



U.S. Securities and Exchange Commission

Speech by SEC Staff: OCA Current Projects: Remarks Before the 2006 AICPA Conference on Current SEC & PCAOB Developments

by

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Good afternoon - it's a pleasure to speak before this group today. Those of you who have experience in making filings with the Commission probably are well aware of the interaction between the SEC's Division of Corporation Finance and Office of the Chief Accountant on financial reporting matters. Many of you may be less aware -- some blissfully so -- of the interaction between our Office and the SEC's Enforcement Division in identifying and consulting on financial reporting problems that may warrant enforcement actions. The Office of the Chief Accountant assumes this responsibility under our role as principal advisor to the Commission on accounting and auditing matters arising from the administration of the federal securities laws. OCA's interaction with the Enforcement Division on financial fraud is the focus of my remarks.

It's been well publicized through various surveys and SEC staff speeches that a significant portion of the SEC's financial fraud cases involve revenue recognition abuses. The abuses range from improper bill and hold transactions, to so-called "round tripping", to various forms of premature revenue recognition. In such cases, OCA staff within our accounting group with expertise in revenue recognition issues work closely with our enforcement staff to ensure that there exists an adequate basis for bringing forward a particular allegation for Commission action. Any Commission action would be initiated by a recommendation from the Enforcement Division

concurrent with by OCA. Also, to the extent that a particular case raises issues as to the possible culpability of a registrant's independent auditors, staff within our office's professional practice group will work with Enforcement to evaluate the auditor's compliance with the relevant auditing standards.

As for current trends in financial fraud, it is difficult to read the financial press these days without coming across an article concerning the backdating of stock option grants. The subject of options backdating is a fertile area for AICPA member Jack Ciesielski, who regularly includes commentary on options backdating issues in his weekly Weblog. As with matters involving alleged improprieties in revenue recognition, potential enforcement cases are referred to office experts in stock compensation accounting and -- where possible auditor culpability is being evaluated -- auditing experts within our professional practice group. However, in the options backdating arena, I sometimes think that we should be adding experts in other disciplines to the mix -- possibly an expert in behavioral psychology given the critical mass that seems to have developed.

At-the-money vs. in-the-money

At its basic terms, the financial reporting problems with options backdating are caused by attempts to disguise "in-the-money" stock option grants as being 'at-the-money'. This is not a mere technical violation but rather a misstatement that has been demonstrated to cause many, if not all, of the following financial reporting problems:

1. Measurement issues
2. Books and records issues
3. Internal control adequacy issues
4. Disclosure problems
5. Corporate governance issues

In the options backdating cases that I have reviewed, the companies elected to account for options under the alternative APB Opinion 25 methodology permitted under the literature. That methodology, of course, is based on an intrinsic value measurement that calculates compensation expense as the difference between the market price of the underlying common stock at date of grant and the option's exercise price. By disguising in-the-money options as being-at-the-money, these companies have presented financial statements that understate compensation expense and overstate net income and earnings per share data.

Furthermore, these instances call into question the adequacy of the underlying corporate books and records, leaving these issuers susceptible to allegations of having violated the books and records provisions under Section 13(b)(2) of the 1934 Act. Also called into question is the adequacy of internal controls, possibly violating other provisions under that Act.

Further, companies that elect to apply the APB Opinion 25 methodology may

have provided misleading footnote disclosures of the fair value of the company's stock option grants called for under FASB Statement 123 when attempting to disguise in-the-money options as being at-the- money. All other things being equal, an in-the-money option will have greater value than a similar option granted at-the- money. Finally, in attempting to disguise in-the-money options as being at-the-money, companies may have called into question the validity of issuance of the stock option grants, for which shareholder and corporate approval may have been obtained through misrepresentations.

In testimony on options backdating before the Senate Committee on Banking, Housing, and Urban Affairs, Chairman Cox in September reported that our Enforcement Division was in the process of investigating over 100 companies for possible fraudulent financial reporting of stock option grants. The companies are located throughout the country, and include Fortune 500 companies as well as smaller cap issuers. The companies span multiple industry sectors.

Most of these investigations are ongoing and cannot be discussed at this public forum. It also is important to emphasize that not all of these investigations ultimately will result in enforcement proceedings. However, two recent cases have been publicly disclosed and merit special attention. The cases in question involve allegations of option backdating practices which occurred at Brocade Communications Systems and Comverse Technology, Inc.

Staff from our Enforcement Division likely will discuss these cases at tomorrow's session. To pique your interest, however, I'd like to mention two aspects which may be particularly instructional due to the brazen nature of the alleged activity.

In one case, it was alleged that option grants were backdated so routinely as a recruiting inducement that employment offer letters and compensation committee minutes were falsified to such an extent that the falsified dates often preceded the dates that the employee actually was hired.

In the other matter, the Commission alleged that a stock option "slush" fund had been created, under which options were granted to fictitious employees - and locked in at zero compensation expense - and later used as a retention and recruitment tool.

Of course, interesting issues involving financial fraud are not limited to options backdating cases. One recent investigation involved the alleged diversion of massive amounts of corporate assets from a company heavily engaged in mergers and acquisitions activity - both as buyer and seller. A significant component of the alleged fraud resulted from the company's inadequate system of internal controls over that activity.

In OCA's other accounting work, the staff often is asked to assess the propriety of the accounting for a particular business combination. In some

business purchases, the staff occasionally has questioned the allocation of purchase price to a covenant not to compete asset. These concerns focused on the enforceability of such non-compete arrangements.

In this investigation, the enforceability issue was elevated to a much higher plane. Insiders are alleged to have siphoned off corporate funds for their personal benefit by claiming that the payments were due under their personal covenants not to compete with the acquirer of a particular business unit. They claimed entitlement to -- and received -- such payments despite the fact that the acquirer never requested a non-compete agreement in the first place.

Rule 102(e)

Another important element of our enforcement related activity is the consultation that our office provides on matters involving potential suspension and disbarment due to improper professional conduct under Rule 102(e) of the Commission's Rules of Practice. Many in the audience are CPAs who either are employed by or serve as auditors to public companies and are likely to find little consolation in statements that the Commission staff takes our responsibility in this area very seriously. Nonetheless, the staff recognizes that we are dealing with professional livelihoods and reputations and strives at all times to act fairly.

I'd like to wrap up with a few points concerning the staff's recent experience with this rule.

Rule 102(e) applies not only to auditors of public companies but also to corporate accountants with decision-making responsibilities for financial reporting. Some of the Commission's actions involve situations where the accountant's conduct results both in an officer and director bar and Rule 102(e) suspension. This reflects the view that the accountant's work in financial reporting is of equal importance to the goal of investor protection as any of his/her other duties.

In applying Rule 102(e), the fact that a CPA's license is in inactive status does not provide immunity. We recognize that currently inactive CPAs can return to active status. In cases of improper professional conduct, we believe it appropriate for the Commission to have the opportunity to review all that individual's remedial conduct in the event that accountant wishes to again practice before the Commission.

Finally, at other sessions of the conference you are likely to hear concerns that incentives designed to encourage filings by foreign companies may result in an "unlevel playing field" for U.S. registrants when compared with their foreign competitors. The Commission's application of Rule 102(e) should not be susceptible to similar concerns. When appropriate, Rule 102(e) suspensions are invoked against chartered accountants and others licensed in foreign countries.

That concludes my remarks. Thank you for your attention.

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