

## THE STOCK-OPTION BACKDATING SCANDAL AND ITS MINOR IMPLICATION OF AUDIT FIRMS

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### AN OVERVIEW

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# The Stock-Option Backdating Scandal and its Minor Implication of Audit Firms: An Overview

On September 20, 2013 in Washington D.C., Audit Analytics' CEO, Mark Cheffers, gave a presentation at the ALI-CLE Accountants' Liability Conference.<sup>1</sup> In addition to an overview of a number of metrics (i.e., financial restatements, going concerns, securities class action litigation, SOX 404 trends, audit fees, etc.) that provided insight into the market and litigation environment experienced by audit firms, the presentation discussed stock-option backdating cases. This overview of federal cases showed that, despite expected allegations of improper accounting, audit firms were not named as a defendant in most actions and large settlements occurred in only four cases: one where a \$2.2 billion financial restatement resulted and three where the complaint alleged stock-option backdating as ancillary conduct to more severe allegations of fraudulent revenue recognition.

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## The Academic Study

The wave of stock-option backdating cases that started in 2006 was the result of an academic study. In May 2005, the Management Science Journal published a study by Professor Erik Lie, a finance professor at the University of Iowa, that showed a pattern of "abnormal stock returns" that suggested that stock option "awards are timed retroactively." (See: <http://www.biz.uiowa.edu/faculty/eliel/Grants-MS.pdf>) This study caused the SEC to initiate an investigation and caused the media to report stories on a number of companies and executives implicated in what some news outlets described as the "stock-option backdating scandal." During 2006 and 2007, companies disclosed a total of 153 financial restatements due to stock-option backdating and four other companies implemented Staff Accounting Bulletin (SAB) No. 108 to address the misstatements. Since so many companies were practicing stock-option backdating, a subsequent surge in litigation naturally ensued.

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## Stock-Option Backdating Litigation Overview

Stock-option backdating is not illegal if the grant is properly disclosed to the public and the transaction accounted for appropriately. Since an allegation of illegal stock-option backdating practices includes an element of improper accounting, there was a possibility that audit firms would be drawn into these cases, but the extent of the exposure was unclear back in 2006. By 2013, however, almost all of the stock-option cases ended and an overview of the litigation showed only a few auditor settlements worthy of mention.

The information regarding stock-option backdating cases was retrieved from the Audit Analytics litigation database. The database contains all federal material litigation as disclosed by companies to the SEC in Item 3 of Form 10-Ks and other disclosures. In addition, the database contains all federal litigation where an audit firm is involved in the action, even if the involvement is simply an objection to the scope of a discovery request. When analysts review these cases, the category of the cause of action is identified and tagged. The taxonomy of litigation categories maintained by Audit Analytics includes "stock-option backdating." Therefore, all the information needed to perform an overview of all the material federal litigation regarding stock-option backdating was easily retrieved from the database. In addition, the restatement database allowed Audit Analytics to identify 23 additional instances where a complaint did not specifically allege stock-option backdating, but a company filed a restatement addressing backdating or deferred stock-based issues during the litigation.

<sup>1</sup> The Power Point presentation can be viewed at [http://www.auditanalytics.com/doc/ALI\\_CLE\\_2013.pptx](http://www.auditanalytics.com/doc/ALI_CLE_2013.pptx)

A summary of the results of the analysis follows:

- Total Stock-Option Backdating Cases: **181** (consolidated from 206)
  - Specifically Asserting Backdating: **158**
  - No Specific assertion, but an Attendant Financial Restatement Addressing Backdating and/or Deferred Stock-Based Issues: **23**
- Subset of the 181 Cases Filed by the SEC: **32** (16 naming only individuals)
- Subset of the 181 Cases Filed as Derivative Actions: **74**
- Subset of Cases that Name Auditor as Defendant: **13**
- Law Firms Representing Defendant Auditors: **13**

## The Corporate Counsel’s Perspective

When looking at the results above from the viewpoint of corporate counsel one would notice the SEC’s aggressive investigation and enforcement. A total of 32 out of 181 cases were brought by the SEC. This represents a high percentage. Likewise, a large number of derivative actions are identified. Generally, derivative actions are uncommon but the facts that support a claim of improper stock-option backdating lend themselves to this type of action since a company is not motivated to file an action to obtain moneys from their executives that derived from stock options willingly granted. For this reason, the 74 derivative actions are noteworthy but not necessarily surprising.

## The Audit Firm’s Perspective

When looking at the results above from the viewpoint of an audit firm, the total of 13 cases out of 181 demonstrates that the initial concerns harbored by audit firms in early 2006 did not materialize. Indeed, only four auditor settlements (shown below) exceeded one million dollars and in three of these cases, the stock-option backdating allegations were secondary to much more egregious conduct resulting in criminal prosecution of executives.

Case	Total Settlement	Auditor's Settlement	Auditor
In Re Louis Grasso v. Vitesse Semiconductor Securities Litigation	\$43,274,322	\$30,250,000	KPMG LLP
Peregrine Systems Inc. Securities Litigation	\$56,292,922	\$30,000,000	Arthur Andersen LLP
In Re Symbol Technologies Inc. Securities Litigation	\$126,000,000	\$24,000,000	Deloitte & Touche LLP
In Re Sonam Bakshi v. Henry Samuelli et al.	\$173,500,000	\$13,000,000	Ernst & Young LLP

The third case listed above, Symbol Technologies is interesting because it was the first case that involved stock-option backdating and Deloitte & Touche intervened in the case to participate in the settlement. Although the 2005 study by Professor Erik Lie triggered most stock-option backdating cases, the Symbol Technologies securities class action litigation was filed in New York Eastern District Court on March 5, 2002. In a related Accounting & Auditing Enforcement Release (Release No. 2029 dated June 3, 2004) the SEC charged an executive, in part, with the following conduct:

[The executive] manipulated stock option exercise dates to enable select senior executives, including himself, to profit unfairly at the company's expense. Rather than use the actual exercise date as defined by the option plans, Goldner instituted, without board approval or public disclosure, a practice of using a more advantageous date chosen from a 30-day "lookback" period so as to reduce the cost of the exercise to the executive. To create the false appearance that these exercises occurred on the selected dates, Goldner had his staff backdate transactional documents and use the phony exercise dates in the forms on which the executives reported their acquisitions to the Commission and the public.

The primary allegations in the complaint, however, asserted fraudulent revenue recognition achieved through improper accounting for inventory. Only three paragraphs addressed stock-option backdating, so the settlement amount was not a reflection of the stock-option conduct. Deloitte is linked to this case in the database because Deloitte voluntarily intervened in the case and thus is listed on the system as "Intervenor." The docket notes that Deloitte filed a motion to "Intervene *For the Limited Purpose of Objecting to the Proposed Partial Settlement of this Action.*" Deloitte chose to intervene because it was the defendant in the case Louisiana Municipal Police Employees Retirement System et al v. Deloitte & Touche LLP that alleged broad assertions of accounting malpractice with no specific assertions regarding the underlying wrongdoing of Symbol Technologies (although both cases resulted from the same conduct). Deloitte intervened in the stock-option case to be part of the settlement in order to resolve the Louisiana case. Although not directly involved in the first stock-option backdating case, Audit Analytics believes Deloitte's secondary involvement of interest and worthy of mention.

Another interesting entry above is the Peregrine Systems case because it is also an early case and involves Arthur Andersen LLP. The Peregrine Systems complaint was filed in the Southern District of California on May 6, 2002. The complaint, similar to the Symbol Technologies complaint, focused on fraudulent revenue recognition (characterizing contingent transactions as sales) and tangentially mentioned backdating, but this case was added to the research population because the company filed a financial restatement on April 30, 2004 that addressed stock-option backdating transactions. The settlement notice that quantifies the "Andersen Settlement" is dated July 31, 2006 (about two years after the restatement). The conduct in this case resulted in criminal prosecution of executives and an Arthur Andersen partner.

Similar to the first two cases discussed, the Vitesse case also included allegations of fraudulent revenue recognition. The only case above that was a pure stock-option backdating case is In Re Sonam Bakshi ("Broadcom"). The Broadcom complaint focused on stock-option backdating and asserted that the auditor did nothing while knowing about the full extent of the misconduct. The complaint also discusses the filing of a \$2.2 billion restatement due to improper stock-option backdating. Similarly, the SEC complaint focused on stock-option backdating. The conduct surrounding this matter was so egregious that executives were criminally prosecuted. The criminal case, along with an SEC civil case, was dismissed for prosecutorial misconduct after a finding by the judge of government intimidation of three defense witnesses.

Three other stock-option backdating cases, not shown above, resulted in auditor settlements, but the dollar amounts were \$500,000; \$275,000; and \$225,000. Therefore, despite concerns early in 2006, the audit firm industry weathered the stock-option backdating scandal practically unscathed. Audit firms were named defendants in 13 out of 181 federal cases and the cases that required a settlement payment worthy of mention were the result of a huge financial restatement or conduct amounting to fraudulent revenue recognition.

## AUDIT ANALYTICS - PUBLIC COMPANY MARKET INTELLIGENCE

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