Forensic Evidence-Gathering Procedures for Employee Stock Options

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Abstract

Employee stock options (ESOs), as an integral component of long-term compensation plans, are usually offered to directors, senior executives, and key personnel to provide incentives to improve sustainable performance. The timing of option grant dates could be managed in a manner to increase the potential value of ESOs which would have significant governance, legal, ethical, tax, and accounting consequences. Backdating practices of retroactively setting the grant date as the day when the underlying stock price was low have been scrutinized by regulators. This article examines auditors’ responsibilities regarding ESOs and backdating practices as more than 250 public companies have engaged in backdating practices. Independent auditors should be skeptical of the likelihood of backdating practices of their clients and pay particular attention to the disclosures of ESO plans and grants. Auditors should use appropriate forensic accounting techniques and procedures to ensure investors receive relevant, reliable, and transparent information on ESOs. The fraud triangle should be used by auditors to gather and assess evidence about their client’s: (1) incentives or pressure to engage in option backdating; (2) opportunities for backdating practices; and (3) rationalization of their backdating practices of ESOs.

Keywords: Employee stock options (ESOs); Backdating practices; Forensic audit procedures; Fraud triangle.

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