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Options Expensing Spurs Technology Demand

By Carol E. Curtis

If there is a silver lining to the still-simmering options backdating scandal, it may be for the software companies encountering brisk demand for solutions to speed compliance with complicated new accounting requirements.

For public companies' financial statements, 2006 is the first full year in which Financial Accounting Standard (FAS) 123R has been effective. One of a series of measures aimed at ending abusive options practices, FAS 123R requires that the fair value of all stock options granted to employees be recorded as an expense.

Further, under new Securities and Exchange Commission executive compensation disclosure rules, public companies must adjust their internal compliance controls to track options grants by executive compensation committees. They must report options data in easy-to-understand tabular presentations, including the grant-date fair value, the closing market price on the grant date if it is greater than the exercise price of the options, and the date the compensation committee or board took action to grant the option, if that date is different than the grant date.

Such "prophylactic rules" are aimed at "eliminating the opportunities for abusive backdating," said Christopher Cox, chairman of the Securities and Exchange Commission, in testimony last September before the Senate Banking Committee. He was referring to the manipulations of options that have been shown to provide questionable, windfall profits to recipients.

The downside is that compliance has gotten much more complicated. As a result, "great pressure is coming from auditors to move away from manual systems," says Gary Levine, president and CEO of Two Step Software, a Needham, Mass.-based provider of software for corporate governance and stock plan administration. As auditors grapple with their reviews of options administration and accounting, they are seeking integrated plan administration systems that support the new rules as well as general corporate governance, says Levine.


Gary Levine

His company's recently announced system, Equity Focus, allows CFOs and stock plan administrators to calculate FAS 123R valuations, helps them manage complex stock plans and creates fully diluted capitalization tables, says Levine. "Our product consolidates information related to stock option administration, financial accounting and reporting, and good corporate governance into an integrated system," he says. "The key is integrating stock option administration with corporate governance compliance, then automating the computing of these financial calculations."

There are about ten firms offering software solutions for options compliance, Levine says, including Equity Edge from E-Trade Financial Corp. and Transcentive from Computershare. "The conversion to software applications to handle FAS 123R compliance is a fast-growing area," he notes. "The complexity of the new rules is much greater. ... It only makes sense with an automated solution. That is what the auditors want."

Both public and non-public companies are users of Equity Focus. It's the leading options tracking product for venture-backed and privately held companies, the vendor says, because of functionality that relates to tracking options' underlying common stock as well as the ability to create flexible capitalization tables. This type of tracking is not used by public companies, since their common stock is listed on a stock exchange and tracked by transfer agents such as State Street Corp.

Mark Patterson, CFO of Express-1 Expedited Solutions, a trucking company in Buchanan, Mich. and an Equity Focus customer, said, "In the past, FAS 123R had been a point of contention with our auditors. With Equity Focus, we can run a few reports, reach agreement among the audit team and move on. Before [Equity Focus], I tried to do everything on spreadsheets."

Long-standing Issue

Options accounting has long bedeviled the accounting community. In 1972, the Financial Accounting Standards Board (FASB) issued Accounting Principles Board Opinion No. 25, which said that companies do not need to include options expenses in their income statements. The basis of the rule was that FASB lacked a good method for valuing stock options.

Nearly two decades later, with approaches such as the Black-Scholes options pricing model solving the valuation puzzle, FASB revisited the issue and said options should be included in income statements. FAS 123 in 1991 said that companies must calculate the fair value of options and include that with compensation expenses.

After considerable industry push-back, FASB modified its position to allow companies to choose between Opinion 25 accounting and FAS 123. The issue resurfaced in response to the Enron scandal, which created additional pressure for better financial disclosure including greater options transparency. The result, FAS 123R, became effective in June 2005 for general public companies, and in December 2005 for small-business and non-public companies.

Even as financial executives and stock plan administrators struggle to comply, FAS 123R has emerged as a critical part of the SEC's ongoing efforts to deal with options abuses. "FAS 123R has eliminated the accounting benefit of granting at-the-money options," Cox said in his 2006 testimony, adding that the options-abuse issue "strikes at the heart of the relationship among a public company's management, its directors and its shareholders." He cited FAS 123R as a major step toward increasing transparency of public company options plans.

Wide Net

The still-unfolding backdating scandal has ensnared some of the biggest and best-known U.S. companies, including Apple, Barnes & Noble, Home Depot, United Healthcare and VeriSign. Typically, the abusive practices involved granting options with an exercise price lower than that day's market price. As dated, the options grant appeared to have been made earlier, when the market value was lower. The result has been to create windfalls for executives, while violating tax laws as well as SEC reporting requirements. "The [options] backdating scandal is by far the largest scandal to hit Wall Street in a decade," says Levine.

Companies whose executives have so far been charged by the SEC for options backdating violations include Brocade, Comverse and Monster Worldwide. In all, the commission is looking at 160 companies for possible options backdating issues, says SEC spokesperson John Heine, adding that "the process is still under way."

"An encouraging development arising from the scandal has been the number of companies that have now adopted the FASB's fair-value expensing of stock options," says Selva Ozelli, an international tax attorney and CPA. "The rule will provide investors with more transparency regarding executive incentive stock compensation."

And, she might have added, a business opportunity for companies like Two Step Software. ■