Editorial

Option backdating: A reminder to keep the eye on the ball

The Enron convictions were supposed to set an era to rest. Not long after these convictions, revelations appeared about options backdating at various companies. At least 60 public companies have disclosed that they are being investigated for backdating options by the US Securities and Exchange Commission (SEC) or the Justice Department or both, and the SEC itself says that 80 companies are under scrutiny. Though options backdating appears to precede the enactment of Sarbanes Oxley, anyone who thought that the pandemic of fraudulent accounting was put to rest by that legislation has received another dose of the reality of the intractable nature of the probe.

Corporate officers are largely compensated through options exercise rights. Why they should get capital gains treatment on this income when the rest of us must declare ordinary income is a testament to the efficacy of the Business Roundtable. Options make a good deal of sense for start-ups where there is no cash available, but these options are not liquid and their value is unlikely to be realised until an initial public offering (IPO). But far be it from me to critique the powers that be. What concerns me and others is that one of the few axioms in the arena of corporate governance that is empirically provable is the correlation between the value of CEO option rights and fraudulent accounting.

And no, it's not just a bad apple spoiling the bunch. About one in 25 of the top 100 companies restates each and every year. And if the SEC had more resources, no doubt the number of restatements would be significantly greater. Many restatement actions do not end up in disgorgement penalties; very

few result in officer/director bars and an infinitesimal number result in criminal prosecutions. Yet it is hard to imagine that negligence and not intention resulted in higher earnings. After all, only in a very few cases, such as Microsoft or Fannie Mae, did the company actually underreport earnings.

The answer according to corporate governance activists, notably Professor Bebchuck of Harvard Law School, is enhanced shareholder democracy. But this ignores the fact that corporations will not and should not be democracies. Money is entrusted to an enterprise because its corporate structure is better able to organise profit making than individuals. The real problem is not the power of the CEO, but unbridled power, which tempts those individuals to see the firm and its assets as their personal possession, with no responsibility towards shareholders.

Sarbanes Oxley rightly sets up the audit committee as the counterbalance to CEO's absolute power, if only for the purpose of verifying the financial statement. However audit committee membership is a part time job. Only if the internal audit committee and the external auditors report directly to the audit committee and a structure independent of incumbent management exists to ensure accurate accounting can the American corporate structure continue to function. In time, directorships, particularly audit committee membership, is likely to become a career trajectory because the intricacies of accounting for a company with a market cap of US \$50bn cannot be the province of moonlighters. Moreover, if lawyers and accountants lived up to their responsibilities towards shareholders, as opposed to

management, the load of audit committees would lighten. But this requires the SEC and the Public Company Accounting Oversight Board (PCAOB) to bring disciplinary actions in the form of bars from practicing before the commission far more frequently.

Ultimately, however, the underlying problem lies in accounting standards and the ability and temptation they give to manipulate the apparent performance of the firm. We ought to give some credibility to Kenneth Lay and Jeff Skilling in insisting they were the victim of short sellers. Despite the example of Enron, many more companies engage in similar kinds of accounting fraud, but are never caught or get away with a slap on the wrist. Justice should not depend on the marketplace. Before more widespread evidence of fraud had come to light in Enron, Wilmer Cutler and Pickering presented an investigative report in which it reviewed the partnership set up in accordance with the accounting rules on Special Purpose Entities which allowed companies to put liabilities and assets off balance sheet if the company retained less than a 3 per cent interest in the entity. The authors of the report seemed bemused by the fact that Enron had failed to put up its share of the investment, but to most laymen, the rule itself is what appears laughable.

The criminal imagination is beyond my ken, but one can see how the absurdity of certain accounting treatments is an

inducement to fraud. Until we take financial reporting seriously, companies will continue to stretch legal loopholes until they become illegal garden variety fraud. We need a brightline standard founded on principle-based standards, not muddled Emerging Issue Taskforce pronouncements. The SEC should replace the Financial Accounting Standard Board as the standard setter under Sarbanes Oxley with an organisation even more independent of the Big Four.

The point is that financial statements must reflect the financial condition of the company. We need to have numerate individuals willing to devote sufficient time on audit committees of major public companies to ensure that financial statements are more than the wishful thinking of the CEO. In the course of a few years, the corporate structure of the 21st century has become clear. But thus far few companies have come anywhere close to according the importance to audit committees that they have in legislation. The consequence in the event of a serious market downturn will be an unprecedented and severe number of actions against independent directors in the medium term and a vastly improved corporate structure in the long term which will guarantee confidence in the integrity of US equity markets.

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