC's rules implementing Section 403 of the Act now require public company officers and directors to report their receipt of stock options within two days of the grant.[2] Previously, such persons were generally not required to report option grants until 45 days after the fiscal year in which they were received.[3] Given the new filing requirement, the ability to backdate option grants to coincide with low stock prices is greatly curtailed. Indeed, subsequent research has shown that, following the change, when company insiders reported

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[1] See Lie, E., "On the Timing of CEO Stock Option Awards," Management Science (May 2005), at 802, available at http://www.biz.uiowa.edu/faculty/elie/Grants-MS.pdf.

options within the new deadline, there was little to no pattern of abnormal share price increases soon afterward.[4]

Second, accounting standards for employee stock options have also gone through several changes over the last few years. Historically, the applicable accounting standard – found in Accounting Principles Board Opinion No. 25 – required companies to record, as compensation cost, the amount, if any, by which the price of an employee stock option exceeded the market price on the date of the grant.[5] Compensation expenses associated with such "in-the-money" stock options was required to be reported as incurred in the period or periods in which the employee performed services

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[2] See SEC Release No. 34-46421, Ownership Reports and Trading by Officers, Directors and Principal Security Holders (August 27, 2002), available at http://www.sec.gov/rules/final/34-46421.htm. Section 403 of the Sarbanes-Oxley Act required certain company insiders to file reports of certain transactions in the securities of their companies within two days of the transaction. In addition, it required such reports to be filed electronically and available on a public, SEC Web site as well as on the company's Web site if it maintains one.

[3] Under Section 16 of the Securities Exchange Act of 1934, and the SEC's implementing rules, directors, officers and certain others are required to report transactions and holdings involving their companies' securities, including the receipt of employee stock options. Until August 29, 2002, stock options awarded under most employee stock purchase and other benefit plans were required to be reported (on the SEC's Form 5) within 45 days after the end of the fiscal year in which they were granted. In its rule implementing Section 403 of the Sarbanes-Oxley Act, the SEC required certain transactions that were formerly reportable annually on Form 5, such as option grants, to be reported, like other insider transactions, on Form 4 within Section 403's new two-day deadline.

[4] That research also shows that the previously identified pattern of stock prices rising shortly after grant dates has continued for those companies whose insiders have not complied with the two-day requirement. See Heron, R. and Lie, E., "Does Backdating Explain the Stock Price Pattern Around Executive Stock Option Grants?" forthcoming in Journal of Financial Economics, available at http://www.biz.uiowa.edu/faculty/elie/Grants-JFE.pdf.

[5] See Accounting Principles Board Opinion No. 25. Accounting Principles Board Opinions were promulgated by the American Institute of Certified Public Accountants until 1973, when the Financial Accounting Standards Board was established. At that time, the FASB adopted outstanding APB Opinions, as amended, and over time has superseded them.

for the option, which could extend for years after the option grant.[6] As a result, failure to account properly for in-the-money options could affect several financial periods.

APB Opinion No. 25 permitted companies not to record any cost, however, when employee stock options were granted at a price equal to or greater than the market price on the date of the grant. APB Opinion No. 25 thus discouraged companies from granting options at less than the prevailing market price, although such discounted options could be more lucrative for recipients. Some companies may have attempted to have it both ways, though, by granting options at prices below market on the date of the grant but treating them for accounting and tax purposes as if they were granted on a date when market prices were lower.

In 1994, the Financial Accounting Standards Board adopted Statement of Financial Accounting Standards No. 123, which encouraged companies to report the cost of stock option grants to employees at their fair value, but permitted them to continue to rely on APB Opinion No. 25, so long as they disclosed what the compensation cost would have been had they recorded such options at their fair value.[7] Finally, in 2004, the FASB eliminated APB Opinion No. 25 and, beginning with financial statements for annual periods starting after June 15, 2005, required companies to

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[6] APB Opinion No. 25, para. 12.

[7] See Statement of Financial Accounting Standards No. 123, Share-Based Payment, available at http://www.fasb.org/pdf/fas123.pdf.

account for employee stock options at their fair value, regardless of any difference between an option's exercise price and the market price at the time of grant.[8]

II. The PCAOB Has Alerted Auditors to Use Judgment in Considering Issues Relating to Stock Option Granting Practices in Their Audits.

Although much of the conduct currently under review appears to predate the Sarbanes-Oxley Act, errors related to such conduct may affect current period financial statements if employee performance related to past option grants continues into the present. That is, if an employee is still earning an option through performance (e.g., the option has not vested yet) then any compensation cost associated with the option may be allocable to the current financial period. In addition, new revelations of such conduct may trigger current auditor obligations with respect to past financial periods.

As the prevalence of problems in dating of stock option grants became clear, the PCAOB considered the implications of such problems for audits, and developed a strategy to draw those issues to auditors' attention so that they can address them in this year's audits. Specifically, the PCAOB reviewed patterns in option granting practices identified in available research, accounting firms' existing guidance to their auditors related to option granting practices, and auditing, accounting and regulatory requirements that have a bearing on audits of stock option grants. In addition, the Board discussed issues related to the timing of stock option grants at the June 2006

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[8] See Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payments, available at http://www.fasb.org/pdf/fas123r.pdf; see also SEC Release No. 33-8568 (April 15, 2005). Certain small business issuers have until annual periods starting after December 15, 2005 to comply with FAS 123(R). Id.

public meeting of its Standing Advisory Group.[9] With the encouragement of members of this advisory group, these efforts led to an Audit Practice Alert publicly issued by the Board's staff on July 28, and disseminated electronically to the more than 1,600 public accounting firms registered with the PCAOB. This tool allowed the PCAOB to provide real-time guidance as auditors begin a new audit season, without adding to the volume or complexity of the body of existing standards.

I have attached a copy of this Alert as Exhibit A. The Alert focuses auditors on several considerations related to evaluating and addressing in their audits the risk that stock option granting practices may have led to material misstatement of financial statements. In doing so, the Alert identifies existing standards that could bear on their work and applies them to the issues that have been raised regarding companies' stock option granting practices; the Alert does not establish new requirements.

Specifically, the Alert tells auditors that, in audits currently underway or to be performed in the future, they should use certain information that existing standards direct them to acquire, in order to assess the nature and potential magnitude of risks associated with their audit clients' stock option granting practices. The Alert also emphasizes that auditors must use professional judgment in making this assessment and in determining appropriate procedures to address any identified risks. In addition, the Alert reminds auditors of several procedural considerations, such as how they

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9 The Board convened its Standing Advisory Group pursuant to Section 103(a)(4) of the Sarbanes-Oxley Act. The Group consists of a select group of experts in auditing and financial reporting, including representatives of investors, accountants, and public companies and meets three times a year to advise the Board on its standards-setting responsibilities.

should approach requests for consents to use past audit opinions, including situations in which they are no longer the auditor of record. The Alert also describes circumstances in which existing standards require auditors to reconsider past audit opinions.

As the Alert points out, in assessing the risk of material misstatement of financial statements, an auditor should consider whether the company accounted for options that are still outstanding under APB Opinion No. 25. If so, and if a company granted options at a price that was lower than the market price on the true grant date, then the auditor should consider whether compensation costs were materially understated (and whether additional disclosures should have been made) in the periods of the recipient-employee's performance, including the current period. The Alert also instructs the auditor to consider the effect of any errors in measuring compensation on the effectiveness of the company's internal control over financial reporting. Finally, the Alert reminds auditors that errors in reported option compensation may have material tax implications for companies[10] and may result in material contingent obligations, including those due to pending legal and regulatory matters.

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[10] The Internal Revenue Code limits the deduction public companies may take for compensation paid to certain executive officers to $1 million, but it excludes from this limit compensation that is performance-based. See Internal Revenue Code Section 162(m). Stock option compensation may be treated as performance-based when the exercise price is equal to or more than the grant date's market price. If, on the other hand, the option provides for a discounted exercise price, it counts toward, and is subject to tax if it exceeds, the deduction limit. Companies that may have granted stock options at an exercise price that differs from the market price on the grant date, may have a tax liability, and potentially penalties, for past taxes due. If material, auditors should confirm that these items are recorded and reported in the financial statements.

In closing, the Board appreciates the opportunity to describe how it has approached concerns about companies' accounting for employee stock options. Alerting auditors to practices and trends that may be relevant to their ongoing audits is a critical part of the PCAOB's approach to oversight. The Board's goal is to help auditors identify and address problems in financial reporting in order to protect investors' interests in high-quality and reliable audits. The PCAOB's work in the area of auditing employee stock option grants is an important step toward this goal.

I would be pleased to answer any questions.