Stock Option “Backdating”

Summary Opinion

In recent weeks, U.S. government agencies have made inquiries of at least 22 companies on the integrity of past stock option grants, including six companies rated by Moody’s. The inquiries concern whether the companies “backdated” awards, providing undisclosed benefit to executives, and we anticipate that additional companies may face investigations. Moody’s believes the controversy raises questions at the rated issuers among this group on:

- Leadership going forward, with the possibility of executive resignations (as has occurred at some non-rated issuers).
- Quality of corporate governance and financial controls, and aggressiveness of corporate culture.
- Potential for reputational damage.

The controversy also poses some financial risk in the potential for fines and shareholder litigation, although we believe the probability of material restatements affecting our view of current financial health of the companies is minimal.

THE BACKDATING CONTROVERSY

The coincidence of award dates with low points in share price has triggered allegations that awards may have been “backdated.” That is, some companies may have retroactively selected award dates to use an exercise price lower than that on the date of actual grant, without disclosing this “date-shopping” or accounting for it properly. This would generate instant but hidden gains for the recipient.

Backdating is not necessarily illegal if it conforms to a company’s option plan and is accounted for properly. While regulators have yet to accuse any company of wrongdoing, the U.S. Securities and Exchange Commission (SEC) and the U.S. Department of Justice (DOJ) have initiated informal inquiries or requested information regarding the timing of option awards at 22 or more companies, including six issuers rated by Moody’s (see Appendix). Media reports have identified more than 30 companies that have notably fortuitous patterns in option grants and may have engaged in backdating.
Questions relate to the timing of awards before 2002 disclosure reforms that made such action much more difficult. While the concern relates to long-ended practices at most or all of the companies, surfacing of this issue raises new questions on whether executives benefited from undisclosed self-dealing, and whether boards of directors were doing their job.

To date, the inquiries have been a factor in a rating action at just one of the six issuers rated by Moody's that to our knowledge have been under SEC or DOJ investigation. In that case—UnitedHealth Group (rated more highly than the other companies) – we lowered the outlook to negative from stable.\footnote{See UnitedHealth Group Rating Action, 22 May, 2006.} In general, it is too early to tell what impact the inquiries will have on the credit quality of the rated issuers. Moody's is following developments at each issuer, and may take additional actions on outlooks and/or ratings as information becomes available.

Uncertainty regarding the outcome of the inquiries, and the possibility that wrongdoing will be found, adds to four categories of credit risk:

- **Leadership risk:** Given that inquiries on this issue at several other non-rated companies have led to resignations within senior management, issuers under scrutiny face a heightened risk of management changes. Disruption in management could impact operations and financial performance.

- **Financial risk:** A finding that backdating did occur would likely lead to costs to settle litigation and pay fines. To a lesser extent, there is also the risk of a financial restatement, although any negative impact this would have on reported earnings would not directly impact credit ratings because of Moody's practice to adjust financial statements and key credit metrics to reflect the costs of share-based compensation as an expense. We believe that any incremental impact from the restatements will not be significant.

- **Reputation risk:** Should regulators find wrongdoing, the negative impact on the company's image could affect its standing with customers, employees, and investors. This is a difficult risk to evaluate because it often takes a relatively long time for its effect on a firm to become apparent. The potential for damaged reputations varies among the issuers facing inquiries.

- **Corporate governance risk:** Backdating may indicate an aggressive culture, lack of proper board oversight, a failure of financial reporting controls, and ineffective “tone at the top,” with negative implications for perception of credit quality. A worst-case scenario would be a showing of securities fraud. We tend to see cultural issues as deep-seated and are likely to be concerned on this point if weaknesses are demonstrated, particularly if senior management and the board have not changed significantly since the time period when options were backdated.

The facts these inquiries uncover will primarily determine the scope and materiality of the credit impact, if any, for each issuer in these four risk areas. To our knowledge, no issuer rated by Moody's has admitted any wrongdoing or taken any action against any employees at this date.

Several issuers have disclosed they will have to restate financial results.

**WHAT IS BACKDATING?**

Backdating occurs when a company retroactively dates options, presumably to a point in time when its stock was trading at a lower price. This sets the strike price of the options at a lower level and provides an instant gain for the option recipients (albeit not yet realizable because of vesting restrictions). Essentially, this is a grant of in-the-money options, which is legitimate (if controversial with some shareholders) if disclosed. Backdating is not illegal so long as it is in accordance with the options plan, properly disclosed, and properly accounted for. What regulators look for—and which could lead to restatements and fines—is a lack of proper disclosure and appropriate accounting, indicating intentional deception on the value of executive pay.

If it is determined that a company used an inappropriate grant date, it could be required to restate its previously issued financial statements to record compensation expense equal to the intrinsic value of the options (market price of stock less strike price of options) on the “real” grant date. In extreme cases, a company may have to apply variable plan accounting to these awards, which would require the company to record compensation expense or income in each reporting period that is based on the movement of the underlying stock price until the date that the option is exercised.
TIMING AWARDS BASED ON NON-PUBLIC INFORMATION IS INSIDER TRADING

Backdating is only one possible explanation for option awards that appear to have been timed to hit low points in the share price. Another possibility is that the awards were not “backdated,” but rather timed with knowledge of upcoming events that would impact the share price. If regulators were able to demonstrate this were the case at any company, the company and executive involved could be vulnerable to charges of insider trading.

VARYING THE DATE OF AWARDS FROM YEAR TO YEAR IS NOT BEST PRACTICE

At the firms under scrutiny, the date past options were awarded has not been consistent from year to year. This does not mean backdating occurred, but it does not follow the best practice, which is to set a firm date for awards well in advance, and then usually keep this practice consistent from year to year. This promotes transparency and lessens the chance that games will be played that may involve inside information (or backdating). There is nothing necessarily illegal or even improper about timing an award with reference to market and company developments as long as those developments are known to the market; there may be special circumstances when it is perfectly appropriate to do so, such as in an effort to retain employees after the company has undergone some traumatic event. But, in general, we believe consistency in grant dates is best practice.

WHAT TYPE OF RESPONSE BEST MITIGATES POTENTIAL CREDIT RISK FOR ISSUERS FACING SCRUTINY?

For those companies facing scrutiny, we would view a prompt, thorough and fully independent investigation under the direction of the independent board members to be an important, positive factor as we determine company credit risk and corporate governance quality.

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How Backdating of Stock Options Increases Compensation Charges

Most companies have historically accounted for stock options under the “intrinsic value” method, which allows them to avoid recognizing share-based compensation expense if a stock option is granted with an exercise price that equals the fair value of the company’s stock (i.e., the intrinsic value, which is the difference between the exercise price and fair value, would be zero). If the backdating of stock options were to occur, the exercise price would be lower than the fair value of the company’s stock on the “real” grant date. In this case, the “in-the-money” options would have an intrinsic value that would require the company to recognize an expense in the income statement over the vesting period of the stock option.

Backdating issues occurred when companies did not have to record stock option expense for “at the money” options. With the adoption of the new share-based compensation rules, companies are now required to expense all share-based compensation costs using a fair value model. Options granted today with zero intrinsic value will still have a fair value which will be expensed over the vesting period of the option. Therefore, the issuance of “in the money” options under the current rules would most likely have a lesser impact to the income statement than under the intrinsic value approach which was essentially an all-or-nothing approach.

The U.S. tax code allows a company to deduct on its tax return an amount equal to the intrinsic value of exercised stock options (the exercise date market price less the option strike price). With the backdating issue, the exercise price of the options granted will not change. Accordingly, we would not expect to see any impact on historical tax deductions and the related cash flows unless the IRS ultimately finds some complex technicality to disallow deductions related to backdated options.
**Appendix: Moody's Rated Issuers Facing Regulatory Scrutiny on Option Timing**

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<thead>
<tr>
<th>Issuer</th>
<th>Rating</th>
<th>Regulatory action</th>
<th>Rating action</th>
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<tbody>
<tr>
<td>Affiliated Computer Services</td>
<td>Ba2</td>
<td>SEC and DOJ inquiry</td>
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<tr>
<td>American Tower</td>
<td>Ba2</td>
<td>SEC and DOJ inquiry</td>
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<td>Caremark Rx</td>
<td>Baa3</td>
<td>SEC and DOJ inquiry</td>
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<tr>
<td>Jabil Circuit Inc.</td>
<td>Baa3</td>
<td>SEC inquiry</td>
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<td>Juniper Networks</td>
<td>Ba3</td>
<td>DOJ inquiry</td>
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<tr>
<td>UnitedHealth Group</td>
<td>A2</td>
<td>SEC and DOJ inquiry</td>
<td>Outlook changed to negative</td>
</tr>
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* Senior unsecured rating.

**Related Reports**

**Special Comments:**
- CEO Compensation and Credit Risk, July 2005 (93592)
- The Downside of Incentive Pay for Outside Directors, April 2006 (97174)

**Rating Methodology:**
- U.S. and Canadian Corporate Governance Assessment, July 2003 (78666)

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