

COMPLIANCE WEEK

Lesson From The IBM Probe: Go Forward, But Carefully

By Melissa Klein Aguilar — July 6, 2005




The early adoption of a new accounting standard that requires stock options to be expensed should have earned IBM a thumbs-up for making its numbers more transparent. Instead, the Armonk, N.Y.-based computer giant is facing an informal investigation by the Securities and Exchange Commission.

The probe, revealed last week, appears to focus on whether the company misled investors about the impact of stock option expensing on its earnings.

In a statement issued last week, IBM said the SEC's informal investigation concerns IBM's disclosures relating to its first quarter earnings and expensing of equity compensation. The company, which is complying with the probe, noted, "The SEC has informed IBM that the informal investigation is not an indication that any violations of law have occurred."

Though the company would not provide Compliance Week with details on the SEC investigation, press reports have focused on the gap between guidance the company provided on the impact of options expensing, and the actual impact the company reported shortly thereafter.

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Big Blue's Red Herring

In an April 5 press release, IBM announced that it would begin treating stock options as an expense in its results when it reported its first quarter 2005 results, well ahead of the deadline for doing so under the Financial Accounting Standards Board's new expensing rule, known as FAS 123(R), "Share-Based Payment."

In a conference call with analysts that day, reports say IBM suggested that the impact of the options expense would be \$0.14 per share. As a result, analysts who track the company lowered their forecasts.

The options expense disclosure raised eyebrows days later, when IBM released less-than-stellar first-quarter results. The company reported 84 cents per share for the quarter, well below the 90 cents per share expected in analysts' revised forecasts. The stock options charge was just 10 cents per share, causing analysts to assert that they were misled to believe the options expense charge would be higher, and raising questions about whether Big Blue had used the options expensing disclosure to offset the shortfall.



Abrams

"My impression is that the issue is one of timing and making a premature announcement," said Daniel Abrams, managing partner of FAS123 Solutions. "Obviously factors other than option expensing contributed to IBM's earnings falling short of expectations."

But according to Abrams, the timing issue may have been a red flag for the SEC, combined with low option expense estimates. "SEC scrutiny was raised by the timing of the expensing announcement relative to a generally disappointing earnings announcement and the fact that the estimated options-based expense was materially below the actual options-based expense," he said. "In reality the option expensing issue is a red herring with respect to IBM's earnings shortfall."

Abrams adds that the probe was probably the result of inadvertent—yet entirely avoidable—disclosure gaffes. "It's hard to believe that it was an intentional diversionary tactic," he said. "It might have been simply a question of bad timing and a poor estimate." Abrams believes the situation could have been sidestepped with more clear and careful disclosure. "In retrospect," he said, "they would have avoided the controversy by announcing their intention to expense options earlier and qualifying any estimate as very preliminary."

But Scott Harshbarger—a former Massachusetts Attorney General who now practices at Boston's Murphy, Hesse, Toomey & Lehane—warns that appearances are everything when it comes to disclosure. "The problem is that it looks like they were doing it for the wrong reasons," Harshbarger told Compliance Week. "This should have been a nice kudos: IBM decided to adopt expensing early to get ahead of the curve. But then it looks like, a-ha, maybe that wasn't the reason they were doing it."



Harshbarger

To many, the IBM incident is symptomatic of quarterly pressures that companies feel to meet The Street's expectations, combined with the increased demands of new regulations and outspoken institutional investors. "The message here is to make those decisions on their own merits, not solely because they're demanded by outside world," Harshbarger said. "Companies ought to make decisions about stock option expensing based on whether they're good for business, whether it's good governance."

Benefit Of The Doubt

While observers doubt anything will come of the SEC probe, they say incident should serve as reminder to companies to use caution in making such disclosures.



Wisniewski

"This is the first time they're disclosing their option expense and these are very difficult calculations," said David Wisniewski of Chamberlain Hrdlicka in Atlanta. Wisniewski, like many others, said he gives IBM the benefit of the doubt. "IBM is such a solid company—I'd be surprised if they had taken advantage of the safe harbor improperly."

However, Wisniewski warned, "If companies voluntarily provide earnings guidance, they have to make sure they comply with the safe harbor for forward-looking statements. They need to have a reasonable basis for the numbers, and they could potentially be liable for misleading statements. A statement can be misleading by being too conservative."

He added that companies "would be well-advised to settle on method for calculating that expense before you give that guidance."

Abrams at FAS123 Solutions agrees with Wisniewski. "It's likely that [IBM] had not computed the final fair value estimate when they ball-parked it," he said. "That was an unfortunate mistake." As a result, Abrams agrees that companies must be careful before providing details on expensing numbers or impact statements "Companies should take care to perform a proper valuation before going public with an estimate of grant date fair value," he said. "Before companies give a number, they should be sure it's pretty close."

"The takeaway on this is that getting the disclosure right is a difficult thing," said Gordon Kaiser, a partner at Squire, Sanders & Dempsey. "IBM was trying to be a good guy. They made the decision to expense early. They made a public disclosure about it right away and it still doesn't get the right reaction."



Kaiser

Still, says Kaiser, the IBM incident shouldn't be construed as a deterrent to expensing early or making relevant disclosures that the market might find helpful. "This shouldn't scare people away," he said. However, adds Kaiser, companies must realize that, "They're going to be looked at by the market and by regulators. [IBM's situation] highlights that."

Don't Play Games

Joel Jameson, president of Cupertino, Calif.-based Silicon Economics, agrees with Abrams and others that IBM could have provided more data to help analysts understand the true meaning of its numbers. "IBM should've come out with a clearer picture at the time," he said. "There's more going on than option expensing—they should've come out with an unbiased portrayal of what was going on at the company."

Jameson noted that the SEC probe "instills a concern to companies about how they announce expensing." That's partially because the disclosures are relatively new to the market. "Expensing is new," he said. "There's uncertainty about how to do it." Jameson adds that the Commission should work to help companies meet their disclosure expectations. "The SEC needs to give guidance on how companies should handle the issue of announcing expensing options," he said.

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Wirtshafter

John Wirtshafter at McDonald Hopkins in Cleveland agrees that companies shouldn't "read too much into the SEC's informal investigation for purposes of deciding whether adopt the new rules early."

"The lesson is not don't adopt early," said Wirtshafter. "What other companies need think about, is, if they're going to disclose information about the impact of expensing, they need to be careful to not be misleading, not to play games."

According to Wirtshafter, transparency should be a key goal when it comes to disclosure of stock option expensing information. "The SEC will be looking at these things in hindsight and at what was said in hindsight," he said. "The lesson is, be careful about how you disclose the information and try to be as truthful and transparent as possible. It's the same lesson we've been learning from the SEC over and over."

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