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Remediation of Material Weaknesses Related to Employee Compensation

By *Dana R. Hermanson, Daniel M. Ivancevich, and Susan H. Ivancevich*

Despite the passage of the Sarbanes-Oxley Act (SOX), public companies have continued to experience accounting and control issues related to employee compensation. The backdating of stock options has emerged as a major employee compensation scandal. Professors Randall Heron and Erik Lie have estimated that over 2,000 companies improperly backdated stock options from 1996 to 2005. (See www.biz.uiowa.edu/faculty/elie/backdating.htm for an overview of the backdating scandal.)

According to *CFO* magazine, as of November 2007, nearly 120 companies faced SEC investigations related to option backdating. In addition, the scandal has spawned investigations by the IRS, the U.S. Attorneys' Office, and Congress, and has resulted in detailed guidance from the SEC and the Public Company Accounting Oversight Board (PCAOB). The SEC also recently adopted new rules governing disclosure of executive compensation that expand disclosure requirements and the transparency of reporting related to executive compensation. (For an overview of the new accounting and disclosure guidance, see Susan Ivancevich, Fara Elikai, and Rebecca Sawyer, "The Stock Options Scandal: A Comprehensive Guide for Internal Auditors," *Internal Auditing*, November/December 2006.)

Why was stock option backdating allowed to occur? Some researchers have studied the role of corporate governance. For example, a study by Daniel W. Collins, Guojin Gong, and Haidan Li, presented at the 2007 Contemporary Accounting Research Conference, finds that companies engaged in stock option backdating have "weaker governance structures that allow CEOs to exercise greater power over the board and its compensation committee."

Beyond the stock option backdating scandal, other companies have experienced problems accounting for other types of compensation, including bonus plans. Such problems may reflect the complexity of accounting issues, as well as weaknesses in oversight and control.

> **The backdating of stock options has emerged as a major employee compensation scandal.**

While the stock option backdating scandal and other employee compensation problems have been widely criticized, the focus on how companies remediate internal control weaknesses in these areas has received less attention. The authors examined 124 companies with material weaknesses in internal control related to employee compensation. Also included is an analysis of the companies' responses to their internal control problems. The analysis sheds insight into the steps companies have taken to recover from accounting and control problems related to employee compensation, as well as the role of the board and its committees in preventing and remediating such weaknesses.

SOX Section 404

SOX section 404(a) requires management to report on the effectiveness of internal control over financial reporting, and under SOX section 404(b) the external auditor must issue an opinion on control effectiveness. For accelerated filers, section 404 was fully effective in November 2004, and it will most likely be fully effective [including auditor attestation under Section 404(b)] for smaller public companies after December 15, 2009—notwithstanding the fact that the effective date of section 404(b) has been delayed several times. Section 404(a) is currently effective for smaller companies.

If the auditor and management determine that the company has one or more material weaknesses in internal control, then the auditor issues an adverse opinion, and the auditor and management reports on internal control describe the nature of the material weaknesses. The management report typically describes the company's efforts to remediate internal control problems.

Companies with Material Weaknesses Related to Compensation

The Audit Analytics database (www.auditanalytics.com) was used to identify companies with material weaknesses related to employee compensation (the "deferred, stock-based, or executive compensation" category in the database). The Audit Analytics data and relevant SEC filings served as the source of the information presented below.

The search revealed 124 companies with material weaknesses related to employee compensation during the period searched. The companies' fiscal year-ends range from December 25, 2004, to February 3, 2007, and the audit report dates range from March 11, 2005, to April 20, 2007.

As shown in *Exhibit 1*, the companies with compensation-related material weaknesses typically have market values under $500 million and revenues and assets under $400 million, which is fairly representative of accelerated filers in general. The companies are predominantly found in the manufacturing and services industries. Not surprisingly, 29 of the manufacturing companies are in computer hardware, and 19 of the services companies are in the software industry (for a total of 48 computer technology firms). Technology companies historically have been heavy users of stock options, thus increasing their likelihood of having material weaknesses related to compensation (e.g., stock option backdating). Most of the companies have Big Four auditors. The median company had two material weaknesses in internal control, and the reported weaknesses ranged from one to 18.

Overview of Material Weaknesses

Exhibit 2 presents a summary of the most common compensation-related material weaknesses. Classifying the material weaknesses—and, to a lesser extent, the remedial steps—required some judgment by the authors and research assistants. Many companies had more than one type of weakness and more than one type of remediation related to employee compensation.

In terms of material weaknesses, the two most common issues were failing to properly account for pro forma stock-based employee compensation expense (51 companies) and having errors in some of the grant dates or other accounting involving stock option grants (50 companies). In both cases, the expenses related to stock option compensation were misstated, sometimes through backdating of stock option grants.

Twenty-nine companies reported problems with the quality of accounting and financial personnel involved in accounting for employee compensation. For example, one company stated that a "lack of personnel with the requisite level of knowledge of stock-based compensation accounting initially resulted in errors in the recorded expense." Given the complexity of employee compensation issues, it appears that some companies have not been able to attract or retain the needed talent to maintain proper accounting treatment.

Sixteen companies had misstatements in other areas of compensation expense, such as bonuses or long-term incentive compensation. Ten companies cited inadequate management review and supervision. For example, one company stated: "The company became aware of the need to restate its consolidated financial statements for the years ended December 31, 2005 and 2004, due to inadequate levels of review of complex accounting issues, resulting in additional stock compensation charges."

There were also several other weaknesses noted: other stock option-related accounting problems (8 companies); failing to properly account for option forfeitures, as required by SFAS 123 (5 companies); lack of communication between departments (5 companies); and incorrectly calculating compensation expense related to deferred compensation (4 companies).

EXHIBIT 1
Companies with Material Weaknesses Related to Employee Compensation
(124 Companies)

Panel A: Company Size (in thousands of dollars)	Median
Market Value	$425,470
Revenues	$264,585
Assets	$347,576
Panel B: Standard Industrial Classification Codes	**Companies**
1000–1999 Mining and Construction	7
2000–3999 Manufacturing	47
4000–4999 Transportation and Communication	5
5000–5999 Wholesale and Retail	11
6000–6999 Financial, Insurance, and Real Estate	10
7000–8999 Services	44
Total	124
Panel C: External Audit Firm	**Companies**
Big Four	94
Other National Firms	14
Local Firms	16
Total	124
Panel D: Total Number of Material Weaknesses	
Median number of material weaknesses per company	2
Range of material weaknesses per company	1–18

Remediation Efforts

Exhibit 3 summarizes the remedial steps that companies have taken to recover from material weaknesses related to employee compensation. The most common remedial step is to be expected—58 companies either restated previous periods' results or corrected material misstatements in the current period financial statements. Such steps are necessary when the material internal control weakness has manifested itself in a material misstatement. This can be costly because the company's stock price can suffer when a restatement is announced. For example, in their article, "Determinants of Market Reactions to Restatement Announcements," Zoe-Vonna Palmrose, Vernon J. Richardson, and Susan Scholz found that, on average, abnormal returns are approximately −9% over the two days surrounding announcements of accounting restatements (*Journal of Accounting and Economics*, vol. 37, no. 1, February 2004). The reactions are more negative when fraud is involved or earnings are reduced.

In terms of remedial steps designed to prevent future misstatements, the most common action is to carefully review certain policies and accounting measurements (49 companies). These companies planned to subject their compensation-related entries to greater scrutiny and review than they had been in the past.

Forty-four companies implemented new general corporate accounting policies, procedures, and controls, and 41 companies filled a number of key staff positions. The personnel changes were often related to accounting or financial positions.

Thirty-two companies discussed plans to provide additional training to employees. This training may cover stock option accounting issues, as well as equity grant rules. In addition, 28 companies adopted new procedures for granting stock options. These changes can prevent option backdating or ensure proper authorization of option grants.

Finally, other companies engaged the services of a third party (20 companies), enhanced their documentation for all stock-based compensation awards or other transactions (20 companies), or planned to more effectively communicate between departments (12 companies). Outside consultants can provide vital technical expertise, and enhanced documentation standards can help ensure that option grant dates are accurately captured. Communications between the compensation committee and senior financial management are especially important for accurate compensation expenses.

The Role of the Board and Its Committees

The disclosures examined above provide insights into the specific steps taken to remediate weaknesses, but they do not highlight the important oversight role played by the board of directors in remedial efforts. The disclosures also do not emphasize the board's responsibility for preventing such failures (Collins, Gong, and Li 2007).

The board of directors has the ultimate responsibility for risk management and control in an organization. The audit committee takes the lead on overseeing internal control over financial reporting, and the compensation committee typically works with outside compensation consultants and oversees the compensation program. In the authors' view, many of the failures discussed in this article fall at the intersection of the audit committee and compensation committee's responsibilities. Both committees can take steps to prevent problems and, if needed, promote remediation of material weaknesses related to compensation.

From the perspective of the audit committee, the following questions are crucial to preventing or remediating internal control problems related to compensation:

- To what extent are complex incentive compensation schemes used, including those involving equity grants or stock options? Frequent communication between the audit committee and the compensation committee is essential in this regard. This will help committee members understand the compensation plans and the risks that need to be addressed.
- What accounting and financial reporting complexities are created by the current compensation methods? Do the financial staff members have the "intellectual horsepower" and background to deal with these issues? If not, where will the organization get access to the needed expertise? Can internal training sessions improve in-house knowledge?
- What internal control challenges are created by the current compensation methods? For example, what controls are in place with regard to stock option grant dates?
- Are other companies in the same industry experiencing trouble related to their accounting for compensation? If so, what can be learned from their experiences?
- What risks do the organization's internal and external auditors anticipate in the compensation area? Are there controls in place to address these risks? When the auditors make recommendations for enhancing controls related to compensation, how does management react? Are enough resources devoted to remediation, and does management seem committed to strong controls?

From the perspective of the compensation committee, the following questions may be relevant:

- Does the committee fully understand the compensation program, or does it rely too heavily on the outside consultant?
- Is the compensation program unduly complex, such that the costs of complexity outweigh the benefits? Is the program appropriate for the organization's size and industry?
- Have the key compensation plan elements, risks, and needed controls been communicated to the audit committee and the full board?
- Are there ways for the outside consultant or other outside experts to help the compensation committee, other board members, and management to fully under-

EXHIBIT 2
Summary of Weaknesses Related to Employee Compensation

Companies	Description of Material Weakness
51	Failed to properly account for pro forma stock-based employee compensation expense
50	Had errors in some of the grant dates or other accounting involving stock option grants
29	Lacked adequate accounting and finance personnel to properly account for certain transactions
16	Did not properly account for compensation expense
10	Lacked adequate management oversight and review
8	Encountered other stock option-related accounting problems
5	Failed to properly account for option forfeitures, as required by SFAS 123, *Accounting for Stock-Based Compensation*
5	Suffered from a lack of communication between parts of the organization
4	Incorrectly calculated compensation expense related to deferred compensation

EXHIBIT 3
Remediation of Employee Compensation Weaknesses
(10 or More Instances)

Companies	Remediation Description	Sample Remedial Efforts
58	Restated its financial statements for prior years or adjusted current financial statements	■ Control deficiency resulted in the restatement of the consolidated financial statements for the year ended June 30, 2006. ■ Management restated its previously issued quarterly financial data for the first and third quarters of 2004 to reflect an increase in stock-based compensation expense, additional paid-in-capital, and accrued compensation. ■ Material weakness resulted in audit adjustments to the company's 2006 annual consolidated financial statements.
49	Implemented detailed reviews of certain policies and accounting measurements	■ Having the computations performed by highly qualified personnel, management intends to review their work and historical records to ensure proper reporting under GAAP. ■ Review and approval of all stock-based compensation awards by the accounting and finance function or a special compensation committee. ■ Performed additional analysis and other post-closing procedures to ensure that the consolidated financial statements were prepared in accordance with GAAP.
44	Implemented new general corporate accounting policies, procedures, and controls	■ The disclosure committee has developed improved policies and procedures to ensure the proper identification of and accounting for both routine and nonroutine significant transactions, as well as transactions subject to significant judgments and estimates. ■ Implementing improved controls to process and approve stock-based compensation grants and periodically determine the accuracy of database records. ■ Developing and implementing a detailed bonus accrual methodology.
41	Filled a number of key accounting and finance positions	■ Hired a new CFO who has the breadth of experience necessary to improve overall recording and reporting processes, including internal controls and procedures over financial reporting. ■ Expanded accounting staff to increase expertise and capabilities of department. ■ Appointed senior finance and accounting personnel with substantial accounting and public company financial expertise.
32	Will provide additional training for accounting personnel	■ Company will allocate additional resources or perform training for personnel in areas associated with the stock option granting process to increase the competency levels of the personnel involved to ensure that the calculation of stock-based employee compensation expense from certain stock compensation arrangements is accurate. ■ Scheduling training for accounting staff to heighten awareness of GAAP. ■ Providing regular training to accounting, legal, and stock administration personnel regarding equity grant accounting rules and proper procedures.
28	Adopted new stock option granting procedures	■ Instituted new stock option granting practices that provide for more systematic authorization of stock option grants to nonexecutive employees. ■ Changed option granting approval policies and procedures to require compensation committee approval of all new option grants on the day of each compensation committee meeting preceding the regularly scheduled quarterly board of directors meeting. ■ Implemented enhanced processes and guidelines that are designed to ensure the proper recording of grant dates for future common stock option awards.

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stand the compensation issues the organization faces?

Overall, the audit committee and compensation committee need to work together with top management to ensure that compensation issues, including risks and controls, are fully understood and addressed. These two board committees can establish a proper organizational tone around compensation risks, and they should communicate with the full board to ensure that all directors have a sufficient understanding of the issues.

Creating Reliable Financial Reporting

Many companies have gotten themselves into trouble in recent years as a result of employee compensation issues. The discussion above summarizes material weaknesses in internal controls related to employee compensation and discusses the most common remedial steps that companies have taken to recover from their material weaknesses. With smaller public companies now scheduled to adopt SOX section 404(b) in late 2009, the results of this study should be particularly useful to companies about to fully enter the section 404 arena.

Based on the remedial efforts undertaken by larger public companies, it appears that the following elements are essential to promoting reliable financial reporting with regard to employee compensation:

- Detailed reviews of compensation-related entries,
- Sound general accounting controls,
- Financial management expertise, and
- Specific training in accounting for employee compensation.

One critical component of preventing and remediating internal control weaknesses related to compensation is the active oversight of the audit committee and compensation committee of the board. Directors should review the questions posed above and take any necessary steps to improve their organization's internal controls. The authors encourage CPAs to help public companies ensure that they have appropriate controls in place to promote reliable reporting of employee compensation—before they face adverse internal control opinions or restatements. ❑

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EXHIBIT 3 (Continued from page 32)
Remediation of Employee Compensation Weaknesses
(10 or More Instances)

20	Engaged the services of a third party	■ Management has engaged the services of a third-party service provider that specializes in the computing of stock-based compensation under the new accounting standard SFAS 123(R), *Share-Based Payment*. ■ Improving the skills, knowledge, and experience available to the company for the preparation and review of stock-based employee compensation expense disclosures by utilizing outside consultants. ■ Expanding the use of independent reviews by outside financial reporting experts during the vacancy of the financial reporting position.
20	Enhanced documentation for all stock-based compensation awards or other transactions	■ Enhanced and standardized documentation required to be maintained for the granting of all such stock-based compensation awards. ■ Ensuring that the actions taken by the compensation committee are accurately documented and reported to the board of directors in a timely manner. ■ Establishing responsibility in one office for maintenance and retention of records documenting all grant approvals.
12	Will communicate with other departments	■ Instituted formal communication to all relevant personnel involved in the stock-based compensation process regarding the importance of the accounting and legal implications of stock-based compensation process. ■ Established processes and procedures to increase the level of communication between the compensation committee, senior management, and financial reporting and accounting personnel regarding stock option grants. ■ Stock administrator updates the information contained in the "Equity Incentive Awards Year-to-Date Status for Fiscal Year" report, which is provided to the Compensation Committee members on a monthly basis.

Note: The wording above is adapted from various companies' public filings.