

American Federation of Labor and Congress of Industrial Organizations



815 Sixteenth Street, N.W.
Washington, D.C. 20006
(202) 637-5000
www.aflcio.org

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August 23, 2007

Mr. James H. Quigley, Chief Executive Officer
Deloitte & Touche LLP
1633 Broadway
New York, New York 10019-6754

Dear Mr. Quigley:

Thank you for meeting with us to discuss the manipulation of stock option grants and the role of independent auditors in preventing and detecting these abusive practices. The meetings helped us develop a better understanding of the need for reforms in the auditing process to give accountants the right tools to protect shareholders against the backdating and spring-loading of stock option grants.

As investors, we care about the improper timing of stock option grants by corporate executives because this malfeasance threatens the retirement security of America's working families, including union members who participate in pension and retirement plans with more than \$5 trillion in assets.

Backdating of stock options involves looking back for low points of the company's stock price, and then pretending the options were granted at those favorable dates, enabling executives to profit handsomely from any subsequent run-up in the stock price.

Spring-loading is the practice of granting stock options just ahead of good news expected to lift the company's stock price, or just after the announcement of bad news that lowered the company's share price, and therefore the exercise price. Companies may also delay announcements of good news until just after stock options are granted to ensure built-in profits for the recipients.

We are especially concerned because stock option abuses appear to have been endemic at U.S. corporations, touching some of the nation's largest companies such as UnitedHealth Group, Home Depot and Apple.

Academic research, most notably by two finance professors, Erik Lee at the Henry B. Tippie College of Business at the University of Iowa, and Randall Heron at the Kelley School of Business at Indiana University, suggests that as many as 2,200 U.S.

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companies may have manipulated the timing of stock-option grants to executives between 1996 and 2005.¹

Two studies by Lucian Bebchuk, the director of Harvard University's Program on Corporate Governance, further reveal the scope of this fraud and abuse. In "Lucky Directors," Bebchuk found that 9 percent of director option grants fell on days with a stock price equal to a monthly low during the years 1996-2005. In "Lucky CEOs," he concluded that 12 percent of firms provided one or more lucky grants to chief executives due to opportunistic timing during the same period.

These studies lead us to believe that hundreds or even thousands of companies could be implicated beyond the 140 being investigated by the U.S. Securities and Exchange Commission, the Internal Revenue Service and the U.S. Justice Department.²

Our meetings helped us reach a common understanding of the problem. In particular, we learned that no accounting firm had comprehensively addressed the backdating and spring-loading of stock options until *The Wall Street Journal's* exposé last year which prompted the biggest investigation by federal regulators of corporate wrongdoing since the probe into improper mutual-fund trading.

The meetings also helped to dispel any doubts about the illegality of the backdating and spring-loading of stock options. Our discussions included the two recent decisions by the Delaware Chancery Court, which definitively held that the timing of stock option grants, without the consent of shareholders, violates Delaware corporate law.³

We believe the Court's holding effectively invalidates the guidance given on spring-loading by the SEC in its September 19, 2006, letter to the Financial Executives International and the American Institute of Certified Public Accountants.

The meetings also helped us recognize that in order to properly deal with the manipulation of stock option grants, independent auditors need far broader access to senior management and the board of directors than they have typically been granted. Our independent review of problems with stock option grants concluded that backdating and spring-loading occurred because they are transactions without a counterparty, in which senior management and the board of directors transact with each other.

¹ Bloomberg News, July 15, 2006

² Testimony by John W. White, SEC director of corporation finance, before the Senate Permanent Subcommittee on Investigations on June 5, 2007.

³ In *Re Tyson Foods Inc.*, No. 1106-N, 2007 Del. Ch. LEXIS 19, and *Ryan v. Gifford*, No. 2213-N, 2007 Del. Ch. LEXIS 22.

I. Why Auditors Should Be Concerned About Stock Option Backdating

Shareholders are not a party to those transactions, although they are directly affected by them. Nor do they have access to examine these transactions in a timely manner. Instead, shareholders count on independent auditors to safeguard the value of their investments in companies through the early detection and disclosure of problems with stock option grants. Investors must be informed when either backdating or spring-loading has occurred because this detection and reporting is indicative of the strength of the company's corporate governance. Investors rely on auditing firms to ensure that these disclosures are made in corporate financial statements.

II. Independent Auditors Are Key to Ensuring Disclosure of Misconduct

As a result of our discussions, we have outlined various steps we believe will help you be more effective.

1. Auditors are required to detect material misstatements caused by fraud: "The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by fraud or error."⁴
2. We expect auditing firms to ensure compliance with the guidance issued by the SEC and the Public Company Accounting Oversight Board (PCAOB) on the matter. We also expect compliance with existing SEC and PCAOB standards governing the detection of fraud in financial statement audits.

As part of the new executive compensation disclosure rules approved in late 2006, the SEC requires that companies disclose in their proxy statements the value of stock option grants and how they chose grant dates. In a statement explaining the new requirements, the SEC said that companies must say whether any option awards are timed "in coordination with the release of material non-public information" and why exercise prices don't match the underlying stock price on the grant date.

In its October 17, 2006, guidance on stock options, the PCAOB asked auditors to obtain an understanding of the process used by companies to estimate the fair value of stock option grants and to "assess the risk of misstatements related to the fair value of employee share options."

⁴ 1. AU Section 316.11, Consideration of Fraud in a Financial Statement Audit.

III. Prevent Malfeasance of Stock Option Grants

We also recommend the following steps to act as a check to prevent inaccurate financial statements as a result of future manipulation by corporate executives and directors.

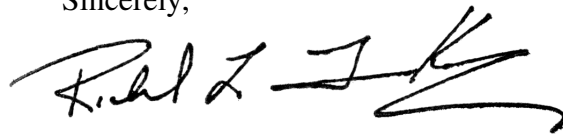
1. Obtain an understanding of the process used by the board of directors in granting equity awards, including options, as well as the internal controls over that process. This should include direct inquiries of members of the board who are responsible for oversight of this process including the chair of the compensation committee, and responsible members of management including the chief executive officer, chief financial officer and vice president of human resources.
2. Confirm the dates of stock option grants with the board of directors' compensation committee and that the grants in question were actually approved by the compensation committee if so required.
3. Examine the legal documents authorizing the equity award grants including the plan documents and minutes of the full board or the compensation committee. Auditors should gain an understanding of the terms and conditions of plans and the policies under which options are granted, including grants of stock options at prices other than the fair value of the stock.
4. Review SEC filings of stock option grants to key executives and members of the board to examine discrepancies against reporting deadlines—within 45 days before the enactment of the Sarbanes-Oxley Act and within 48 hours after August 29, 2002.
 - a. Monitor the status and results of any federal, state or internal investigations relating to the timing of options grants.
 - b. Obtain all publicly available information from outside sources, including investment research and reports by corporate governance analysts, regarding the timing of options grants by the company.
 - c. Review the key assumptions the company used in valuing grants of options, including, but not limited to, the assumptions regarding volatility, vesting periods, expiration date and rates of forfeiture. The assumptions should be consistent with historical data. If they are inconsistent with historical data, ask the company for an explanation.
 - d. Examine the timing of grants to see if they are, or were in previous years, on consistently scheduled dates. If the dates on which options were granted varied significantly, the auditor should then determine if those dates coincided with the low stock price for the quarter or the year, were before announcements that resulted in a significant increase in the stock price, or

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- were just after announcements that resulted in a steep decline in the company's stock price. If those situations for potential fraud exist, auditors must exercise "professional skepticism" as called for under PCAOB auditing standards, and determine if the company engaged in backdating or spring-loading. If the timing of grants was manipulated, auditors should determine if the company properly expensed the grants.
- e. Report errors or fraud to the SEC in a Section 10-A letter as required by the Securities Exchange Act of 1934.
 - f. Evaluate the policies and procedures in place to prevent errors or fraud regarding stock option grants as part of the internal controls review required by Section 404 of the Sarbanes-Oxley Act.
 - g. Exercise a heightened degree of attention to stock option grant practices if a company exhibits any of the following risk factors:
 - i. An inordinately large grant of stock options relative to an employee's total compensation, especially to the CEO or senior executives.
 - ii. The grant dates of stock options vary, especially if the grant dates were recommended or chosen by the CEO or executives themselves.
 - iii. Grants were made on dates preceding significant increase in the stock price or immediately following a significant stock price decline.
 - iv. Grants were made during a "black out" period for trading in the stock.

We are certain you have already incorporated many of these recommendations into your audit procedures. We look forward to hearing from you about any other steps that your firm has taken to improve the examination of your clients' stock option grant practices. Please contact Daniel Pedrotty, Director of the AFL-CIO Office of Investment, or Damon Silvers, AFL-CIO Associate General Counsel, if we can provide you with any additional feedback or recommendations.

Sincerely,



Richard L. Trumka

RLT/ms
opeiu#2, afl-cio

cc: Nicholas Difazio, Deputy Managing Partner, Risk, Professional & Regulatory
Matters
William F. Ezzell, Partner, Government Relations