Scrutinizing Compensation

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The end of July marked the five-year anniversary of the Sarbanes-Oxley Act, the oft-scrutinized and somewhat controversial legislation meant to keep the leaders of corporate America honest.

This law delves deep into the inner workings of a corporation, from the company books to the board, from accounting practices to corporate governance. Some of the issues contributing to the adoption of the law, commonly called "Sarbox" or "SOX," include excessive executive compensation and questionable options backdating.

Yaniv Grinstein, an assistant professor of finance of the Johnson School at Cornell University, has recently studied options backdating. He and co-authors Lucian Bebchuck and Urs Peyer questioned what this not always illegal practice tells us about the state of corporate governance.

Backdating is the practice of granting a stock option, a common form of compensation for executives, which is dated prior to the date the company actually granted the option. Depending on the circumstances, backdating might not be illegal.

According to the July study, titled "Insider Luck" in reference to those chief executives and directors who received backdated options and benefited from the subsequent market activity, more than 200 companies have been scrutinized for the practice. Dozens of executives and directors were forced to resign, and companies have said they will reissue financial statements.

The study looks at how many "lucky" grants were issued before the 2002 adoption of Sarbanes-Oxley, compared with afterward. The results reveal that almost 12,000 options that showed an increase in value were granted prior to SOX, while 7,038 were granted after. Grinstein had said the numbers don't necessarily reveal an admission of guilt on the part of companies, but rather a more careful attempt on their part to record and issue these grants.

The "luckiest" grants (485) issued before SOX had an exercise price of $1.12 more than when they were granted. After SOX, the luckiest grants (333) increased $1.08.

Grinstein reported that backdating was the product of significant, widespread governance breakdown, not a value-maximizing business decision to compensate, or a thoughtless habit developed from industry norms.

The research also indicated that although increased attention by regulators and investors could curtail future backdating, there is no reason to expect that the agency problems producing them have gone away.